



# Clarien Bank Limited

Interim Pillar 3 Disclosures | June 30, 2016

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## **1. CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING STATEMENTS**

These Capital and Risk Management Pillar 3 Disclosures as at June 30, 2016 contain certain forward-looking statements with respect to the financial condition, results of operations and business of Clarien Bank Limited (“The Bank”). All statements, other than statements of historical facts, included or referenced in this document which address the activities, events or developments that we expect or anticipate will or may occur in the future, are forward-looking statements. The words ‘will’, ‘believe’, ‘expect’, ‘anticipate’, ‘project’, ‘estimate’, ‘predict’ and similar expressions are also intended to identify forward-looking statements. These forward-looking statements may include, among others, statements with respect to our liquidity and capital requirements; business strategy; financial and operating targets or plans; projections of revenues, income, market share or other financial forecasts; expansion and growth of our business and operations; and future capital expenditures.

These statements are based on certain assumptions and analyses we have made in light of our experience and perception of historical trends, current conditions and expected future developments, as well as other factors believed to be appropriate in the circumstances. However, whether actual results and developments will conform to expectations and predictions is subject to a number of risks and uncertainties that could cause actual results to differ materially from expectations, including, among others, the risks discussed in this disclosure document.

Consequently, all of the forward-looking statements made in this document are qualified by these cautionary statements and the results or developments that we anticipate may not be realized or, even if substantially realized, they may not have the expected consequences to, or effects on, us or our business or operations. We assume no obligation to update publicly any such forward-looking statements, whether as a result of new information, future events or otherwise.



## 2. INTRODUCTION

### 2.1 Background

The Bank is incorporated under the laws of Bermuda and has a banking license under the Banks and Deposit Companies Act, 1999. The Bank provides retail and private banking services to individuals and commercial banking services to small and medium-sized businesses. The services offered include demand and term deposits, consumer, commercial and mortgage lending, credit and debit cards, and letters of credit. The Bank also, through its subsidiary operations, engages in investment management, brokerage and advisory services, and trust administration.

Basel II was introduced to the global marketplace in June 2006 by the Basel Committee on Banking Supervision replacing the 1988 Basel Capital Accord (Basel I). The Bermuda Monetary Authority (“BMA”) implemented Basel II in Bermuda with effect from January 1, 2009. The rules for adoption were set out in the BMA’s paper “*Revised Framework for Regulatory Capital Assessment*” (“Framework”). Basel II aims not only to align regulatory capital more closely with risk but to promote a more sophisticated approach to risk management and to create a ‘risk culture’, whereby the organization, and senior management in particular, understand risk and remain alert to it as a core issue. Basel II is structured around three ‘pillars’:

Pillar 1 – Describes the calculation for minimum regulatory capital for Credit, Operational and Market risk. Credit risk regulatory capital requirements are more risk-based than the 1988 Accord. An explicit Operational risk regulatory capital charge was introduced for the first time while Market risk requirements remained the same in the current accord. The Bank adheres to the standardized approach to both Credit and Operational risk with a *de minimis* exemption from the BMA from holding Market risk capital due to the nature of its operations.

Pillar 2 – The Supervisory review process. This is intended to bridge the gap between regulatory and economic capital requirements giving supervisors discretion to increase regulatory capital requirements based on the assessment of risk factors. Management of the Bank assesses, measures and documents all risk exposures (Pillar 1 and 2), governance and internal control environment and strategic and capital planning considerations in the Capital Assessment and Risk Profile document (“CARP”) which is submitted annually to the BMA. Pillar 2 risks include Concentration risk, Strategic risk and Reputational risk. The BMA assesses the Bank’s CARP and determines adequacy against standards required under the Basel II Accord Statement of Principles resulting in a final capital requirement. This is expressed as a ratio of total capital: Pillar 1 capital or at any point in time as an absolute dollar figure with the BMA expecting management to operate with a capital cushion above that minimum.

Pillar 3 – Market discipline. This is designed to promote market discipline by providing market participants with key information on a firm’s risk exposures and risk management processes. Pillar 3 also aims to complement the minimum capital requirements described under Pillar 1, as well as the supervisory processes of Pillar 2.

## 2.2 Basel III

Basel III superseded Basel II and took effect on January 1, 2015 with transitional arrangements until full implementation in 2019. The three pillar framework of Basel II is unchanged but there have been changes to the detailed requirements within each pillar. Pillar 3 has more detailed disclosure requirements and will adopt generic templates over the course of the transition to allow improved comparability and transparency between institutions covered by Basel accords.

Basel III has strengthened the rules on the quality of capital to ensure loss absorption is adequate and allow financial institutions to deal with shocks and stresses related to financial and economic factors. Basel III requires that the quality of capital to cover Pillar 1 capital requirements is improved in terms of its ability to absorb losses, meaning that more of the Pillar 1 capital requirement must be met by Common Equity Tier 1 (CET1). Basel III has increased the value in the Bank's risk weighted assets, primarily driven by the increased risk weightings across the loan book.

In addition to minimum capital ratios, a capital conservation buffer of 2.5% is being introduced and phased in over the implementation period. Furthermore, a capital surcharge for Domestic Systemically Important Banks ('D-SIB') ranging between 0.5% and 3.0% for all Bermuda Banks has also been implemented. The new Basel rules also address areas of leverage and liquidity. The Authority has adopted a Liquidity Coverage Ratio ('LCR') with phased implementation consistent with that published by the Basel Committee. The LCR aims to ensure Banks have sufficient stock of unencumbered highly liquid assets to survive a high liquidity stressed scenario lasting 30 days. Further information regarding the implementation of Basel III can be found on the Bermuda Monetary Authority's website [www.bma.bm](http://www.bma.bm).

### 2.3 Basis of Disclosure

The following represents the Bank's Pillar 3 disclosures as of June 30, 2016. All figures are expressed in Bermuda dollars. All risk disclosures are made in respect of the Bank as a consolidated legal entity, in line with regulatory returns made to the BMA. As such, the Bank's subsidiaries are included in these Pillar 3 disclosures.

The Bank's Consolidated Financial Statements as of June 30, 2016 include the results of operations for the following subsidiary companies, all of which are wholly owned:

Legal entity	Activity
First Bermuda Group Ltd.	Holding Company
First Bermuda Securities Ltd. formerly First Bermuda Securities (BVI) Ltd.	Brokerage Services; Subsidiary of First Bermuda Group Ltd.
Onshore Nominees Limited	Nominee Company of First Bermuda Group Ltd.
Offshore Nominees Limited	Nominee Company of First Bermuda Group Ltd.
Clarien Investments Limited ("CIL")	Investment management
Clarien Brokerage Limited	Brokerage Services; Subsidiary of CIL
Clarien Nominees Limited	Nominee entity of CIL
Clarien BSX Services Limited	Trading member of Bermuda Stock Exchange; Subsidiary of CIL
Clarien Trust Limited	Trust administration
Clarien UK Limited	Inactive

The Bank has no capital deficiencies, nor are there any restrictions, practical or legal impediments to the transfer of funds between the Bank and any of its subsidiaries.

In addition, these Pillar 3 disclosures have also been prepared in accordance with regulatory capital adequacy concepts and rules.

The following disclosures have not been subject to external audit.

## **2.4 Media and Location**

The Pillar 3 disclosures for June 30, 2016 are available on the Bank's website ([www.clarienbank.com](http://www.clarienbank.com)).

## **3. RISK MANAGEMENT OBJECTIVES AND POLICIES**

### **3.1 Enterprise Risk Management ("ERM")**

Enterprise Risk Management ("ERM") is a process effected by an entity's Board of Directors, management and other personnel across the enterprise, designed to identify potential events that may affect the Bank and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of the Bank's objectives.

The Bank has in place an Enterprise Risk Policy that:

- Clearly articulates Clarien Bank Limited's and its subsidiaries' (together referred to as the Bank) approach to risk governance and ERM; and
- Provides a clear linkage between the Bank's strategic plan and governance arrangements and operational considerations detailed in the ERM Framework.

This ERM Policy outlines the operational structure and processes for the management of enterprise-wide risk and includes the following five key components:

- Risk Strategy and Appetite;
- Risk Governance;
- Risk Assessment and Measurement;
- Risk Management and Monitoring; and
- Risk Reporting and Insights.

### **3.2 Risk Governance**

The Board of Directors (the 'Board') is ultimately responsible for enterprise-wide risk management and has created governance structures that are outlined in the ERM Policy and related Charters. Risk governance encompasses the Bank's efforts to direct, manage and report risk management activities across the organization in accordance with the Three Lines of Defence approach to risk management set out in the ERM Policy,

#### **The Board**

The Board of Directors of the Bank is responsible for:

- Reviewing the ERM Policy and Framework;
- Overseeing all key risks associated with the activities of the Bank, and in establishing a strong internal control environment that fulfils the expectations of the stakeholders and is consistent with safe and sound banking practices;
- Understanding the major aspects of the Bank's overall risk profile through the periodic review of high-level reports that address material risks, capital adequacy, and strategic implications for the Bank;
- Understanding and approving the Bank's risk appetite and tolerance;
- Reviewing significant financial and other risk exposures and the steps management has taken to monitor, control, and report such exposures;

- Ensuring that management demonstrates active use of the ERM Framework in assessing and managing risks; and
- Ensuring that mechanisms exist to allow for independent verification of the ERM Framework and associated policies and procedures, implementation and validation activities.

The Bye-Laws of the Bank define the powers of the directors and allow for the Board to delegate powers to individual directors or to any committee consisting of one or more persons. Where such a committee is established, its proceedings and decisions must be fully reported to the Board at the next Board meeting following each meeting of the committee. The Board's Terms of Reference include a schedule of matters reserved for the Board.

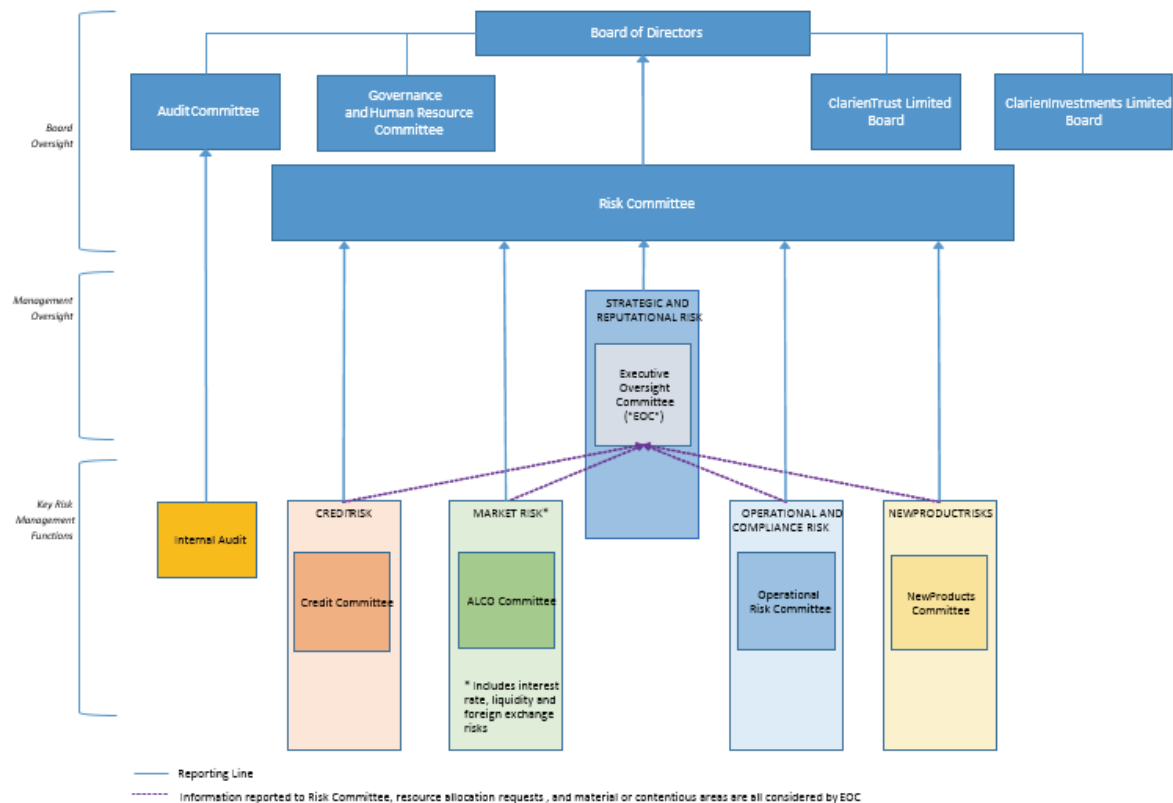
The Bank's Delegated Authorities document sets out the authority limits for individual employees within the relevant processes.

The Board has established Board Committees that are responsible for acting on its behalf in relation to risk management. These committees are the:

- Audit Committee;
- Governance and Human Resource Committee; and
- Risk Committee.

The three Board Committees are comprised of the appropriate mix of both independent and non-independent members, with the majority being independent directors and the mix taking into consideration their skill set and experience. Each committee reports on its activities to the Board of Directors on at least a quarterly basis.

A representation of the risk governance structure is provided below.



### Audit Committee

The Audit Committee is responsible for ensuring the adequacy of the Bank's corporate accounting and financial reporting processes and the quality and integrity of the Bank's financial statements and reports. It is also responsible for reviewing and ensuring the effectiveness of the Bank's internal control system, the Bank's internal audit function and the performance of the Head of Internal Audit. It also reviews and ensures the adequacy of the qualifications, independence and performance of the Bank's external auditor. An additional key role of the Committee is to maintain an open avenue of communication between it and the external auditor, management and its internal auditors.

### Governance and Human Resources Committee

The Committee is responsible for assisting the Board in fulfilling its oversight responsibilities for the Bank's corporate governance framework. This includes monitoring Board Committee effectiveness, director nominations, assessment and remuneration. The Committee is also responsible for assisting the

strategies and succession planning, philosophy and principles for compensation programs and the design and application of material compensation programs.

#### **Risk Committee**

The Risk Committee has oversight of the Bank's enterprise-wide risk management function. The Risk Committee is also responsible for the Bank's risk management policies and procedures, and for reviewing the adequacy of the ERM Framework in relation to risks faced by the Bank.

The responsibilities of the Risk Committee are set out in its Charter which is approved by the Board. The Risk Committee is comprised of an appropriate mix of both executive and non-executive directors and meets at least four times annually.

#### **Executive Oversight Committee**

The purpose of the Executive Oversight Committee ("EOC") is to:

- Communicate and adopt the tone set by the Board throughout the Bank;
- Review and recommend to the Board at least annually any changes to the Bank's Risk Appetite Statement;
- Develop for recommendation to the Board annually, a three year strategic plan and budget. This plan and budget influences and informs the Bank's Risk Appetite Statement;
- Oversee and manage the execution of the Bank's strategic business plan in accordance with the Bank's risk appetite and policies approved by the Board;
- Monitor operating, financial and risk performance and report to the Board, at least quarterly, progress against targets, limits and/or budgets;
- Review and approve, at least annually, the membership of the Bank's risk management committees, to ensure that the committee has appropriate resources and are able to meet the expectations required to fulfill the obligations of their respective charters;
- Consider the strategic assessment of risks assumed across the Bank as a whole based on an integrated view of the eight major sources of risk categories (Reputational, Strategic, Credit, Operational, Compliance, Interest Rate, Liquidity and Foreign Exchange), ensuring that these exposures are consistent with the risk appetites and tolerance thresholds promulgated by the Board;
- Ensure that appropriate risk treatment decisions are taken to address material risks that are outside the Bank's Risk Appetite Statement; and
- Oversee the resolution of any contentious issues that may arise from the various Risk Management Committees prior to those areas being reported to the Risk Committee.

The responsibilities of the EOC are set out in its Charter and includes the strategic and reputational risk categories. The EOC meets at least monthly.

The EOC reviews and challenges the Risk Appetite Statement, the Quantitative Risk Appetite and Tolerance Limits, and presents these to the Board's Risk Committee for approval at least annually.

#### **Credit Committee**

The Credit Committee is responsible for the management of credit risk in the Bank. The responsibilities of the Credit Committee are set out in its Charter and include all aspects of credit risk management, including credit policy development and approval, portfolio review, credit transaction approval, determining

delegated credit authority levels and model performance oversight. The Credit Committee meets at least monthly.

#### **Asset and Liability Committee**

The Asset and Liability Committee (“ALCo”) is responsible for the oversight and strategic management of the investment portfolio, liquidity and funding positions, market risk exposure and capital management activities. The ALCo ensures the effectiveness of the market risk management control framework built on policies and principles, including balance sheet structure and interest rate, liquidity, funding and foreign exchange risks. The responsibilities of the ALCo are set out in its Charter and it meets at least monthly.

#### **Operational Risk Committee**

The Operational Risk Committee’s purpose is to assist the Board and the EOC by providing oversight of Bank policies and management activities relating to the identification, assessment, measurement, monitoring and management of the Bank’s operational and compliance risks. Further the ORC is responsible for all aspects of operational and compliance risk. This Committee focuses on regulatory compliance risks and operational risks of the Bank, and shared services units, and oversees and supports the Bank’s objectives regarding operational and compliance risk. The responsibilities of the Operational Risk Committee are set out in its Charter and it generally meets at least monthly.

#### **New Product Committee**

The New Product Committee (NPC) is responsible for ensuring that all risk aspects are considered prior to approving the launch of a new product. The NPC will focus on three primary areas of review which are relevant to new products, being due diligence, risk management controls and processes and performance monitoring. The responsibilities of the NPC are set out in its Charter.

The Chairman shall call a meeting as needed to consider a new product or meaningful change to an existing product that is ready for consideration by the Committee. The Committee shall meet as required.



## **4. CAPITAL STRUCTURE**

The Bank's regulatory capital is allocated into three tiers.

### **4.1 Total Common Equity Tier 1 Capital**

Total Common Equity Tier 1 Capital ("CET 1") includes ordinary shares, share premium (contributed surplus), retained earnings and reserves created by appropriations of retained earnings. Within retained earnings, profits are only included where audited or reviewed by external auditors, however, losses must be taken into account, whether reviewed or not. A deduction from CET 1 is made in respect of goodwill. Ordinary shares carry no right to regular dividends.

### **4.2 Additional Tier 1 Capital**

Additional Tier 1 Capital includes the Bank's preferred shares, these are redeemable at the option of the Bank, floating rate with non-cumulative dividends.

### **4.3 Tier 2 Capital**

Tier 2 Capital comprises fixed assets revaluation reserves and the collective allowance for credit losses.

### **4.4 Leverage Ratio**

Basel III introduced a non-risk based leverage ratio to supplement the risk based capital requirements. The ratio shows the Tier 1 capital as a proportion of on and off balance sheet assets. The BMA leverage ratio framework requires a minimum ratio of 5%. The Bank's ratio exceeds the minimum requirement as disclosed in the table below.

# Interim Pillar 3 Disclosures

June 30, 2016



The following table summarizes the composition of regulatory capital for the Bank, as a consolidated entity, as reported to the BMA, as at June 30, 2016.

	<u>Jun 30, 2016</u>
	<u>\$'000</u>
<b>CET 1 Capital</b>	
Common Share Capital	5,000
Share Premium	18,550
Retained Earnings and Other Reserves	53,021
General Reserve	10,000
Current year's profit reviewed by external audit	-
Goodwill	(7,456)
<b>Total CET 1 Capital</b>	<u><b>79,115</b></u>
<b>Additional Tier 1 Capital</b>	
Preferred Share Capital	20,000
<b>Total Tier 1 Capital</b>	<u><b>99,115</b></u>
<b>Tier 2 Capital</b>	
Fixed Assets Revaluation Reserves	668
Collective Allowance for Credit Losses	6,301
<b>Total Tier 2 Capital</b>	<u><b>6,969</b></u>
<b>Total Regulatory Capital</b>	<u><u><b>106,084</b></u></u>
<b>Capital Ratios</b>	
CET 1 Ratio	12.92 %
Tier 1 Ratio	16.19 %
Total Capital	17.32 %
Leverage Ratio	8.63 %

## **5. CAPITAL ADEQUACY**

### **5.1 Overview**

Capital is held to provide a cushion for unexpected losses. The Board sets the internal level of capital with the aim of ensuring minimum regulatory capital levels, as set and monitored by the BMA, are always exceeded.

The Bank's minimum regulatory capital is a combination of the requirements derived from Pillar 1 and Pillar 2 rules, as detailed in section 2.1.

Management of the Bank assesses, measures and documents all risk exposures (Pillar 1 and 2), governance and internal control environment and strategic and capital planning considerations in its CARP which is submitted annually to the BMA. In addition to the annual CARP process, the Bank's Pillar 1 capital requirements are regularly monitored and are formally reported on a quarterly basis to the BMA and the Board.

### **5.2 Regulatory Capital Requirements for Pillar 1**

Regulatory ratios for Pillar 1 are calculated by dividing total capital by risk weighted assets (RWA). RWA are determined according to the varying levels of risk attached to assets and off-balance sheet exposures, using Basel guidelines.

The table below sets out the Bank's Pillar 1 capital requirements under the standardized approach for credit and operational risk based on 8% of the RWA for each applicable exposure class, as at June 30, 2016. Amounts are shown gross of any credit risk mitigation.

# Interim Pillar 3 Disclosures

June 30, 2016



Pillar 1 capital requirements have been set at a minimum capital requirement of 8% of RWA's as at June 30, 2016.

Credit Risk Category	Asset \$'000	Risk weighted asset value \$'000	Minimum capital required \$'000
<b>Treasury Assets</b>			
Cash	8,161	-	-
Sovereign and Multilateral Development Banks	193,981	247	20
Public Sector Entities: Treasury Assets	5,058	1,012	81
Corporates: Treasury Assets	17,726	3,696	296
Banks	90,889	18,178	1,454
Securitizations	77	167	13
<b>Total Treasury Assets</b>	<b>315,892</b>	<b>23,300</b>	<b>1,864</b>
<b>Loans and Advances to customers</b>			
Public Sector Entities: Loans & Advances	7,285	3,642	291
Corporates: Loans & Advances	18,348	18,348	1,468
Qualifying Revolving Retail	6,166	4,794	384
Other Retail	34,000	26,006	2,081
Mortgages	719,833	402,397	32,192
Off-Balance Sheet Commitments	31,858	3,261	261
<b>Total Loans and Advances to customers</b>	<b>817,490</b>	<b>458,448</b>	<b>36,677</b>
<b>Other assets</b>	<b>40,709</b>	<b>40,709</b>	<b>3,257</b>
<b>Total credit risk exposures and capital resources required</b>	<b>1,174,091</b>	<b>522,457</b>	<b>41,798</b>
<b>Operational risk capital requirement</b>	<b>-</b>	<b>89,893</b>	<b>7,191</b>
<b>Total Pillar 1 capital requirement</b>	<b>1,174,091</b>	<b>612,350</b>	<b>48,989</b>
<b>Total own funds per section 4</b>	<b>-</b>	<b>-</b>	<b>106,084</b>
<b>Excess of own funds over minimum requirement under Pillar 1</b>	<b>-</b>	<b>-</b>	<b>57,095</b>

## 6. CREDIT RISK

Credit risk is inherent in the Bank's various lending and business activities. Credit risk is the risk of loss arising from a customer or counterparty failing to meet their financial obligations to the Bank as they fall due. The Bank provides credit through residential and commercial mortgages, secured and unsecured loans and credit cards. Credit risk also arises through other activities not directly related to the provision of services to clients, such as short-term investments and interbank loans relating to liquidity management. All mortgage lending is originated by the Bank and retained and serviced within its lending division and Loan Portfolio Group ("LPG").

### 6.1 Credit Risk: Loans and Mortgages

The effective management of credit risk requires the establishment of an appropriate credit risk culture. Key credit risk policies and credit risk management strategies are important elements used to create this culture. The Bank has implemented appropriate internal processes and risk-oriented strategies for actively identifying, managing, monitoring and reporting credit risk on its mortgage and non-mortgage portfolios which are suitable to the nature, scale and complexity of the business. This is supported by policies and controls such as internal approval limits and thresholds.

The Board, through its Risk Committee and management level Credit Committee, reviews and approves the Bank's credit risk strategy and credit risk policies.

The objectives of the credit risk strategy are to ensure that:

- The risk parameters for new underwritings, and for the portfolio as a whole are clearly specified;
- Target markets and product offerings are well defined at both enterprise-wide and business line levels;
- Transactions and limits are managed in a manner that is consistent with the Bank's risk appetite;
- Loans are priced on a risk adjusted basis;
- Loans are appropriately collateralized and collateral is maintained and valued periodically;
- Credit risk is managed from concentration and country risk perspectives; and
- Maintain sufficient information and data to be able to track and monitor changes over time.

The credit risk policy articulates the credit risk management framework, including:

- Aggregate limits for all lenders, beyond which credit applications must be escalated to the Bank's Credit Committee; and
- Single name/aggregation exposures, beyond which exposures must be reported and reviewed by the Credit Committee, with Board oversight.

The Bank's Credit Risk Management ("CRM") team develops the credit risk management framework and policies that detail, among other things, the credit risk rating system and associated parameter estimates; the delegation of authority for granting credit; the calculation of the allowance for credit losses; and the authorization of write-offs. Both commercial credit exposures, as well as residential credit risk, are segmented by purpose codes, collateral and applicable industries. The Bank does not have excessive concentration to any single borrower or related group of borrowers. A review of exposures in excess of 5% of the capital base is conducted by the Risk Committee on a quarterly basis.

An integral part of the CRM & LPG function is to formally review and monitor past due and potential problem loans to determine which credits, if any, need to be charged off. The allowance for loan losses is reviewed quarterly to determine the amount necessary to maintain an adequate provision for credit losses.

Banking units and the CRM regularly review the various segments of the loan portfolio to assess the impact of economic trends or specific events on the performance of the portfolio, and determine whether corrective action is required. The results of these reviews are reported to the Credit Committee and, when significant, to the Risk Committee of the Board.

The Bank's credit risk rating system utilizes an eight point scale used to differentiate the risk of default of borrowers and the risk of loss on facilities. The Bank's credit risk rating system is subject to a governance and oversight framework. The objectives of this framework are to ensure that:

- Credit risk ratings, methodologies and parameters are appropriately designed and developed, independently validated, and regularly reviewed; and
- The review and validation processes represent an effective challenge to the design and development process.

#### **6.1.1 Enterprise-wide Adjudication**

Business groups form adjudication units within the Bank which analyze and evaluate all significant credit requests and financial restructurings. To ensure that risks are adequately assessed, properly approved, continually monitored and actively managed, CRM provides an oversight function. The decision-making process begins with an assessment of the credit risk of the individual borrower or counterparty. Key factors considered in the assessment include:

- The borrower's debt service ability;
- The borrower's current and projected income, financial results or credit statistics;
- The industry in which the borrower operates;
- Economic trends;
- Collateral risk; and
- An assessment of the borrower's management.

Based on this assessment, a risk rating is assigned at the facility (or counterparty) level, taking into consideration additional factors, such as collateral/security, structure, term and any other forms of credit risk mitigation or credit enhancements that may affect the amount of potential loss in the event of a default. Security typically takes the form of registered mortgages or charges over real estate; or inventory, receivables and operating assets when lending to corporate and commercial borrowers; and cash or treasuries for trading lines such as securities lending, repurchase transactions, and derivatives. The use of such collateral is in line with terms that are usual and customary to standard lending activities in Bermuda. The types of acceptable collateral and related third party valuation processes are documented in risk management policies and manuals. Other forms of credit risk mitigation include third party guarantees and, in the case of derivatives facilities, master netting agreements.

The Chief Risk Officer and Credit Committee (depending on the size of the overall exposure) is the final arbiter of internal risk ratings. Individual credit exposures are regularly monitored by both the business line units and CRM for any signs of deterioration and losses are re-rated as necessary.

## 6.2 Credit Risk: Interbank Lending and Investment Securities

The Bank engages in short-term lending to other bank counterparties and investments in securities as part of its ongoing liquidity management program. Risks are managed within specific counterparty limits approved by the Credit Committee and limits, asset quality plans and criteria set out in the Bank's Investment Policy Statement, which is approved by the Risk Committee. Furthermore the portfolio will comply with the current Counterparty Risk Policy and Country Risk Policy, and limits approved by the Credit Committee. The Bank uses external credit agency ratings, as detailed in section 6.6, supplemented by internal analysis to manage the risks associated with interbank lending and investment activities.

## 6.3 Average and Total Credit Risk Exposure

The following table sets out asset class exposures as at June 30, 2016. Amounts include on- and off-balance sheet exposures after applying regulatory credit conversion factors.

<b>Exposures under the Standardized Approach</b>	<b>Average Exposure 2015/16 \$'000</b>	<b>Exposure as at Jun 30, 2016 \$'000</b>
Cash	8,985	8,161
Sovereigns and Multilateral Development Banks	167,840	193,981
Public Sector Entities	17,159	12,343
Corporates	35,985	36,074
Banks and Securities Firms	90,666	90,889
Securitizations	82	77
Retail Loans	36,091	33,295
Residential Mortgages	598,138	573,132
Commercial Mortgages	52,158	49,631
Past Due Loans	96,114	103,941
Other Balance Sheet Exposures	41,077	40,709
Off-Balance Sheet Commitments	19,121	31,858
<b>Total Exposures under the Standardized Approach</b>	<b>1,163,416</b>	<b>1,174,091</b>

#### 6.4 Standardized Gross Exposures by Geographical Area

The table below shows an analysis of credit risk by geographical location as at June 30, 2016. The geographical area is determined by the country of incorporation for companies and for individuals by the country of residence.

<b>Exposures under the Standardized Approach</b>	<b>North America*</b> <b>\$'000</b>	<b>Europe</b> <b>\$'000</b>	<b>Total</b> <b>\$'000</b>
Cash	8,161	-	8,161
Sovereigns and Multilateral Development Banks	183,961	10,020	193,981
Public Sector Entities	12,343	-	12,343
Corporates	36,074	-	36,074
Banks and Securities Firms	90,889	-	90,889
Securitizations	77	-	77
Retail Loans	33,295	-	33,295
Residential Mortgages	573,132	-	573,132
Commercial Mortgages	49,631	-	49,631
Past Due Loans	103,941	-	103,941
Other Balance Sheet Exposures	40,709	-	40,709
Off-Balance Sheet Commitments	31,858	-	31,858
<b>Total Exposures under the Standardized Approach</b>	<b>1,164,071</b>	<b>10,020</b>	<b>1,173,291</b>

\* North America includes Bermuda



### 6.5 Standardized Gross Exposures by Residual Maturity

The table below sets out an analysis of credit risk by maturity as at June 30, 2016. Residual maturity of exposures is based on contractual maturity dates and not expected or behaviorally adjusted dates. Cash flows receivable over the life of the exposure are not included.

<b>Asset Class</b>					
<b>Exposures by Residual Maturity</b>	<b>Within 1 year</b>	<b>After 1 but within 5 years</b>	<b>After 5 years</b>	<b>No Specific Maturity</b>	<b>Total</b>
	<b>\$'000</b>	<b>\$'000</b>	<b>\$'000</b>	<b>\$'000</b>	<b>\$'000</b>
Cash	8,161	-	-	-	8,161
Sovereigns and Multilateral Development Banks	106,608	87,373	-	-	193,981
Public Sector Entities	-	5,058	7,285	-	12,343
Corporates	35,102	753	219	-	36,074
Banks and Securities Firms	70,663	20,226	-	-	90,889
Securitizations	-	-	77	-	77
Qualifying Revolving Retail	3,631	2,535	-	-	6,166
Other Retail	4,801	9,514	19,685	-	34,000
Mortgages	17,893	26,175	675,764	-	719,833
Other Balance Sheet Exposures	3,688	-	-	37,022	40,709
Off-Balance Sheet Commitments	26,591	5,267	-	-	31,858
<b>Total Exposures under the Standardized Approach</b>	<b>277,138</b>	<b>156,901</b>	<b>703,030</b>	<b>37,022</b>	<b>1,174,091</b>

### 6.6 Application of the Standardized Approach for Credit Risk

The standardized approach stipulates that banks should use an External Credit Assessment Institution (“ECAI”), such as a credit rating agency, to determine the risk weighting applied to exposures to certain counterparties. The Bank has used Standard & Poor’s (“S&P”) rating group as its nominated ECAI. S&P’s ratings are used to assign exposures a credit quality step and thus calculate the credit risk capital requirement for the following classes of exposure: Sovereigns and multilateral development banks (“MDB’s”); Public sector entities; Corporates; and Banks and Securities firms. The Bank does not make material use of on- or off-balance sheet netting. The alignment of the BMA’s credit quality steps and S&P’s assessments are as follows:

Credit Quality Step	S&P's assessments
1	AAA to AA-
2	A+ to A-
3	BBB+ to BBB-
4	BB+ to BB-
5	B+ to B-
6	CCC+ and below

All other exposure classes are assigned risk weightings as prescribed in the BMA’s regulatory guidance.

The following tables provide, for material segments only, an analysis of exposures by credit quality steps as at June 30, 2016:

#### 6.6.1 Sovereigns and MDB’s

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	\$'000	\$'000
1	0%	192,744	192,744
2	20%	1,237	1,237
<b>Total</b>		<b>193,981</b>	<b>193,981</b>

#### 6.6.2 Public Sector Entities

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	\$'000	\$'000
1	20%	5,058	5,058
2	50%	7,285	7,285
<b>Total</b>		<b>12,343</b>	<b>12,343</b>

### 6.6.3 Corporates

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	\$'000	\$'000
1	20%	17,224	17,224
2	50%	502	502
3	100%	18,348	18,348
<b>Total</b>		<b>36,074</b>	<b>36,074</b>

### 6.6.4 Banks

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	\$'000	\$'000
1	20%	57,240	57,240
2	20%	12,494	12,494
3	20%	21,155	21,155
<b>Total</b>		<b>90,889</b>	<b>90,889</b>

## 6.7 Past Due and Impaired Financial Assets

At each reporting date, the Bank assesses whether there is objective evidence that financial assets not carried at fair value through profit and loss are impaired. A financial asset or a group of financial assets are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the asset(s), and that the loss event has an impact on the future cash flows of the asset(s) that can be estimated reliably.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, the disappearance of an active market for a security or other observable data relating to a group of assets such as adverse changes in the payment status of the issuers in the group, or economic conditions that correlate with defaults in the group.

Other than loans, mortgages and credit card receivables, (see below), no other financial assets were considered to be impaired as at June 30, 2016.

Collateral obtained to mitigate credit risk is contracted, documented and safely stored.

#### **6.7.1 Past Due and Impaired Loans**

In the opinion of management, a loan or mortgage is considered impaired when there has been deterioration in credit quality of the borrower to the extent that there is no longer reasonable assurance as to the timely collection of the full amount of principal and interest. Secured loans and mortgages where interest or principal is contractually past due 91 days or more are automatically classified as impaired, unless management determines that the loan or mortgage is fully secured, is in the process of collection and the collection efforts are reasonably expected to result in repayment of the loan or mortgage and overdue interest in full. For regulatory reporting purposes, loans are classified as past due after 90 days have passed since a payment is missed. Credit card receivables that are contractually 180 days past due are automatically written off.

#### **6.7.2 Allowance for Credit Losses on Loans, Mortgages and Credit Card Receivables**

The adequacy of the allowance for credit losses on loans, mortgages and credit card receivables is regularly reviewed by management taking into consideration matters such as current economic conditions, past loss experience, and individual circumstances which may affect a borrower's future ability to pay. The allowance for credit losses is established by charges against income and a corresponding reduction of the related asset category, based on management's assessment of the estimated amount of incurred but not specifically reported losses within the loan, mortgage and credit card portfolios. The allowance for credit losses consists of specific and collective loan loss allowances. The specific loan loss allowance is the amount required to reduce the carrying value of an impaired loan to its estimated realizable amount. Generally, the estimated realizable amount is determined by discounting the expected future cash flows at the loan's original effective interest rate.

Collective allowance for groups of homogeneous loans is established using a formula approach based on historic data. The methodology uses statistical analysis of historical data on delinquency and collateral trends to estimate the probability of default and expected collateral values respectively. The loss given default is then estimated based on the expected collateral values. The estimate of loss arrived at on the basis of historical information is then reviewed to ensure that it appropriately reflects the economic conditions and product mix at the reporting date. Default rates and loss factors are regularly benchmarked against actual loss experience.

# Interim Pillar 3 Disclosures

June 30, 2016



The following tables show the past due and impaired loans as at June 30, 2016 for the Bank, as well as the movement on collective and specific allowances for the year ended June 30, 2016.

	<b>Commercial Mortgages \$'000</b>	<b>Residential Mortgages \$'000</b>	<b>Retail &amp; Other Loans \$'000</b>	<b>Total Loans Jun 30, 2016 \$'000</b>
Past due, but not impaired:				
7 to 90 days*	13,730	18,853	1,308	33,891
More than 90 days	7,288	40,301	2,722	50,311
Individually assessed impairments:				
7 to 90 days*	-	5,993	90	6,082
More than 90 days	18,979	46,012	6,377	71,368
	<b>39,997</b>	<b>111,158</b>	<b>10,497</b>	<b>161,652</b>
Net impairment loss on financial assets for the period ended June 30, 2016 as recorded in the Bank's Profit & Loss Statement	983	2,732	258	3,973

	<b>Specific Provisions \$'000</b>	<b>Collective Provisions \$'000</b>	<b>Total Provisions \$'000</b>
Balance at Jan 1, 2016	20,674	5,902	26,576
Net write-offs	(2,053)	-	(2,053)
Provision for credit losses	3,574	399	3,973
Balance at June 30, 2016	<b>22,195</b>	<b>6,301</b>	<b>28,496</b>

\* Given the Bank's credit policies and procedures, management does not consider loans past due less than 7 days as delinquent.

## **6.8 Credit Risk Mitigation**

### **6.8.1 Loans & Mortgages**

The effective management of credit risk in the Bank's loan book is supported by relevant policies and guidelines on the role of collateral supporting these obligations. The purpose of taking collateral is to act as a secondary source of repayment of the loan if the borrower defaults, and is unable to cure the default by means other than the sale of the collateral.

The Bank relies heavily on the valuation and revaluation of individual collaterals, determination of the value of pledged collateral for secured loans, determination of collateral acceptability for the purposes of credit risk mitigation and collateral enforcement, should the client be in default.

Lending/Relationship Managers, through their credit underwriting analysis and under the guidance of LPG, determine whether and what type of collateral is required and the value of that collateral. The type of collateral held can include, but is not limited to: residential real estate; commercial properties; debentures covering business assets such as receivables and equipment; and pledging of cash deposits and investment securities portfolios. Guarantees from third parties are also obtained in some instances. Independent third party valuations of collateral are monitored. All external valuation providers are vetted by LPG.

### **6.8.2 Interbank Lending and Investment Securities**

Collateral held as security for investment securities is determined by the nature of the instrument. Debt securities and treasuries are generally unsecured whereas asset-backed securities and similar instruments are secured by pools of financial assets.

### **6.8.3 Financial Collateral**

The overall value of financial collateral used as credit risk mitigation within the Pillar 1 calculations was \$10.1 million against loans and advances to customers, predominately retail loans, as incorporated in the determination of RWA values in Section 5.2 above.

## **6.9 Counterparty Credit Risk for Derivative Contracts \***

The Bank uses derivative instruments to hedge its exposure to market risk, for example foreign exchange and interest rate risk. Counterparty Credit Risk ("CCR") is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default. Unlike exposure to credit risk through a loan, where the exposure to credit risk is unilateral and only the lending bank faces the risk of loss, CCR creates a bilateral risk of loss whereby the market value for many different types of transactions can be positive or negative to either counterparty. The market value is uncertain and can vary over time with the movement of underlying market factors.

*\* Includes unsettled spot transactions*

The following table shows the exposures to counterparty credit risk for derivative contracts held by the Bank as at June 30, 2016:

	<b>Notional Principal Amount \$'000</b>	<b>Potential Future Credit Exposure \$'000</b>	<b>Credit Equivalent Amount \$'000</b>
Foreign Exchange Contracts	331	3	3
<b>Total</b>	<b>331</b>	<b>3</b>	<b>3</b>

#### 6.10 Securitizations

The Bank's only exposure to securitizations is through investment in third party securities. The following table sets out these investments as at June 30, 2016:

<b>Credit quality step</b>	<b>Risk weight %</b>	<b>Exposure \$'000</b>	<b>Exposure after credit risk mitigation \$'000</b>
3	100%	41	41
4	350%	36	36
<b>Total RWA</b>		<b>77</b>	<b>77</b>

All the above securities are mortgage or other asset-backed.

## **7. MARKET RISK**

Market risk is the potential adverse change in Bank income or in the value of the Bank's holdings of financial instruments arising from movements in interest rates, foreign exchange rates or equity prices. The objective of market risk management is to manage and control market risk exposure within acceptable parameters, while optimizing the return on risk.

The Bank's exposure to market risk is governed by a policy approved by the ALCo and ratified by the Risk Committee. The policy sets out the nature of risk which may be taken, and applicable maximum risk limits. Compliance with Bank risk limits and the Bank's exposure to market risks are reviewed at monthly meetings of ALCo and quarterly meetings of the Risk Committee. Since the Bank does not engage in propriety trading activities, its market risk exposure principally arises from its regular banking activities.

Day-to-day monitoring and management of market risk is undertaken by the Treasury Department. Exposure to market risk is managed by using hedging instruments or by utilizing natural hedges existing within the variety of financial instruments the Bank holds.

The Bank has submitted a policy statement to the BMA declaring its activities as non-trading and has obtained a *de minimis* exemption from holding market risk capital due to the nature of its operations.

### **7.1 Interest Rate Risk**

The principal market risk faced by the Bank is interest rate risk. The net interest income and market value of the Bank's assets are exposed to movements in interest rates. Primarily, risk arises when asset and liability principal and interest cash flows have different payment, repricing or maturity dates. Interest rate risk exposure is managed on a continuous basis.

The Bank at times hedges selected interest rate exposures through interest rate swap contracts, which are linked to and adjust the interest rate sensitivity of specific financial instruments. These hedges modify exposure to interest rate risk by converting fixed rate instruments to a floating rate, or vice versa. Any decrease in the value of these contracts is mitigated to an extent by a corresponding increase in the fair value of the deposit obligations being hedged under an effective hedge.



The Bank has set various limits and restrictions over its interest rate risk exposure and these have been approved by ALCo and the Risk Committee. The Treasury Department uses a variety of reporting and measurement tools to monitor interest rate risk within the Bank, including Asset-Liability Management (ALM) analysis of the impact on net interest income and expense for given movements in interest rates and gap analysis in relation to various repricing and maturity scenarios covering the Bank's deposit products.

Interest rate risks are monitored by way of sensitivity analysis. These show the estimated effects of changes in market interest rates that management believes would be reasonably possible over the next twelve months, on net income and shareholders' equity as at June 30, 2016. The interest rate sensitivity analysis is based on the assumption that volumes remain stable over the analysis period and that management responds to changes in market interest rates and other risk factors. The interest rate sensitivity analysis doesn't reflect the movement in fair value of investment securities from changes in market interest rates, which would be recorded as OCI within shareholders' equity.

## **8. LIQUIDITY RISK**

Liquidity risk is the risk that the Bank is not able to meet its financial obligations as they fall due, or can only do so at excessive cost. The Bank's policy is to ensure that sufficient funds are available to meet its ongoing commitments to customers and counterparties, both with respect to the demand for loans and the repayment of deposits, and to maintain the confidence of the marketplace in which the Bank operates.

This is achieved by (i) adhering to a Board approved loan to deposit guidelines (ii) adherence to regulatory mandated liquidity mismatch guidelines with respect to the amount of potential projected cash outflow, looking out one month, as a percentage of total deposits (iii) maintaining holdings of high quality liquid assets and short maturity interbank placements and (iv) maintaining external counterparty repurchase facilities.

The development and implementation of a liquidity policy is the responsibility of ALCo, and, is ratified by the Risk Committee. The day-to-day monitoring and management of liquidity is the responsibility of the Treasury Department. The Treasury Department prepares liquidity reports and performs stress tests on a monthly basis and reports the results to ALCo and the Risk Committee.

The Bank transacts only a small number of FX positions, predominantly spot transactions for customer flow. As a result the Bank has no substantial net exposure to foreign exchange rate fluctuations. Again, this mismatch does not represent material market or liquidity risk.

## **9. OPERATIONAL RISK**

### **9.1 Objectives and Policy**

The Bank has adopted the definition of operational risk as proposed by the Basel Committee and endorsed by the BMA, namely “The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events”. This definition includes legal risk but excludes strategic and reputational risk.

The Bank complies with the Basel Committee on Banking Supervision (BCBS) guidelines, and the Bermuda Monetary Authority’s (BMA) guidance papers on the management of Operational Risk. These requirements have been tailored proportionately in this framework to reflect our comparatively small size, lack of complexity and risk profile.

In line with the Basel committee’s report on “Sound Practices for the Management and Supervision of Operational Risk” the Bank sees the following as core components of the ORM framework:

- Oversight by the Board of Directors and Executive Management;
- A strong ERM, ORM and internal control culture;
- Effective internal reporting; and
- Robust business contingency planning.

Operational risk is relevant to every aspect of the Bank’s business and owned by every employee within the organization. The broad definition covers events ranging from fraud to systems failure and downtime. The importance of managing these risks in a cost efficient and effective manner is critical to the organization meeting its business/strategic goals.

## 9.2 Capital Calculation Methodology

The Bank has adopted the Standardized Approach for calculating its Basel II Pillar 1 operational risk capital. This approach divides the Group's activities into 8 primary business lines (corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management and retail brokerage). The capital charge for each business line is calculated by multiplying audited gross income by a factor ( $\beta$ ) assigned to that business line. Audited gross income is averaged over 3 years, with  $\beta$  being an industry-wide relationship between operational risk loss experience for a given business line and the aggregate level of gross income for that business line.

## **Clarien Bank Limited**

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Bermuda

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#### **Clarien Investments Limited**

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Clarien Bank Limited through its wholly owned subsidiary companies is licensed to conduct bank, investments and trust business by the Bermuda Monetary Authority.