



# Pillar 3 Disclosures

## 31 December 2008



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## **1 Overview**

### **1.1 Background**

The European Union (“EU”) Capital Requirements Directive (“CRD” or “the Directive”) came into effect on 1 January 2007. It introduced consistent capital adequacy standards and an associated supervisory framework in the EU based on the Basel II Framework agreed by the G-10. Implementation of the Directive in the United Kingdom (“UK”) was by way of rules introduced by the Financial Services Authority (“the FSA<sup>1</sup>”).

The Basel II Framework is structured around three pillars: Pillar 1 (minimum capital requirements), Pillar 2 (supervisory review) and Pillar 3 (market discipline). The disclosure requirements of Pillar 3 are designed to promote market discipline by providing market participants with key information on firms’ risk exposures and risk management processes. Pillar 3 aims to complement the minimum capital requirements described under Pillar 1 and the supervisory review process of Pillar 2.

Bank of China (UK) Limited (“BOC UK” or “the Bank”) adopted the Standardised Approach to credit risk, the Basic Indicator Approach (“BIA”) to operational risk and the standard Position Risk Requirement (“PRR”) for market risk from 1 January 2008. BOC UK also became subject to Pillars 2 and 3 from that date.

### **1.2 Basis and Frequency of Disclosures**

The Pillar 3 disclosures have been prepared by the Bank in accordance with the requirements of Pillar 3 as set out in Chapter 11 of BIPRU.

Unless otherwise stated, all figures are as at 31 December 2008, which is the Bank’s financial period-end.

Future disclosures will be issued on an annual basis and published as soon as practicable after the publication of the Annual Report and Accounts.

### **1.3 Scope**

BOC UK is a bank offering retail, corporate, and trade finance services in the UK. BOC UK is a wholly owned subsidiary of Bank of China Limited (“BOC China”), located in Beijing, China. BOC UK is authorised and regulated by the FSA.

There are no differences between the basis of consolidation of the Bank for accounting and prudential purposes.

The Bank has established the following subsidiaries:

- China Visa Services Limited - a wholly owned, non-banking subsidiary in London, UK; and
- Bank of China (Suisse) S.A. (“BOCS”) – a wholly owned private banking subsidiary in Geneva, Switzerland. In December 2008 BOCS acquired a 70% holding in an established fund management company. The acquired company’s name was changed to BOC (Suisse) Fund Management S.A. Both of these entities are regulated by the Swiss Financial Market Supervisory Authority.

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<sup>1</sup> FSA Handbook – General Prudential sourcebook (“GENPRU”), and Prudential sourcebook for Banks, Building Societies and Investment Firms (“BIPRU”).

For accounting purposes, the Bank has availed itself of the exemption available under IAS27 “Consolidated and Separate Financial Statements” that permits an entity to prepare separate financial statements (refer to note 2 of BOC UK’s Annual Report and Accounts for the period ended 31 December 2008) and therefore has not consolidated these subsidiaries.

For prudential purposes, the Bank calculates and maintains regulatory capital based on its own financial position and results. There is no material difference between the amount of capital determined by and available to support the Bank’s own activities, and the amount which would be determined if the aforementioned subsidiaries were included.

The Bank does not foresee any material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities among the parent undertaking and its subsidiaries.

#### **1.4 Location and Verification**

These disclosures have been reviewed by the Bank’s Audit Committee and approved by the Board of Directors (“the Board”), and are available at the Bank’s registered office at 90 Cannon Street, London EC4N 6HA UK and on the Bank’s website [www.bocukltd.co.uk](http://www.bocukltd.co.uk)

The disclosures have not been subjected to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Bank’s Annual Report and Accounts.

## **2 Risk Management Objectives and Policies**

### **2.1 Strategies and Risk Management Processes – Risk Appetite**

Risk appetite is a top-down articulation of the quantum of risk that the Board of the Bank is prepared to accept in relation to the Bank's business strategy. The Bank's risk appetite is very conservative and in line with the approach deemed appropriate by the Bank's shareholders and the Board. This is then communicated by the Bank's executive management to the various business divisions through the implementation of the Bank's strategic plans.

The Bank's conservative approach is reflected in the targeting of investment grade counterparties and the avoidance of high leverage, development, structured or project finance lending businesses.

### **2.2 Oversight and Governance**

The objective of the Bank's risk management governance structure is to ensure that various risks are adequately managed and controlled within the thresholds of the Bank's risk appetite. The Bank has in place a clear hierarchical risk management organisational structure as well as a comprehensive set of policies and procedures to identify, measure, monitor and control the various risks across the Bank. These risk management policies and procedures are regularly reviewed and updated to reflect changes in markets and the Bank's business strategies.

The Board, representing the interests of the Bank's shareholders, has the ultimate responsibility for risk management and the setting of the Bank's risk appetite. The Board, with the assistance of the various committees, has the primary responsibility for setting the Bank's risk management strategies and to ensure that effective risk management infrastructure is in place to support these strategies.

The Bank's Chief Executive Officer ("CEO"), who reports to the Board, is responsible for the implementation of the policies and procedures and various risk limits in accordance with the risk management strategies and risk appetite set by the Board. The CEO is also responsible for overseeing the operating effectiveness of the processes and controls over the management and monitoring of risks in the day-to-day operations of the Bank.

### **2.3 Risk Management Objectives and Policies**

The Bank has adopted a "Three Lines of Defence" model in its risk management framework. Primary responsibility for the identification, management, monitoring and mitigation of risks lies with the respective business divisions. The management teams of these business divisions are the Bank's first line of defence.

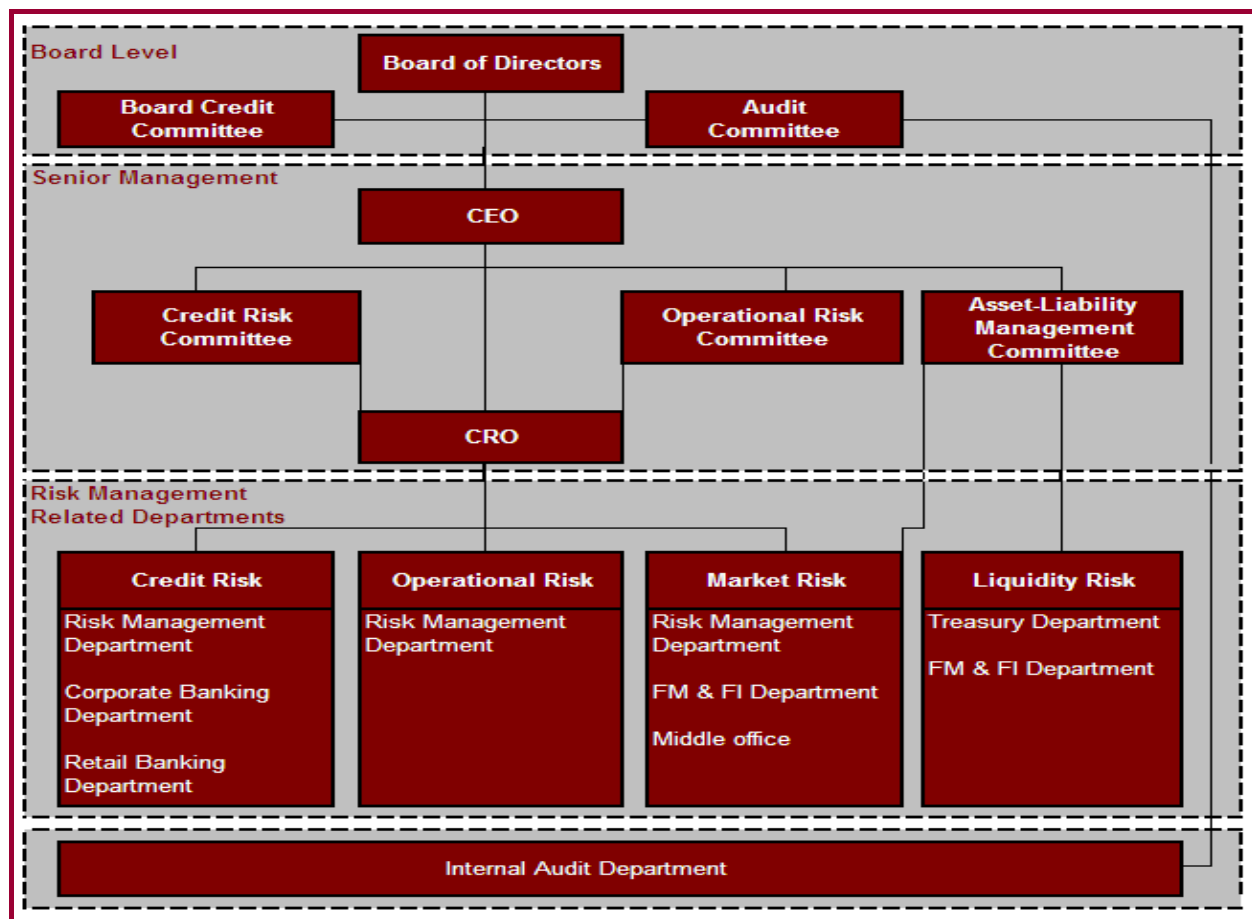
The Bank's second line of defence is provided through the Compliance function and the following functions and committees, which are responsible for the Bank's risk governance and oversight:

- Specialist risk support functions (i.e. Credit Risk Management, Operational Risk Management, Market Risk Management and Liquidity Risk Management functions);
- Dedicated Risk Committees (i.e. the Credit Risk Committee, the Operational Risk Committee and the Asset-Liability Management Committee);
- Executive Management Committee ("EMC"); and
- Board Credit Committee ("BCC").

Finally, independent assurance, which is the Bank's third line of defence, is provided by the Bank's Internal Audit Department and the Bank's Audit Committee.

## 2.4 Risk Management Governance Structure

The composition of the Bank's risk management governance structure is made up of several functions, committees and the Chief Risk Officer ("CRO"). An illustration of the various reporting lines up to the Board and the description of key roles and responsibilities are outlined below:



- **Audit Committee** - performs an oversight role over internal controls, risk management, financial reporting issues and external auditor liaison.
- **Board Credit Committee ("BCC")** – approves all non-standard credits, and assists the Board of the Bank with the establishment and ongoing review of the Bank's credit policy statement and approval of delegated authorities over limits.
- **Asset-Liabilities Management Committee ("ALCO")** - establishes and maintains asset and liability management policies and procedures, including the review and approval of policies relating to market risk and liquidity risk management.
- **Business Development Committee** - reviews and monitors the Bank's performance against its business plans and budgets and, formulates corrective action on major variances. It is also responsible for the initiation and review of market research on new products and services.

- **Credit Risk Committee (“CRC”)** - review and management of the Bank’s credit risk, authorisation of new facilities within its authorised approval limits, review and approval of pricing decisions, credit policies and procedures.
- **Operational Risk Committee (“ORC”)** - review and management of the Bank’s operational risk; legal risk and reputational risk. It is also responsible for maintenance of the Bank’s operational risk monitoring framework and operational risk compliance.
- **Compliance Committee** - review and management of the Bank’s compliance with UK laws and regulations by means of an effective compliance programme, best-practice control standards, and the implementation of compliance-focused elements in the Bank’s policies, procedures and guidelines.
- **Chief Risk Officer (“CRO”)** – with direct reporting line to the Bank’s CEO, is responsible for the monitoring and control of credit, market and operational risks. The CRO is also responsible for providing recommendations to the policies and procedures over the management of those risks.
- **Risk Management Related Teams** – comprising Credit Risk Management, Operational Risk Management, Market Risk Management and Liquidity Risk Management. These teams are responsible for the day-to-day management of the various risk exposures.

The structure described above is applied to all types of risks which may have a significant negative impact on the Bank’s performance if they were to materialise. Such material risks represent the Bank’s “Risk Profile” and are reviewed and reassessed at least annually as part of the Bank’s Internal Capital Adequacy Assessment Process (“ICAAP”) (see section 4.2 of this document). Based on the Board’s assessment, the Bank’s significant risk exposures are to credit risk, market risk, liquidity risk, and operational risk.

Key Risks	First Line	Second Line Oversight	Second Line Governance
	Risk Management	Risk Oversight (RMD <sup>2</sup> )	Risk Governance
<b>Credit Risk</b>			
Retail credit risk	Retail banking branches	Retail credit risk team	CRC & BCC
Corporate credit risk	Corporate banking	Corporate credit risk team	CRC & BCC
Markets counterparty credit risk	FM & FI <sup>3</sup>	Treasury middle office	CRC & BCC
<b>Market Risk</b>	Treasury department	Middle office	ALCO
<b>Operational Risk</b>	All business areas	Operational risk unit	ORC
<b>Liquidity Risk</b>	FM & FI <sup>3</sup>	Treasury department	ALCO

In addition to the above, the Bank is also exposed to other types of risks noted as follows:

<sup>2</sup> Risk Management Department (“RMD”)

<sup>3</sup> Financial Markets (“FM”) & Financial Institutions (“FI”)

**Pension risk**

Pension risk arises from an underfunded defined benefit pension plan. All retired employees and some of the existing employees of the Bank are on a defined benefit pension plan, which means that the Bank promises to pay a specific defined benefit to employees following their retirement. The Bank bears the risk of pension investment risk because it has promised the payment of a fixed benefit and therefore must make up for any investment losses.

**Liquidity risk**

Liquidity risk is the risk that the Bank is unable to meet its obligations as they fall due. The Bank manages its liquidity risk by:

- Maintaining strong capital ratios and credit quality;
- Maintaining a stable source of funding;
- Monitoring the timing and magnitude of cash flow mismatches;
- Monitoring the liquidity risk of contingent liabilities, and
- Holding an appropriate level of marketable assets.

**Concentration risk**

Concentration risk is the risk arising from not having a well diversified portfolio. The Bank regularly reviews the concentration risks by geographical locations, industry sector and individual counterparty credit concentration within its corporate lending, retail lending and bond portfolios.

### 3 Capital Resources

#### 3.1 Total Available Capital

As at 31 December 2008 and throughout the year, the Bank has complied with the capital requirements that were in force as set out by the FSA. The following table shows the breakdown of the Bank's total available capital as at 31 December 2008:

<b>Total available capital</b>	<b>31 December 2008</b>
	<b>£'000</b>
<hr/>	
<b>Tier 1 Capital</b>	
Share Capital	140,000
Profit and loss account and other reserves	3,259
<hr/>	
<b>Tier 2 Capital</b>	
Collective allowance for impairment	24
Subordinated debt	60,000
Less: Investments in subsidiaries	(32,128)
<hr/>	
<b>Total Tier 1 and 2 capital after deductions</b>	<b>171,155</b>

#### 3.2 Tier 1 Capital

The Bank's Tier 1 capital includes ordinary share capital and profit and loss reserves. The profit and loss reserves represent the Bank's audited accumulated accounting profits.

The Bank currently has no innovative Tier 1 instruments.

#### 3.3 Tier 2 Capital

The Bank's Tier 2 capital includes qualifying subordinated debt and collective impairment allowances.

The subordinated debt is issued on terms which qualify for inclusion in the Bank's capital resources. Information on the terms of the subordinated debt is included in note 30 of the Bank's Annual Report and Accounts for the period ended 31 December 2008.

Deductions from capital relate to the carrying amounts of investments in subsidiaries that are not included in the prudential consolidation.

#### 3.4 Tier 3 Capital

The Bank currently has no Tier 3 capital.

It is the Bank's policy to maintain a strong capital base so as to maintain creditor and market confidence and to sustain and support future business developments. The impact of the level of capital on shareholders' return is also recognised and the Bank acknowledges the need to maintain a balance between the higher returns that may be possible with greater gearing and the advantages and security afforded by a sound capital position.

## 4 Capital Adequacy

### 4.1 Capital Management

The Bank has adopted the Standardised Approach to credit risk, the BIA to operational risk and the standard PRR rules for market risk since 1 January 2008 to determine its Basel II Pillar 1 minimum capital requirements.

Overall responsibility for capital management resides with the Board of the Bank. The responsibility for exercising oversight has been delegated to the CEO, who in turn has delegated responsibility for the management, review and escalation to ALCO and to the Chief Financial Officer (“CFO”).

The capital planning and management framework is in place to facilitate a top-down approach to the management of the Bank’s capital supply and capital usage. A forward looking capital planning process is conducted via a detailed planning of business and risk forecasts, stress and business scenarios and management actions to determine the impact of potential economic scenarios. This enables the Bank to manage its capital requirements, both current and projected (using base and stressed cases), by forecasting capital adequacy ratios and updating them in line with the business performance and any changes in the business environment. In this way, the Bank aims to ensure that it has sufficient capital even in reasonably severe stressed market events.

The Bank’s regulatory capital requirements are reported quarterly to the Board.

### 4.2 Internal Capital Adequacy Assessment Process (“ICAAP”)

The Bank undertakes the ICAAP, which is an internal assessment of the Bank’s risk profile and its capital needs on an annual basis or more frequently should the need arise. This internal assessment makes use of the Bank’s regulatory capital calculator and the economic capital model.

The outcome of the ICAAP is presented in an Internal Capital Assessment (“ICA”) document. The Bank’s ICA includes an analysis of the Bank’s material risk exposures in the determination of the capital requirement over a three-year horizon, including the impact of stressed scenarios to satisfy the regulatory requirements. The FSA, under its supervisory approach, sets Individual Capital Guidance (“ICG”) for the Bank. The Bank submitted its ICA document to the FSA in October 2008 and the ICG was agreed with the FSA in March 2009.

### 4.3 Pillar 1 Minimum Capital Requirement and Capital Adequacy

The Bank’s Pillar I minimum capital requirements (covering credit risk, market risk and operational risk) and its capital adequacy position as at 31 December 2008 is set out in the table below:

<b>Pillar I minimum capital requirements</b>	<b>31 December 2008</b>
	<b>£’000</b>
Credit Risk (Standardised Approach)	64,190
Market Risk (Foreign Exchange PRR)	670
Operational Risk (Basic Indicator Approach)	2,891
<b>Total minimum capital requirement</b>	<b>67,751</b>
<b>Total capital resources</b>	<b>171,155</b>
<b>Excess of capital resources over minimum capital requirement</b>	<b>103,404</b>

## Credit risk

The Bank's minimum capital requirement (expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes) relating to credit risk broken down by exposures classes under the Standardised Approach is set out in the table below:

<b>Breakdown by exposures classes under the Standardised Approach</b>	<b>As at 31 December 2008</b>	
	<b>Risk Weighted Asset £'000</b>	<b>Capital Requirement £'000</b>
Central governments or central banks	1,947	156
Institutions	92,994	7,440
Corporates	643,620	51,490
Retail	16,090	1,287
Secured on real estate property	389	31
Past due items	557	45
Securitisation positions <sup>4</sup>	13,915	1,113
Short term claims on institutions and corporates	14,175	1,134
Other items	18,685	1,494
<b>Total</b>	<b>802,372</b>	<b>64,190</b>

## Market risk

The market risk requirement is calculated using the standard PRR rules. The only market risk requirement is the foreign exchange PRR, which amounts to £670k. Please refer to section 6 for a full analysis of market risk.

## Operational risk

The operational risk requirement is calculated on a BIA approach, which amounts to £2,890k. Please refer to section 7 for a full analysis of operational risk.

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<sup>4</sup> The Bank has applied BIPRU 9 for its securitisation positions

## 5 Credit Risk Measurement, Mitigation and Reporting

### 5.1 Credit Risk Overview

#### Introduction

Credit risk is defined as the risk that a borrower or counterparty fails to pay the interest or to repay the capital on a loan. Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent across most of the Bank's activities. Adverse changes in the credit quality of borrowers or a general deterioration in economic conditions could affect the recoverability and value of the Bank's assets and therefore its financial performance. Comprehensive risk management methods and processes have been established as part of its overall risk governance framework to measure, mitigate and manage credit risk in accordance with the Bank's risk appetite.

The Credit Risk Management team, under the supervision of the CRO, provides a centralised management of credit risk within the Bank. Credit policies and procedures are formulated by RMD and are approved by the CRC, EMC and the Board. Such policies include the setting of relevant controls over the maximum level of the Bank's exposure to customers and customer groups and other risk concentrations in selected market sectors, industries and products. These credit policies and procedures are regularly updated and serve as guidance to the respective business divisions as to the on-going risk appetite of the Bank.

#### Risk Management and Controls

The Bank conforms to the BOC China's practice of independent assessment of credit risk. There are three levels in the Bank's credit risk control process.

The **first level** is the initial credit assessment process, where credit reports / business proposals are prepared by the relevant business divisions

These credit reports / business proposals are submitted to the respective Risk Management team within RMD for the **second level review**. RMD performs a due diligence on the credit reports / business proposals submitted by the respective business divisions. The results of RMD's due diligence process, together with the original credit reports / business proposals, are forwarded either to the CRO or are presented for discussion (depending on the materiality of the business proposal and the related credit risk exposures) in the open forum of the CRC meeting.

Thereafter, the **third level review** is applied where recommendations by the CRC and the CRO are presented to the ultimate sanctioning authority (i.e. the CEO and / or the Board) for approval and sign off.

### 5.2 Credit Risk Exposures

The Bank's credit risk appetite is conservative and is in line with the approach deemed appropriate by the Bank's shareholders and the Board.

Further details of the Bank's credit risk exposures arising from its retail and corporate business and its treasury activities are outlined in sections 5.4, 5.5 and 5.6 of this document.

The Bank's gross credit risk exposure (based on the definitions for regulatory capital purposes, i.e. before credit risk mitigation) and the average of the quarterly amounts for the year are summarised as follows:

<b>Breakdown Under the Standardised Approach By Exposure Classes</b> <b>? 00</b>	<b>Average</b> <b>2008</b>	<b>31 December</b> <b>2008</b>
Central governments or central banks	19,522	9,689
Institutions	332,198	315,121
Corporates	663,570	705,106
Retail	34,380	31,115
Secured on real estate property	4,471	455
Past due items	403	420
Securitisation positions	77,806	69,573
Short term claims on institutions and corporates	67,632	33,998
Other items	11,390	19,530
<b>Grand Total</b>	<b>1,211,372</b>	<b>1,185,007</b>

The geographical distribution of these exposures as at 31 December 2008 is as follows:

<b>Geographic Distribution By Exposure Classes</b> <b>? 00</b>	<b>UK</b>	<b>Other European Countries</b>	<b>North America</b>	<b>Rest of the World</b>	<b>Total</b>
Central governments or central banks				9,689	9,689
Institutions	84,045	72,355	115,682	43,039	315,121
Corporates	296,329	263,350	72,907	72,520	705,106
Retail	29,380	125		1,610	31,115
Secured on real estate property	455				455
Past due items	419			1	420
Securitisation positions	23,537	40,947		5,089	69,573
Short term claims on institutions and corporates	26,279			7,719	33,998
Other items	19,530				19,530
<b>Grand Total</b>	<b>479,974</b>	<b>376,777</b>	<b>188,589</b>	<b>139,667</b>	<b>1,185,007</b>

The following table shows the residual maturity of the exposures as at 31 December 2008:

<b>Residual Maturity By Exposure Classes</b> <b>? 00</b>	<b>Up to 12 months</b>	<b>1-5 years</b>	<b>More than 5 years</b>	<b>Total</b>
Central governments or central banks		9,689		9,689
Institutions	6,867	160,049	148,205	315,121
Corporates	59,551	431,838	213,717	705,106
Retail		443	30,672	31,115
Secured on real estate property		97	358	455
Past due items		420		420
Securitisation positions			69,573	69,573
Short term claims on institutions and corporates	33,998			33,998
Other items		19,530		19,530
<b>Grand Total</b>	<b>100,416</b>	<b>622,066</b>	<b>462,525</b>	<b>1,185,007</b>

The following table provides an analysis of credit exposure by industry sector as at 31 December 2008:

<b>Exposure Classes</b>	<b>Industry</b>	<b>Gross Exposure £'000</b>
<b>Central governments or central banks</b>	Business and other services	12
	Transport	9,677
<b>Institutions</b>	Financial	315,121
<b>Corporates</b>	Business and other services	130,151
	Construction	25,807
	Energy and water supply industries	110,806
	Other	51,181
	Garages, distribution, hotels and catering	46,742
	Manufacturing industry	281,764
	Postal services & telecommunication	51,846
	Transport	6,809
<b>Retail</b>	Business and other services	188
	Garages, distribution, hotels and catering	1,968
	Persons	28,923
	Transport	36
<b>Secured on real estate property</b>	Business and other services	44
	Financial	97
	Garages, distribution, hotels and catering	264
	Transport	50
<b>Past due items</b>	Business and other services	1
	Garages, distribution, hotels and catering	254
	Persons	20
	Transport	145
<b>Securitisation positions</b>	Financial	69,573
<b>Short term claims on institutions and corporates</b>	Energy and water supply industries	5,474
	Financial	21,358
	Garages, distribution, hotels and catering	7,054
	Manufacturing industry	112
<b>Other items</b>	Business and other services	19,530
<b>Grand Total</b>		<b>1,185,007</b>

### 5.3 Impairment Provisions

The Bank assesses whether, as a result of one or more events that occurred after initial recognition, there is objective evidence that a financial asset or group of financial assets are impaired.

In general, evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficulty, default or delinquency in interest or principal payments, covenant breach or the debt being restructured to reduce the burden on the borrower. The respective branch managers are responsible for the identification of such borrowers within the retail banking business. The Corporate Banking Department is responsible for the identification of such borrowers within the corporate banking business. All potential impairments are risk assessed by appropriate departments for recovery action, reclassification and provisioning. Such assessments are evaluated and authorised by RMD.

If there is objective evidence that an impairment loss has incurred, the amount of the loss is measured as the difference between the carrying amount of the asset and the present value of estimated future cash flows discounted at the asset's original effective interest rate for loans and advances and market value for debt securities.

Further details of the approaches to impairment reviews and provision methodologies for the assets accounted for at amortised cost and the available-for-sale financial assets are outlined below.

The following table shows the past due and provisions for impaired exposures and charges to the income statement for the period ended 31 December 2008.

For the purpose of this table, past due is defined as a minimum of one month.

Impairment and Past Due Exposures £'000	Rest of the world			UK		
	Impaired	Provision <sup>5</sup>	Past due	Impaired	Provision <sup>5</sup>	Past due
Business and other services	-	-	-	(1)	25	-
Financial	(14,403)	7,305	-	(4,811)	1,660	-
Garages, distribution, hotels and catering	-	-	-	(326)	325	(24)
Persons	(2)	1	(1)	(126)	67	(34)
Transport	-	-	-	(3)	3	(201)
<b>Grand Total</b>	<b>(14,405)</b>	<b>7,306</b>	<b>(1)</b>	<b>(5,267)</b>	<b>2,080</b>	<b>(259)</b>

#### Assets accounted for at amortised cost

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the balance sheet carrying value of the asset and the present value of estimated future cash flows discounted at that asset's original effective interest rate.

<sup>5</sup> This is the Bank's first year of operations. Therefore, the provision amount will equate to those charged to the Bank's income statement.

For the Bank's lending portfolios, allowances are established on a case-by-case basis. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralised asset or group of assets reflects the cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

A loan or advance is normally written-off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery (as a result of the customer's insolvency, ceasing to trade or other reason) and the amount of the loss has been determined. Subsequent recoveries of amounts previously written-off decrease the amount of impairment losses recorded in the income statement.

#### **Available-for-sale financial assets**

For financial assets classified as available-for-sale a significant or prolonged decline in the fair value of the asset below its cost is considered to be objective evidence of impairment, when reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer and assessing the future cash flows expected to be realised.

If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is removed from equity and recognised in the income statement.

If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement.

However, impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

#### **Renegotiated loans**

Loans that are either subject to collective impairment assessment or individually significant and whose terms have been renegotiated are no longer considered to be past due but are treated as new loans. In subsequent years, the asset is considered to be past due and disclosed only if further renegotiated.

The Bank has not renegotiated loans during the course of the financial period ended 31 December 2008.

The following table summarises the movements in the Bank's impairment provisions during the financial period ended 31 December 2008:

(a) **Loans and advances to banks and customers**

£'000	Specific		Collective	
	Loans and advances to banks	Loans and advances to customers	Loans and advances to banks	Loans and advances to customers
Balance at 1 October 2007	-	-	-	-
Transfers	-	44	-	-
Charges	-	400	-	24
Recoveries	-	(3)	-	-
Write-offs	-	(63)	-	-
<b>Balance at 31 December 2008</b>	<b>-</b>	<b>378</b>	<b>-</b>	<b>24</b>

(b) **Available for sale financial investments**

£'000	Movement in fair value recognised in equity	Impairment
Balance at 1 October 2007	-	-
Charges	34,234	8,965
Allocated as impaired	(8,965)	-
Write-offs	-	-
<b>Balance at 31 December 2008</b>	<b>25,269</b>	<b>8,965</b>

#### 5.4 Retail Credit Risk

Retail lending activity is split between secured products (prime and specialist lending) and unsecured products (credit cards and temporary overdrafts).

Retail credit risks are managed in accordance with limits set out within the policy approved by CRC.

For residential mortgages, the Bank's lending policy criteria are used to make a decision on the respective mortgage applications. All mortgages are secured by way of a first legal charge against the property.

Ongoing monitoring of all retail credit portfolios is undertaken by the Retail Credit Risk function within RMD. In the event that particular exposures show adverse features such as arrears, a debt recovering team will be appointed to work with borrowers to resolve the situation.

## **5.5 Corporate Credit Risk**

The Bank's corporate lending activity is split between its syndication loan and bilateral lending business.

Corporate credit risks are managed in accordance with limits and asset quality measures stipulated in the policy approved by the CRC. The policy places limits on business volumes as well as by industry sector and country risk exposures.

Lending decisions are based upon independent credit risk analysis performed by the Corporate Credit Risk function within RMD, supplemented by the use of external models which assess the obligor's probability of default. The output of these models is a borrower grade which then maps to a long-run average, one-year probability of default. All borrowers are reviewed at least annually, allowing for the identification of adverse individual and sector trends.

## **5.6 Treasury Credit Risk**

Treasury credit risk arises from the management of the Bank's balance sheet (i.e., the hedging of banking book risks which gives rise to counterparty credit risk) and cash flows.

Treasury credit risks are managed in accordance with limits, asset quality measures and criteria set out within the policy approved by the CRC. The policy also sets out powers which require higher levels of authorisation depending on the size of the transaction and / or the nature of the associated risk.

The ongoing monitoring of the quality of assets is performed by the FM & FI Department and the RMD. Reports are sent on a monthly basis to senior management. Where necessary, exception reporting also takes place against a range of asset quality triggers including economic capital analysis.

## **5.7 Credit Quality Step ("CQS") Analysis**

In its assessment of credit risk under the Standardised Approach, the Bank uses ratings assigned by the FSA's recognised External Credit Assessment Institutions ("ECAIs"), e.g. Standard and Poor's ("S&P"), and Moody's Investors Service ("Moody's") for all its exposure classes. The Bank has not used any export credit agencies.

Where rating is not available, the Bank follows the provision of the BIPRU.

The following table shows the exposure values for each of the standardised credit risk exposure classes associated with each credit quality step prescribed in BIPRU 3 as at 31 December 2008:

	<b>Risk weight</b>	<b>Moody's ratings</b>	<b>S&amp;P ratings</b>	<b>Exposure values<sup>6</sup> £'000</b>
<b>CQS for Central Governments or Central Banks</b>				
2	20%	A1 to A3	A+ to A-	9,689
				9,689
<b>CQS for Institutions</b>				
1	20%	Aaa to Aa3	AAA to AA-	215,221
2	50%	A1 to A3	A+ to A-	56,393
3	50%	Ba1 to Ba3	BB+ to BB-	42,117
Unrated	50%	-	-	1,390
				315,121
<b>CQS for Corporates</b>				
1	20%	Aaa to Aa3	AAA to AA-	8,767
2	50%	A1 to A3	A+ to A-	109,283
3	100%	Ba1 to Ba3	BB+ to BB-	130,363
4	100%	Ba1 to Ba3	B+ to B-	39,060
5	150%	B1 to B3	B+ to B-	338
Unrated	100%	-	-	417,296
				705,106
<b>CQS for Securitisation positions</b>				
1	20%	Aaa to Aa3	AAA to AA-	69,573
				69,573
<b>Retail</b>				31,115
<b>Secured on real estate property</b>				455
<b>Past due items</b>				421
<b>Other items</b>				19,530
<b>Short term claims on institutions and corporates</b>				33,998
<b>Grand Total</b>				<b>1,185,007</b>

## 5.8 Credit Risk Mitigation

The Bank mitigates credit risk through the application of internal systems and controls. During the financial period ended 31 December 2008, the Bank has not used any credit risk mitigation techniques prescribed in the BIPRU. The Bank's internal systems and controls over the mitigation of credit risk in each business division are described below:

<sup>6</sup> Exposures value is the amount after applying credit conversion factors to off balance sheet exposures in accordance with the FSA regulatory rules. The Bank has not used any credit risk mitigation techniques during the financial period ended 31 December 2008.

## **Risk monitoring process**

The Bank uses a range of techniques to reduce the credit risk of its lending business. The most basic of these is performing an assessment of the ability of a borrower to service the proposed level of borrowing without distress. The Bank also has a risk monitoring process including daily, monthly and quarterly reports on Lending Portfolio by Customer, Quality of Credit Assets and Credit Portfolio Analysis. However, the risk can be further mitigated by obtaining security for the funds advanced.

## **Residential mortgages**

Residential property is the Bank's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolios. All mortgage lending activities are supported by an appropriate form of valuation using either an independent firm of valuers or indexed valuation.

All residential property must be insured to cover property risks, which may be through a third party.

## **Commercial mortgages and Buy-to-Let**

For property-based lending, supporting information such as professional valuations are an important tool to help determine the suitability of the property offered as security and, in the case of investment lending, generating the cash to cover interest and repay the advance. All valuations are undertaken by members of an internally approved panel of valuers.

All standard documentation is subject to independent legal review and sign-off in order to ensure that the Bank's legal documentation is robust and enforceable. Documentation for large advances is tailor-made, specifically prepared by independent solicitors.

## **Treasury**

Debt securities, treasury bills and other eligible bills are generally unsecured with the exception of asset-backed securities and similar instruments, which are secured by pools of financial assets.

The International Swaps and Derivatives Association ("ISDA") Master Agreement is the Bank's preferred method of documenting derivative activity.

## **5.9 Counterparty Credit Risk ("CCR")**

The Bank uses derivative instruments to hedge its exposure to market risk, for example, interest rate risk in the banking book and foreign exchange risk. Counterparty credit risk is the risk that a counterparty to a derivative instrument could default prior to the maturity of the contract. The counterparty credit risk for derivative and foreign exchange instruments is subject to credit limits on the same basis as the Bank's other credit exposures (see section 5.1 for further details).

The Bank measures its counterparty credit exposure using the CCR mark-to-market method, which is the sum of current exposure (i.e. replacement cost) and potential future exposure. The potential future exposure is an estimate based on factors such as the residual maturity of the contracts and the types of contract.

The Bank has not received nor provided collateral in respect of derivative contracts. Therefore, no collateral would need to be provided in the event of a downgrade in the Bank's credit rating.

The Bank may also take advantage of the netting benefits afforded under the ISDA Master Agreement so that risk can be mitigated by offsetting the amounts due to the same counterparties. However during the financial period ended 31 December 2008, the Bank has not applied any netting benefits.

## Counterparty credit risk exposures for derivative contracts as at 31 December 2008:

	<b>Total £'000</b>
Interest rate contracts	714
Foreign exchange contracts	4,840
<hr/>	
Gross positive fair value of contracts	5,554
Netting benefits	-
<hr/>	
Netted current credit exposure	5,554
Collateral held	-
<hr/>	
<b>Net derivatives credit exposure</b>	<b>5,554</b>

### 5.10 Securitisation

The Bank is only involved as an investor in Asset Backed Securities (“ABS”). The Bank is not involved in any other securitisation activities. Securitisations are defined as structures where the cash flow from an underlying pool of financial assets is used to secure at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures.

As at 31<sup>st</sup> December 2008, the Bank’s exposure to ABS is £69,573,000 and the related impairment provision to these positions amounted to £8,061,000.

The above ABS assets are classified as available-for-sale for accounting purposes. Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently measured at fair value, and changes therein are recognised in equity until the financial assets are either sold or impaired. When these assets are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement.

When there is objective evidence that an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is removed from equity and recognised in the income statement.

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through the income statement.

The types of ABS assets which the Bank has invested in are a combination of automobile receivables and mortgage-backed securities.

The Bank uses ratings assigned by S&P and Moody’s for purposes of the calculation of its credit risk capital requirement under BIPRU 9.

## 6 Market Risks

### 6.1 Market Risk Overview

The Bank's business model and its Trading Book Policy Statement mean that the Bank does not undertake any trading book activities. The Bank's market risk exposures relate mainly to its exposure to foreign exchange risk.

The Bank's Treasury Middle Office is responsible for the daily monitoring of the Bank's market risk. This department ensures that the overall and individual market risk positions are within the Bank's risk tolerance level.

### 6.2 Market Risk Control Procedures

The overall market risk limits are set by the Bank's EMC and allocated to the respective banking book. Any breaches of limits are reported and managed promptly by the related department, which then reports to the EMC with the causes of the breaches and solutions to those breaches.

### 6.3 Foreign Exchange Risk

A proportion of treasury funding and investment activity is undertaken in foreign currencies. Foreign currency exposure is hedged by using derivatives to reduce currency exposures to acceptable levels. The Bank has no substantial net exposure to foreign exchange risks. The Bank's foreign exchange positions as at 31 December 2008 are set out below:

<b>£'000</b>	<b>US Dollars</b>	<b>EURO</b>	<b>Other</b>	<b>YEN</b>	<b>CHF</b>
Total net exposure	(47)	(7,487)	(846)	83	93

### 6.4 Interest Rate Risk in Banking Book ("IRRBB")

Interest rate risk means the risk of losses to the Bank in terms of the Bank's earnings and economic value due to fluctuations in interest rates. According to the Bank's Trading Book Policy Statement, the Bank does not, at present, undertake any trading book activities. Therefore, at present the Bank is only exposed to interest rate risk in the banking book. The Bank's objective in the management of IRRBB is to decrease the sensitivity of the Bank's earnings and economic value exposure to interest rate fluctuations.

The sources of interest rate risk include re-pricing risk, yield curve risk, basis risk and embedded option risk. The Bank at the moment mainly utilises the interest rate sensitivity gap to analyse the re-pricing risk on a static basis from both the net interest income and economic value perspectives. Interest rate-sensitive liabilities in each time band are subtracted from the corresponding interest rate-sensitive assets to produce a re-pricing gap for that time band.

The Bank sets a limit for its 1 year cumulative gap ratio (i.e. cumulative gap divided by interest-bearing assets) for all currencies expressed in sterling. The limit ranges from -15% to +15%. The 1 year cumulative gap ratio as at 31 December 2008 is 5.46% which is within the defined limit.

The table below provides an analysis of the possible changes in the Bank's earnings and equity as a result of a 100bp parallel increase and decrease in interest rates:

<b>£'000</b>	<b>100bps parallel increase</b>	<b>100bps parallel decrease</b>
<b>Sensitivity of projected net interest income at</b>		
31 December 2008	(624)	624
<b>Sensitivity of reported equity to interest rate movements at</b>		
31 December 2008	10,552	(10,552)

### **IRRBB Management**

The ALCO, RMD, Treasury Department and relevant business divisions (i.e. the FM & FI Department) are involved in the management of interest rate risk in the banking book.

ALCO approves and reviews the banking book interest rate policy, the related methods of monitoring the risks and the interest rate risk limits. ALCO is also responsible for making the decision as to whether to adjust the Bank's interest rate risk appetite.

The Treasury Department is responsible for drafting the Bank's banking book interest rate risk policy and the related risk controlling methods. The Treasury Department is also responsible for advising RMD on the setting of and / or adjustment of the banking book interest rate risk limits, and the supervision and inspection of the implementation of the Bank's banking book interest rate risk management.

The FM & FI Department is responsible for maintaining the risk exposure of the Bank's marketable portfolios within defined limits.

RMD is responsible for reviewing and reporting to ALCO on the banking book interest rate limits and any necessary adjustments.

### **IRRBB Control and Monitoring**

In order to closely control the risk in the bond investment portfolio which contains the majority of the banking book interest rate risk, Value at Risk (VaR) exposure and PVBP exposure are calculated and reported on the portfolio on a daily basis.

The Bank's Middle Office function is responsible for monitoring whether the business division (i.e. the FM & FI Department) is maintaining the risk in the Bank's bond investment portfolio within the defined limits.

## **7 Operational Risk**

### **7.1 Operational Risk Overview**

Operational risk relates to the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events.

The primary risks the Bank faces are identified as:

- Fraud
- Health and safety issues
- Process weaknesses
- Damage to the Bank's physical assets
- Business disruption
- Regulatory breaches
- Product weaknesses
- Legal risks

The Operational Risk team within RMD is responsible for providing oversight over operational risks across all departments, branches and subsidiaries of the Bank. The day-to-day identification and management of operational risk lies with the respective business and support departments. Within each department, there is a nominated Risk Coordinator who is the main point of contact for the RMD Operational Risk team.

### **7.2 Operational Risk Oversight & Governance**

Operational risk oversight is provided firstly by a network of Risk Coordinators within each department, supported by a "hub and spoke" approach with a centralised Operational Risk team providing oversight to ensure consistency of practices across the Bank.

Oversight and governance arrangements for the setting and management of a robust operational risk management policy and culture are the responsibility of the Board and the ORC. The terms of reference and responsibilities of the ORC are set out below:

- Defining and reviewing, on a regular basis, the Operational Risk Policy, methodology and standards;
- Create awareness, across the Bank, of the need to manage operational risk effectively;
- Monitor and report the management of significant operational risks across the Bank;
- Ensure that appropriate training and guidance is given to raise staff awareness; and
- Report to Executive Management.

### 7.3 Operational Risk Framework

The Bank's operational risk framework is summarised below:



### 7.4 Mitigation of Material Operational Risks

Given the limited scope of the business, the product range and a “procedure driven” approach to all operations, the level of operational risks to the Bank is not significant. However set out below are the tools and techniques used in the mitigation and management of the Bank's operational risks.

#### Training & Awareness

There are currently three training programmes designed to increase the Bank's awareness of operational risk. These are summarised below:

- The Risk Coordinator Forum, which is conducted every six months, is firstly used for the training of Risk Coordinators. It is also a forum for the Risk Coordinators to provide feedback on any concerns to be addressed by the RMD Operational Risk team.
- Employee Induction process, which is led by Human Resources and the RMD Operational Risk team, where an overview of operational risk and how this will affect all employees of the Bank is presented and discussed.
- Operational Risk publications, prepared by the Operational Risk team, which provide an overview of operational risks and the Bank's operational risk management framework. These publications are issued to all employees.

## **Control Self Assessment (“CSA”)**

CSAs are conducted annually or as and when significant change or an operational risk event occurs. The key operational risk events identified are then allocated to a risk owner. The risk owners are responsible for evaluating the severity and frequency of their allocated operational risk event. A description and analysis of the implication of existing compensation controls in the mitigation of the operational risk event is provided. The residual risk will again be evaluated for severity and frequency.

## **Operational Risk Event Reporting (“ORER”)**

ORERs are to be completed within 5 working days of an operational risk event occurring. The event is mapped within the ORER database to a process already identified within the CSA process. In addition the event is mapped to a Basel II loss event category, and is also classed as actual loss, potential loss or near miss.

## **Action Plans**

Action plans are then derived from CSAs and ORERs to manage and mitigate the identified operational risks. Action plans are constantly monitored by the Operational Risk team. Actions plans outstanding for completion are reported to the ORC.

## **Reporting**

Key risks stemming from the ORER or CSA are reported to the ORC.

## **7.5 Operational Risk Capital Requirement**

The Bank has adopted the BIA for the determination of its capital requirement for operational risk. The capital requirement is 15% of the average over the previous three years annual gross income. The Bank’s average gross income for the previous three years was £19,270,000 and the capital requirement for operational risk as at 31 December 2008 was £2,890,000.