



# Clarien Bank Limited

Pillar 3 Disclosures | December 31, 2014

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

These Capital and Risk Management Pillar 3 Disclosures as at December 31, 2014 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 Bank and Deposit Companies Act, 1999. The Bank is involved in community banking and 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. 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 Basis of Disclosure

The following represents the Bank's Pillar 3 disclosures as of December 31, 2014. 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 December 31, 2014 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 Ltd.	Nominee Company of First Bermuda Group Ltd.
Offshore Nominees Ltd.	Nominee Company of First Bermuda Group Ltd.
Clarien Investments Limited ("CIL")	Investment management
Clarien Brokerage Limited	Brokerage Services; Subsidiary of CIL
Clarien Nominees Ltd.	Nominee entity of CIL
Clarien BSX Services Limited	Trading member of Bermuda Stock Exchange; Subsidiary of CIL
Clarien Trust Limited	Trust administration

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 and consequently they do not constitute any form of financial statement and should not be relied upon in making any judgement on the Bank.

## 2.3 Overview of Basel III

Basel III will supersede Basel II and takes effect on January 1, 2015 with transitional arrangements until full implementation in 2019. The three pillar framework of Basel II is unchanged but there has 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 from Common Equity Tier 1 (CET1). 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).

## 2.4 Media and Location

The Pillar 3 disclosures for December 31, 2014 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")

ERM is a process effected by an entity's Board of Directors, management and other personnel, applied in business and strategic planning and utilized consistently across the enterprise. It is designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite and to provide reasonable assurance regarding the achievement of an entity's objectives.

The Bank has defined its approach to ERM in a formal risk management and governance framework that is reviewed and approved by the Bank's Board level Governance, Risk and Compliance ("GRC") Committee on an annual basis. This framework operates within the boundaries of the Group's overarching ERM policy framework. Key objectives are as follows:

- Identify and manage key risks and supporting control framework (including cross-enterprise risks);
- Promote ownership, training and awareness with respect to the key risks the entity faces;
- Align risk profile with risk appetite and strategy;
- Enhance risk response decisions;
- Reduce likelihood and incidence of earnings volatility;
- Seize opportunities; and
- Optimize the deployment of capital.

The approach to achieve these objectives includes:

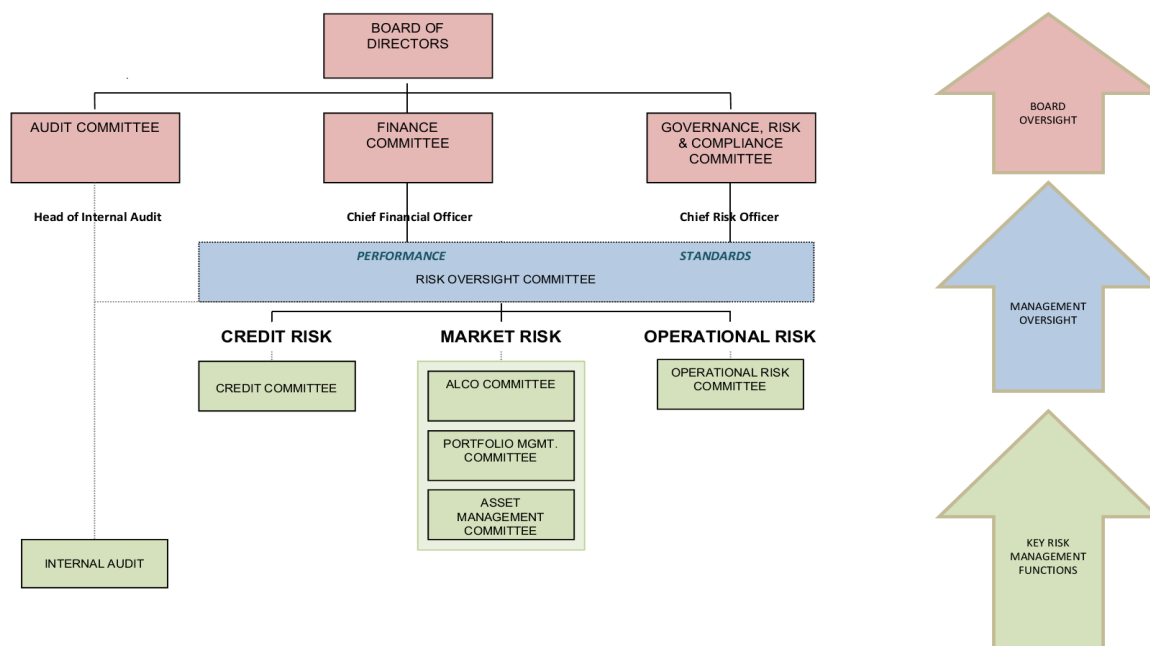
- The implementation of an appropriate governance model (see below);
- The implementation of an internal risk adjusted return on capital ("RAROC") model and methodology used to optimize both internal risk capital and regulatory capital;
- Adoption of traditional three lines of defense risk model (risk owners, risk oversight and independent audit);
- The approval, implementation, management and training with respect to appropriate risk policies and procedures aligned to strategy;
- The assignment of Executive/Business Risk Owners throughout the Group's operating units;
- Development of business level risk monitoring tools;
- Development of risk mitigation strategies;
- Oversight and monitoring; and
- Effective day-to-day management of enterprise-wide risk and detailed reporting to the Board (and its sub-committees) on at least a quarterly basis. Additional Board oversight includes an annual approval of an enterprise-wide risk appetite statement and delegated signing authorities applied throughout the Bank by area and type of transaction and associated risk. Specific transaction threshold levels are also established at least annually by the Board, requiring management to notify and, in certain instances, also receive approval by the Board prior to execution of transaction(s).

Risk is not static and as such the Group's risk profile is subject to changes resulting from a wide range of factors. This reinforces the need to continually monitor and assess the Group's risk environment. A key part of meeting this requirement is ensuring an appropriate governance structure is in place.

### 3.2 Risk Governance

The Group's Governance structure enables oversight of and accountability for the effective management of risk. Following the recent amalgamation, the Group has undertaken changes to its Governance structure in alignment with the BMA's Corporate Governance Code for Banks and Deposit Companies. These changes took place in early 2014. The text below outlines the Group's Governance structure.

The Board of Directors and its three sub-Committees are comprised of the appropriate mix of both executive and non-executive members, with a majority of non-executive directors. The sub-Committees each report on a quarterly basis to the Board of Directors on their activities. The Board Committees are supported by a management level Risk Oversight Committee and five sub-committees: Credit Committee, ALCo Committee, Portfolio Management Committee, Asset Management Committee and the Operational Risk Committee. Each of these five management level committees are responsible for developing and maintaining risk management policies and related procedures, and reporting for their respective areas.



*Group Governance Structure April 2014*

#### Board of Directors (Board)

The Board has overall responsibility for the business and its affairs, the establishment of the Bank's strategy, capital raising and allocation activities. The Board monitors and oversees the Bank's operations, ensuring competent and prudent management, sound planning, proper policies for the maintenance of adequate accounting and other records and systems of internal control, and for compliance with statutory and regulatory obligations. In carrying out the duties of the Bank, the Board will act in accordance with all relevant and applicable legislative and regulatory rules.



The Board has overall responsibility for the establishment and oversight of the Bank's risk management framework as well as the establishment of the Bank's risk appetite. The Board has established three Board committees: Audit, Finance and GRC, each of which are responsible for approving and monitoring the Bank's risk management policies in their respective areas.

**Audit Committee (Board Level)**

The Audit Committee is accountable to the Board and has responsibility to ensure the adequacy of the Group's corporate accounting and financial reporting processes and the quality and integrity of the Group's financial statements and reports along with the effectiveness of the Group's internal control system in providing assurance in areas including reporting, monitoring compliance with laws, regulations and internal policies, efficiency and effectiveness of operations and safeguarding of assets. The Audit Committee also ensures the qualifications, independence and performance of the registered public accountants engaged by the Group as its independent auditors. The responsibilities of the Audit Committee are set out in its charter which is approved by the Board. The Audit Committee meets at least four times annually.

**Finance Committee (Board Level)**

The Finance Committee is accountable to the Board and has responsibility with respect to the Bank's financial strategies and objectives by: keeping under review and monitoring the financial (excluding accounting) risk management of the Bank, reviewing the capital management of the Bank, reviewing the Bank's financial performance, monitoring regulatory compliance applicable to financial matters and reviewing relevant corporate development matters as they relate to the Bank's financial strategies and objectives. The responsibilities of the Finance Committee are set out in its charter which is approved by the Board. The Finance Committee meets at least four times annually.

**Governance, Risk and Compliance Committee (Board Level)**

The GRC Committee is accountable to the Board and has oversight responsibilities in regards to the Bank's corporate governance practices including reviewing the Corporate Governance Guidelines, monitoring Bank regulatory compliance, allocation of committee responsibilities and annual performance of those committees, identification and nomination of director candidates, annual evaluation of the Bank's CEO and oversight of the Bank's enterprise-wide risk management function. The GRC Committee is also responsible for the Bank's risk management policies and procedures, and for reviewing the adequacy of the risk management framework in relation to risks faced by the Bank. The responsibilities of the GRC Committee are set out in its charter which is approved by the Board. The GRC Committee meets at least four times annually.

The six management level committees below will report to both the Board's GRC and Finance Committees (i) to the Board's GRC Committee for their charters, policies and reporting any exceptions to those policies and (ii) to the Board's Finance Committee for performance, particularly as it impacts the Bank's financial statements. The charters of each of these management committees were either created or amended in 2014 and were approved by the Board's GRC Committee in 2014.

***a) Risk Oversight Committee (Management Level)***

The purpose of the Risk Oversight Committee is to facilitate management and ensure the creation and successful implementation of policies and processes to measure, monitor, review and align the Risk Management practices of the Bank and to assist the GRC Committee fulfill their management and control responsibilities in accordance with prescribed legislation and corporate governance principles. The responsibilities of the Risk Oversight Committee are set out in its charter and includes all aspects of credit, market and operational risk. The Risk Oversight Committee and its charter were established in early 2014. It will meet at least four times annually and is flexible and nimble to meet as often as needed to address all risk issues as they are identified. The Risk Oversight Committee prepares the "Risk Appetite Statement" and presents it to the Board's GRC Committee at least annually.

***b) Credit Committee (Management Level)***

The Credit Committee is responsible for the oversight and control of credit risk in the Bank. The Credit Committee ensures the effectiveness of the credit risk management control framework built on policies and principles, including portfolio review, credit transaction approval within its discretion as well as delegated credit authority levels given to the appropriately skilled and trained individuals, policy approval and model performance oversight. The responsibilities of the Credit Committee are set out in its charter, which was amended in 2014. The Credit Committee generally meets weekly.

***c) Asset and Liability Committee (Management Level)***

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. ALCo decides what capital is available from a corporate perspective to allocate to each business segment. 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 ALCo are set out in its charter, which was amended in 2014. ALCo generally meets at least monthly.

***d) Portfolio Management Committee (Management Level)***

The Bank's Portfolio Management Committee and its charter were established in early 2014. This Committee's charter has a primary focus to optimize capital on a risk-adjusted and regulatory basis for each asset category. This Committee is responsible for the development, implementation, and control of standardized RAROC models to apply to asset categories across the organization. Using these models, capital is appropriately allocated to each proposed transaction in order to facilitate decision-making and ensure that the Bank's balance sheet is used in the most prudent and responsible way. This Committee also focuses on the Bank's product mix and the pricing parameters applied to the Bank's loans and deposits in order to achieve appropriate risk-adjusted returns whilst also considering prices offered by competitors in the marketplace.

***e) Asset Management Committee (Management Level)***

The Asset Management Committee and its charter were established in early 2014. It is responsible for the establishment and oversight of those policies and procedures that focus on two primary sources of risk; a) Risk of Loss, being non-market related risk, focusing on counterparty and operational risks, where the goal is to minimize risks to the level which is both cost effective and practical given the business scope, b) Market risk, unlike ‘risk of loss’, does not need to be minimized but rather optimized in order to maximize risk-adjusted returns for portfolios. The Committee oversees and monitors the general level of risk taken at the portfolio level via Investment Policy Statements (IPS’s), Strategic Asset Allocation, and Asset Classes. The Committee generally meets at least quarterly.

***f) Operational Risk Committee (Management Level)***

The Bank’s Operational Risk Committee and its charter were established in early 2014. This Committee’s charter encompasses all aspects of Operational Risk throughout the Bank and its subsidiaries. This Committee’s focus is on the broad range of non-market and credit risks embedded in the Bank’s business and shared services units and oversees and supports the Bank’s objectives regarding Operational Risk discussed in section 9 of this document. The Committee generally meets monthly.

## 4. CAPITAL STRUCTURE

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

### 4.1 Tier 1 Capital

Tier 1 Capital includes ordinary and preferred share capital, 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 Tier 1 Capital is made in respect of goodwill. Ordinary shares carry no right to regular dividends. The Bank's preferred shares are redeemable, floating rate with non-cumulative dividends.

### 4.2 Tier 2 Capital

Tier 2 Capital comprises fixed assets revaluation reserves, the collective allowance for credit losses and unrealized gains on equity securities.

The following table summarizes the composition of regulatory capital for the Bank, as a consolidated entity, as reported to the BMA, as at December 31, 2014.

	<u>December 31, 2014</u>
	<u>\$'000</u>
<b>Tier 1 Capital</b>	
Preferred Share Capital	20,000
Common Share Capital	5,000
Share Premium	7,200
Retained Earnings and Other Reserves	52,159
General Reserve	10,000
Current year's retained profit reviewed by external audit	523
Goodwill	(7,456)
<b>Total Tier 1 Capital</b>	<u><b>87,426</b></u>
<b>Tier 2 Capital</b>	
Fixed Assets Revaluation Reserves	1,049
Collective Allowance for Credit Losses	4,716
<b>Total Tier 2 Capital</b>	<u><b>5,765</b></u>
<b>Total Tier 1 and 2 Capital</b>	<u><u><b>93,191</b></u></u>
<b>Capital Ratios</b>	
Tier 1 Capital	14.56 %
Total Capital	15.52 %

## **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 whilst allowing for growth in the business.

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 II 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 December 31, 2014. Amounts are shown gross of any credit risk mitigation.

## Pillar 3 Disclosures

December 31, 2014



Pillar 1 capital requirements at minimum capital requirement of 8% as at December 31, 2014.

<b>Credit Risk Category</b>	<b>Asset \$'000</b>	<b>Risk weighted asset value \$'000</b>	<b>Minimum capital required \$'000</b>
<b>Treasury Assets</b>			
Cash	5,950	-	-
Sovereign and Multilateral Development Banks	137,764	-	-
Public Sector Entities: Treasury Assets	10,387	2,078	166
Corporates: Treasury Assets	17,825	3,716	297
Banks	76,452	15,290	1,223
Securitizations	101	236	19
<b>Total Treasury Assets</b>	<b>248,479</b>	<b>21,320</b>	<b>1,705</b>
<b>Loans and Advances to customers</b>			
Public Sector Entities: Loans & Advances	10,614	1,553	124
Corporates: Loans & Advances	18,761	18,761	1,501
Qualifying Revolving Retail	6,702	5,026	402
Other Retail	42,204	33,288	2,663
Mortgages	806,938	382,873	30,630
Off-Balance Sheet Commitments	20,845	2,266	181
<b>Total Loans and Advances to customers</b>	<b>906,064</b>	<b>443,767</b>	<b>35,501</b>
<b>Other assets</b>	<b>45,916</b>	<b>45,916</b>	<b>3,673</b>
<b>Total credit risk exposures and capital resources required</b>	<b>1,200,459</b>	<b>511,003</b>	<b>40,879</b>
<b>Operational risk capital requirement</b>	<b>-</b>	<b>89,380</b>	<b>7,150</b>
<b>Total Pillar 1 capital requirement</b>	<b>1,200,459</b>	<b>600,383</b>	<b>48,029</b>
<b>Total own funds per section 4</b>	<b>-</b>	<b>-</b>	<b>93,191</b>
<b>Excess of own funds over minimum requirement under Pillar 1</b>	<b>-</b>	<b>-</b>	<b>45,162</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 personal and business lending units.

### 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 internal limits or thresholds with key controls.

The Board, through its GRC 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, financial restructurings and for the portfolios as a whole are clearly specified;
- Target markets and product offerings are well defined at both the 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 a more senior lender, the Bank's Credit Committee or the Board for approval; and
- Single name/aggregation exposures, beyond which exposures must be reported and reviewed by the Credit Committee, with Board oversight.

The Bank's Global Loan Portfolio Group ("GLPG") 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 in any single borrower or related group of borrowers. A review of exposures in excess of 5% of the capital base is conducted by the Finance Committee on a quarterly basis.

An integral part of the GLPG 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 GLPG regularly review the various segments of the credit portfolio on an enterprise-wide basis 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 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, GLPG 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 that affect the amount of potential loss in the event of a default of the facility. Security typically takes the form of 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 GLPG is the final arbiter of internal risk ratings. Individual credit exposures are regularly monitored by both the business line units and GLPG for any signs of deterioration.



## 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 Finance Committee. Furthermore the portfolio will comply with the current 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 December 31, 2014. Amounts include on- and off-balance sheet exposures after applying regulatory credit conversion factors.

Exposures under the Standardized Approach	Average Exposure 2014 \$'000	Exposure as at Dec 31, 2014 \$'000
Cash	4,754	5,950
Sovereigns and Multilateral Development Banks	137,881	137,764
Public Sector Entities	22,663	21,001
Corporates	38,137	36,586
Banks and Securities Firms	84,705	76,452
Securitizations	107	101
Retail Loans	45,929	41,455
Residential Mortgages	678,345	655,353
Commercial Mortgages	70,325	68,453
Past Due Loans	88,459	90,582
Other Balance Sheet Exposures	53,567	45,916
Off-Balance Sheet Commitments	5,211	20,845
<b>Total Exposures under the Standardized Approach</b>	<b>1,230,083</b>	<b>1,200,458</b>

## 6.4 Standardized Gross Exposures by Geographical Area

The table below shows an analysis of credit risk by geographical location as at December 31, 2014. 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>Total</b>
	<b>\$'000</b>	<b>\$'000</b>
Cash	5,950	5,950
Sovereigns and Multilateral Development Banks	137,764	137,764
Public Sector Entities	21,001	21,001
Corporates	36,586	36,586
Banks and Securities Firms	76,452	76,452
Securitizations	101	101
Retail Loans	41,455	41,455
Residential Mortgages	655,353	655,353
Commercial Mortgages	68,453	68,453
Past Due Loans	90,582	90,582
Other Balance Sheet Exposures	45,916	45,916
Off-Balance Sheet Commitments	20,845	20,845
<b>Total Exposures under the Standardized Approach</b>	<b>1,200,458</b>	<b>1,200,458</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 December 31, 2014. 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 Exposures by Residual Maturity</b>	<b>Within 1 year \$'000</b>	<b>After 1 but within 5 years \$'000</b>	<b>After 5 years \$'000</b>	<b>Total \$'000</b>
Cash	5,950	-	-	5,950
Sovereigns and Multilateral Development Banks	60,109	75,295	2,360	137,764
Public Sector Entities	-	13,236	7,765	21,001
Corporates	-	19,104	17,482	36,586
Banks and Securities Firms	55,948	20,504	-	76,452
Securitizations	-	-	101	101
Qualifying Revolving Retail	3,999	2,720	-	6,719
Other Retail	5,641	15,111	21,434	42,186
Mortgages	27,522	21,447	757,969	806,938
Other Balance Sheet Exposures	4,553	-	41,363	45,916
Off-Balance Sheet Commitments	16,305	4,540	-	20,845
<b>Total Exposures under the Standardized Approach</b>	<b>180,027</b>	<b>171,957</b>	<b>848,474</b>	<b>1,200,458</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 December 31, 2014:

### 6.6.1 Sovereigns and MDB’s

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	\$'000	\$'000
1	0%	137,764	137,764
<b>Total</b>		<b>137,764</b>	<b>137,764</b>

### 6.6.2 Public Sector Entities

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	\$'000	\$'000
1	20%	21,001	18,153
<b>Total</b>		<b>21,001</b>	<b>18,153</b>

## 6.6.3 Corporates

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	\$'000	\$'000
1	20%	17,321	17,321
2	50%	504	504
3	100%	18,761	18,761
<b>Total</b>		<b>36,586</b>	<b>36,586</b>

## 6.6.4 Banks

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	\$'000	\$'000
1	20%	58,136	58,136
2	20%	9,646	9,646
3	20%	8,670	8,670
<b>Total</b>		<b>76,452</b>	<b>76,452</b>

## 6.7 Past Due and Impaired Financial Assets

Impaired loans and advances are defined as loans and advances in respect of which the Bank has raised a specific impairment allowance. A specific impairment allowance is raised in respect of a loan when objective evidence demonstrates that a loss event has occurred and the present value of expected future cash flows is less than the carrying value of the loan. Such objective evidence may include significant financial difficulty of the borrower, a breach of contract such as a default or delinquency in interest or principal payments, or a decline in the value of collateral held against a past due loan, with ageing arrears as the primary driver.

No other financial assets were considered to be impaired as at December 31, 2014.

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 amount required to meet expected future losses arising on the portfolios of loans, mortgages and credit card receivables. 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.

The collective provision calculation is based on a roll-rate approach, where the percentage of assets that move from initial delinquency to default is derived from statistical probabilities based on experience. Recovery amounts are calculated using a weighted average for the relevant portfolio. Future cash flows for a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the group and the historical loss experienced for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based, and to remove the effect of conditions in the historical period that do not currently exist.

## Pillar 3 Disclosures

December 31, 2014



The following tables show the past due and impaired loans as at December 31, 2014 for the Bank, as well as the movement on collective and specific allowances for the year ended December 31, 2014.

	<b>Commercial Mortgages \$'000</b>	<b>Residential Mortgages \$'000</b>	<b>Retail &amp; Other Loans \$'000</b>	<b>Total Loans Dec 31, 2014 \$'000</b>
Past due, but not impaired:				
7 to 90 days*	1,140	43,742	3,003	47,884
More than 90 days	5,026	39,893	3,197	48,116
Individually assessed impairments:				
7 to 90 days*	1,357	278	377	2,013
More than 90 days	18,297	34,290	7,778	60,365
	<b>25,820</b>	<b>118,203</b>	<b>14,355</b>	<b>158,378</b>
Net impairment loss on financial assets for the period ended December 31, 2014 as recorded in the Bank's Profit & Loss Statement	4,508	4,295	1,018	9,821

	<b>Specific Provisions \$'000</b>	<b>Collective Provisions \$'000</b>	<b>Total Provisions \$'000</b>
Balance at Jan 1, 2014	11,634	4,185	15,819
Net write-offs	(2,934)	-	(2,934)
Provision for credit losses	9,290	531	9,821
Balance at December 31, 2014	<b>17,990</b>	<b>4,716</b>	<b>22,706</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.

Loan officers, through their credit underwriting analysis and under the guidance of GLPG, 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, and 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 directly vetted by GLPG.

### **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 \$11.4 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.

The exposure value to the counterparty is derived by adding the net market value of the contract (replacement cost) to the contract's potential credit exposure, which is derived by applying a multiple based on the contract's residual maturity to the notional value of the contract.



The following table shows the exposures to counterparty credit risk for derivative contracts held by the Bank as at December 31, 2014.

	<b>Notional Principal Amount \$'000</b>	<b>Potential future Credit Exposure \$'000</b>	<b>Credit Equivalent Amount \$'000</b>
Foreign Exchange Contracts	0	0	0
<b>Total</b>	<b>0</b>	<b>0</b>	<b>0</b>

Wrong way risk is not material to the Bank, however, it may occur. Wrong way risk may occur when exposure to a counterparty is adversely correlated with the credit quality of that counterparty. An example being that an exposure is likely to increase as the creditworthiness of the counterparty decreases. Such factors are taken into account when counterparty/country reviews are undertaken.

#### 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 December 31, 2014:

<b>Credit quality step</b>	<b>Risk weight %</b>	<b>Exposure \$'000</b>	<b>Exposure after credit risk mitigation \$'000</b>
3	100%	47	47
4	350%	54	54
<b>Total RWA</b>		<b>101</b>	<b>101</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 Finance 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 Finance 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 is 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 using a combination of derivative instruments and cash instruments such as loans and deposits.

Periodically, the Bank enters into interest rate swap contracts to manage the risks associated with certain of its financial instruments. 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. 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 Finance 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 December 31, 2014. 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. In light of the current low interest rate environment, the Bank does not believe it is reasonably possible for there to be a substantial decrease in interest rates.

	<b>Increase in net interest income and equity</b>
100 basis point increase	\$ 3,746
200 basis point increase	\$ 7,508

## **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 Bank has a repurchase facility with an S&P A- rated financial institution which was undrawn at December 31, 2014.

The development and implementation of a liquidity policy is the responsibility of ALCo, and, is ratified by the Finance 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 Finance 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.

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.

The Bank has defined its approach to Operational Risk Management (“ORM”) in a formal policy framework that, in the future, will be approved by the Bank’s Board level GRC Committee. This policy operates within the boundaries of the Group’s overarching ERM policy framework. Key objectives are as follows:

- Identify and manage key operational risks and supporting control framework (including cross-enterprise risks);
- Promote ownership, training and awareness with respect to the key operational risks the entity faces;
- Align operational risk profile with risk appetite and strategy;
- Enhance operational risk response decisions;
- Reduce operational risk incidents and losses;
- Manage effective deployment of IT resources; and
- Manage an effective Business Continuity Planning (“BCP”) process.

The Group approach to achieve these objectives includes:

- The implementation of an appropriate ERM framework and governance model;
- Adoption of traditional three lines of defense risk model (risk owners, risk oversight and independent audit);
- The approval, implementation, management and training with respect to appropriate operational risk policies and procedures aligned to strategy;
- The assignment of Executive/Business Risk Owners throughout the Group’s operating units;
- Development of a business level operational risk toolkit;
- Development of operational risk mitigation strategies including:
  - Information Technology risk management;
  - Outsourcing/vendor management;
  - BCP and testing; and
  - Insurance.
- Oversight and monitoring; and
- Effective Management and Board Reporting.

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