Clarien Bank Limited

Interim Pillar 3 Disclosures

June 30, 2018

CLARIEN

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1. CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING STATEMENTS

These Capital and Risk Management Pillar 3 Disclosures as at June 30, 2018 contain certain forward-looking statements with respect to the consolidated 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.

The Net Stable Funding Ratio ('NSFR') was also adopted by the BMA, this ensures that the Bank maintains a stable funding profile in relation to the composition of their assets over a one year horizon, and from January 1, 2018 the BMA requires all Banks to maintain a 100% NSFR.

Further information regarding the implementation of Basel III can be found on the Bermuda Monetary Authority's website www.bma.bm.

2.3 Basis of Disclosure

The following represents the Bank's Pillar 3 disclosures as of June 30, 2018. 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, 2018 include the results of operations for the following subsidiary companies, all of which are wholly owned:

Legal entity	Activity
First Bermuda Group Limited	Holding Company
First Bermuda Securities Limited	Brokerage Services; Subsidiary of First Bermuda Group Limited
Onshore Nominees Limited	Nominee Company of First Bermuda Group Limited
Offshore Nominees Limited	Nominee Company of First Bermuda Group Limited
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, 2018 are available on the Bank's website (www.clarienbank.com).

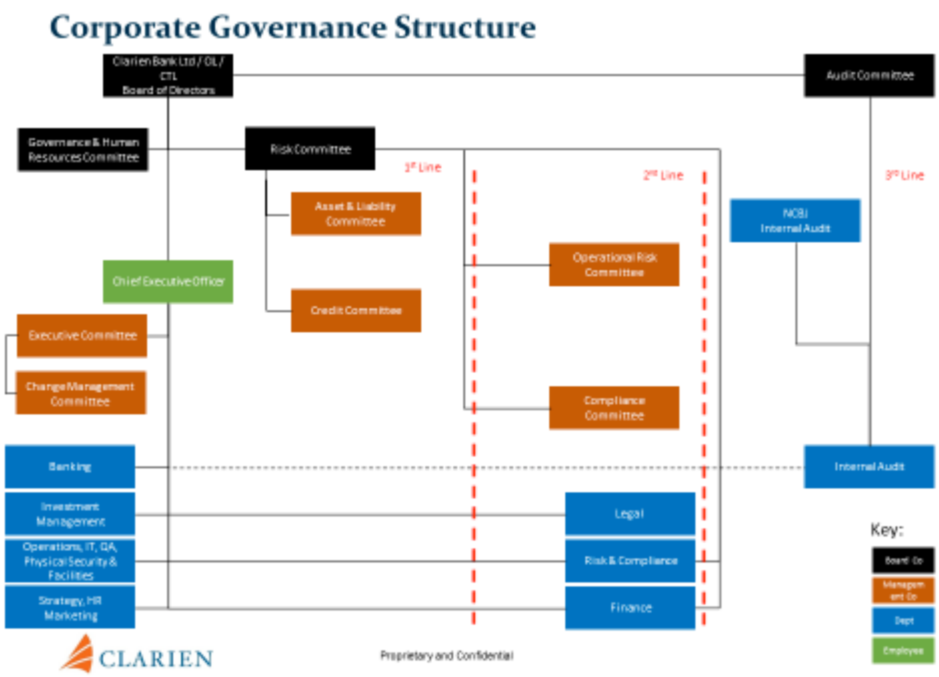
3. RISK MANAGEMENT OBJECTIVES AND POLICIES

3.1 Governance

The Bank's governance structure enables oversight and accountability for the effective management of risk. The Bank has implemented a robust structure to provide clear lines of responsibility, accountability and a greater focus on risk management.

A representation of the Bank's risk governance structure is provided below. The Boards of CTL and CIL report directly to the Board of CBL, as represented in this diagram. Additionally, the business activities of CTL and CIL, as well as the business activities of the Bank, are overseen by the Bank's management-level Operational Risk, Change Management Committee and Compliance Committees.

The Group has adopted the three lines of defense model which addresses how specific duties related to risk and internal control are assigned and coordinated. This ensures that responsibilities for risk management are clearly articulated to all levels of the Bank.



Boards & Board Committees

The Board is ultimately responsible for oversight of the Group, and has established Board Committees, with delegated authority to assist the Board in discharging its duties. These Board Committees are as follows:

- Audit Committee;
- Governance and Human Resources 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.

Additionally, the Boards of the Bank's subsidiaries, Clarien Investments Limited and Clarien Trust Limited, report to the Bank's Board at least quarterly on the activities of those subsidiaries.

Audit Committee

The Audit Committee is responsible for ensuring the adequacy of the Group'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 Group's internal control system, the 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 chartered public accountants engaged as the Group's independent auditor. An additional key role of the Committee is to maintain an open avenue of communication between it and the independent auditor, the Bank's management and its internal auditors.

Governance and Human Resources ("GHR") Committee

The GHR Committee is responsible for assisting the Board in fulfilling its oversight responsibilities for the Group's corporate governance framework. This includes monitoring Board committee effectiveness, Director nominations, assessment and remuneration. The Committee is also responsible for assisting the Board in fulfilling its oversight responsibilities for the appointment, performance evaluation and compensation of the Chief Executive Officer and certain other Senior Executives, talent development, retention strategies and succession planning, philosophy and principles for compensation programs and the design and application of material compensation programs.

Risk Committee

The Risk Committee provides oversight of the Group's ERM Framework and risk function, including the strategies, policies, procedures, processes, and systems, established by management to identify, assess, measure, monitor, and manage the key risks facing the Group. The Committee assists the Board of Directors and its other committees to oversee specific risk-related issues including setting overall risk appetite and mitigating risks inherent to the Group's business. The Committee oversees the process by which risk-based regulatory capital requirements are determined, including the Bank's internal capital assessment and risk profile. The Committee provides a supportive culture, setting the "tone at the top" in relation to the management of risk and maintenance of a strong internal control framework that fulfils the expectations of stakeholders and is consistent with safe and sound banking practices.

The following Committees report to the Risk Committee:

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 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.

Compliance Committee

The general purpose of the Compliance Committee is to provide executive management oversight of the Group's Compliance Function, including the strategies, policies, procedures and systems established by management to identify, assess, measure, monitor and manage the key compliance risks facing the Group.

The Compliance Committee assists the Boards of Directors for each Group company and the Board Risk Committee of the Bank in their obligations of oversight of the Group's Compliance Function, and the identification, assessment and effective mitigation of compliance risks to the Group. The Committee reports to the Executive Committee and the Bank Board Risk Committee meets at least quarterly.

Operational Risk Committee

The Operational Risk Committee is responsible for all aspects of operational risk. This Committee focuses on operational risks of the Group, and shared services units, and oversees and supports the Bank's objectives regarding operational risk. The responsibilities of the Operational Risk Committee are set out in its Charter and it generally it meets at least monthly.

Management Level Committees

The Board Committees are supported by management level committees, namely: the Executive Committee, the Credit Committee, the Asset and Liability Committee ("ALCo"), the Compliance Committee, the Operational Risk Committee, and the New Products Committee. Each of these management level committees are directly responsible for defined areas of risk, developing related risk management policies and procedures and quarterly reporting to the Risk Committee.

Executive Committee

The Board delegates its authority to the Executive Committee of the Bank ("ExCo") to manage the day-to-day activities of the Bank and its subsidiaries, Clarien Trust Limited and Clarien Investments Limited, and ensure that the Group's activities are consistent with the execution of business plans and strategy. In doing so the ExCo monitors and reviews business units' performance against plan, and the Group's activities' alignment to approved risk appetite metrics, thresholds and tolerances and adherence to policies approved by the Bank's Board.

The ExCo's responsibilities include the receipt, review and challenge of regular, at least quarterly, formal reports from the ExCo membership (comprised of the Executive Management Team for the Group) with respect to their area of responsibility, and comparison of each business unit's, and the Group's financial and operational performance against the Group's Strategic Plan.

Change Management Committee

The Change Management Committee ("CMC") is responsible for the governance, oversight and monitoring of the Bank's programme for change management and portfolio of approved projects. The CMC is also responsible for review and approval of new products and significant revisions to existing products offered by the Bank or its subsidiaries. The CMC reports to the ExCo management committee.

3.2 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 Group. The process is 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 Group's objectives.

The Group has in place an Enterprise Risk Policy that:

- Clearly articulates the Group's approach to risk governance and Enterprise Risk Management ("ERM"); and
- Provides clear linkage between the Group's strategic and governance arrangements, and operational considerations detailed in the ERM Framework.

The Group has in place an ERM Framework which 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.

4. KEY PRUDENTIAL METRICS

The table below provides an overview of the Banks key prudential regulatory metrics for the previous 5 quarters.

KM01 Key Metrics $'000	Jun-18	Mar-18	Dec-17	Sep-17	Jun-17
Available capital (amounts)					
Common Equity Tier 1 (CET1)	114,053	106,790	105,254	81,194	81,417
Tier 1	114,053	106,790	105,254	101,194	101,417
Total capital	116,148	109,302	111,115	107,485	107,273
Risk-weighted assets (amounts)					
Total risk-weighted assets (RWA)	586,327	587,156	583,051	604,253	605,438
Risk-based capital ratios as a percentage of RWA					
Common Equity Tier 1 ratio (%)	19.45%	18.19%	18.05%	13.44%	13.45%
Tier 1 ratio (%)	19.45%	18.19%	18.05%	16.75%	16.75%
Total capital ratio (%)	19.81%	18.62%	19.06%	17.79%	17.72%
Additional CET1 buffer requirements as a percentage of RWA					
Capital conservation buffer requirement (2.5% from 2019) (%)	1.88%	1.88%	1.88%	1.88%	1.88%
Countercyclical bugger requirement (%)	-	-	-	-	-
Bank D-SIB additional requirements (%)	1.00%	1.00%	1.00%	1.00%	1.00%
Total of bank CET1 specific buffer requirements (%) (row 8 + row 9+ row 10)	2.88%	2.88%	2.88%	2.88%	2.88%
CET1 available after meeting the bank's minimum capital requirements (%)	12.70%	11.44%	11.30%	6.69%	6.70%
Basel III Leverage Ratio					
Total Basel III leverage ratio measure	1,246,559	1,242,097	1,205,318	1,246,713	1,209,426
Basel III leverage ratio (%) (row 2/row 13)	9.15%	8.60%	8.73%	8.12%	8.39%
Liquidity Coverage Ratio					
Total HQLA	411,355	373,126	363,356	366,370	331,502
Total net cash outflow	251,922	216,758	246,395	231,677	213,073
LCR ratio (%)	156%	165%	143%	151%	148%
Net Stable Funding Ratio					
Total available stable funding	1,240.3	1,234.1	1,189.4	1,063.3	1,178.2
Total required stable funding	1,235.5	1,232.6	1,189.7	1,230.9	1,191.2
NSFR ratio (%)	146%	142%	145%	144%	138%

There was an increase in CET1 capital as the Banks preference shares were removed from the additional Tier 1 capital in December 31, 2017, as they were repaid.

5. CAPITAL STRUCTURE

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

5.1 Total Common Equity Tier 1 Capital

Total Common Equity Tier 1 Capital ("CET 1") includes ordinary shares, 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.

5.2 Tier 2 Capital

Tier 2 Capital comprises of the expected credit losses, stage 1.

The table below shows a reconciliation between accounting and regulatory capital.

LI1 Reconciliation of Capital amounts in $'000

Reconciliation of accounting capital to regulatory capital	**Jun-18**
Common share capital	5,000
Retained earnings	61,096
Contributed surplus	46,406
General reserve	10,000
Accumulated other comprehensive income	(3,853)
Total Shareholder's Equity	**118,649**
Regulatory adjustments:	
Goodwill	(7,456)
AOCI: Unrealized gains(losses) on AFS Porfolio	3,854
Revaluation adjustement	(994)
Total CET 1 Capital	**114,053**

5.3 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 table below provides a reconciliation of accounting assets and the leverage exposure measure as at June 30, 2018

LR1 Ratio Exposure measure amounts in $'000	**Jun-18**
Total consolidated assets as per published financial statements	1,243,967
Adjustments for investments in banking, financial, insurance or commercial entities that are consolidated for accounting purposes but outside the scope of regulatory consolidation	(7,457)
Adjustments for off-balance sheet items (ie conversion to credit equivalent amounts of off-balance sheet exposures)	10,048
Other adjustments	0
Leverage ratio exposure measure	**1,246,559**

The Bank's ratio exceeds the minimum requirement as disclosed in the table below as prescribed in the guidance, as at June 30, 2018.

	LR2 Leverage Ratio amounts in $'000	**Jun-18**	**Mar-18**
On-balance sheet exposures			
	On-balance sheet exposures (excluding derivatives and securities financing transactions (SFTs), but including collateral)	1,243,967	1,242,592
	(Asset amounts deducted in determining Basel III Tier 1 capital)	(7,457)	(7,457)
	Total on-balance sheet exposures (excluding derivatives and SFTs)	1,236,511	1,235,136
Other off-balance sheet exposures			
	Off-balance sheet exposure at gross notional amount	46,001	36,316
	(Adjustments for conversion to credit equivalent amounts)	(35,953)	(29,354)
	Off-balance sheet items	10,048	6,962
Capital and total exposures			
	Tier 1 capital	114,053	106,789
	Total exposures	1,246,559	1,242,097
Leverage ratio			
	Basel III leverage ratio	9.15%	8.60%

6. CAPITAL ADEQUACY

6.1 Overview

Capital is held to provide a cushion for unexpected losses. The Board sets the internal level of capital within its risk tolerance articulated in the risk appetite statement 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.

6.2 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 following table shows the Bank's overall minimum Pillar I capital requirement for credit, operational, and market risk, based on 8% of risk weighted assets as at June 30, 2018.

OV1 Risk Weighted Assets	**RWA**		**Minimum capital requirements**
amounts in $'000	**Jun-18**	**Mar-18**	**Jun-18**
Credit risk (excluding counterparty credit risk)	**500,623**	**499293**	**40,049.8**
Of which: standardised approach (SA)	500,623	499,293	40,049.8
Equity positions under the simple risk weight approach	641	639	51.3
Securitisation exposures in the banking book	**53**	**54**	**4.2**
Of which: securitisation standardised approach (SEC-SA)	53	54	4.2
Market risk	-	-	-
Of which: standardised approach (SA)	-	-	-
Operational risk	85,010	87,171	6,801
Total	**586,327**	**587,157**	**46,906**

7. 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.

The table below shows the credit quality of assets as at June 30, 2018.

CR1 Credit Quality of Assets	Carrying values of		Allowances/ impairments	Net values
amounts in $'000	Defaulted exposures	Non-defaulted exposures		
Loans	96,095	674,845	28,475	742,465
Debt securities	0	413,281	0	413,281
Off-balance sheet exposures	0	46,001	0	46,001
Total	**96,095**	**1,134,128**	**28,475**	**1,201,748**

7.1 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
- Sufficient information and data is maintained 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, Collections and Workouts 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.

7.1.1 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.

7.2 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 7.6, supplemented by internal analysis to manage the risks associated with interbank lending and investment activities.

7. 3 Average and Total Credit Risk Exposure

The following table sets out asset class exposures as at June 30, 2018. Amounts include on- and off-balance sheet exposures after applying regulatory credit conversion factors.

Exposures under the standardised approach	**Average Exposure $'000**	**Exposure as at Jun-18 $'000**
Cash	8,551	7,992
Claims on Sovereigns and multilateral development banks	298,956	331,753
Claims on Public Sector Entities	29,503	25,721
Claims on Corporates	44,692	62,540
Claims on Banks and Securities Firms	91,372	67,529
Securitisations	56	53
Retail Loans	30,562	29,892
Residential Mortgages	541,901	533,883
Commercial Mortgages	69,153	74,765
Past Due Loans	73,123	67,620
Other Balance Sheet Exposures	36,317	35,076
Non-market Related Off Balance Sheet Credit Exposures	47,625	46,001
Total exposures under the standardised approach	**1,271,811**	**1,282,826**

7. 4 Standardized Gross Exposure by Geographical Area

The table below shows and analysis of credit risk by geographical location as at June 30, 2018. The geographical area is determined by the country of incorporation for companies and individuals by the country of residence.

Exposures under the standardised approach	North America $'000	Europe $'000	Asia & Middle East $'000	Total $'000
Cash	7,992	-	-	7,992
Claims on Sovereigns and multilateral development banks	312,095	10,014	9,645	331,753
Claims on Public Sector Entities	25,721	-	-	25,721
Claims on Corporates	62,540	-	-	62,540
Claims on Banks and Securities Firms	67,529	-	-	67,529
Securitisations	53	-	-	53
Retail Loans	29,892	-	-	29,892
Residential Mortgages	533,883	-	-	533,883
Commercial Mortgages	74,765	-	-	74,765
Past Due Loans	67,620	-	-	67,620
Other Balance Sheet Exposures	35,076	-	-	35,076
Non-market Related Off Balance Sheet Credit Exposures	46,001	-	-	46,001
Total exposures under the standardised approach	**1,263,167**	**10,014**	**9,645**	**1,282,826**

7. 5 Standardized Gross Exposures by Residual Maturity

The table below sets out an analysis of credit risk by maturity as at June 30, 2018. 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.

Asset class exposures by residual maturity	Within 1 yr $'000	After 1 but within 5 years $'000	After 5 years $'000	Total $'000
Cash	7,992	-	-	7,992
Claims on Sovereigns and multilateral development banks	215,969	110,082	5,702	331,753
Claims on Public Sector Entities	9,933	9,920	5,869	25,721
Claims on Corporates	2,255	33,234	27,051	62,540
Claims on Banks and Securities Firms	38,036	29,492	-	67,529
Securitisations	-	-	53	53
Retail	8,639	8,077	13,177	29,892
Residential Mortgages	1,543	32,588	499,752	533,883
Commercial Mortgages	11,916	20,977	41,872	74,765
Past Due Laons	4,475	4,086	59,058	67,620
Other Balance Sheet Exposures	3,812	-	31,264	35,076
Non-market Related Off Balance Sheet Credit Exposures	32,760	13,241	-	46,001
Total exposures under the standardised approach	**337,330**	**261,697**	**683,798**	**1,282,826**

7.6 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, 2018:

Sovereigns and MDB's

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	$'000	$'000
1	0%	315,265	315,265
2	20%	16,488	16,488
Total		**331,753**	**331,753**

Public Sector Entities

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	$'000	$'000
1	20%	9,933	9,933
2	50%	15,788	15,788
Total		**25,721**	**25,721**

Corporates

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	$'000	$'000
1	20%	12,251	12,251
2	50%	11,952	11,952
3	100%	38,337	37,248
Total		**62,540**	**61,451**

Banks and securities firms

Credit quality step	Risk weight	Exposure	Exposure after credit risk mitigation
	%	$'000	$'000
1	20%	67,529	47,944
Total		**67,529**	**47,944**

7.7 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, 2018.

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

7.7.1 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 90 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.

CR2 Changes in defaulted loans and securities amounts in $'000	Jun-18
Defaulted loans and debt securities at the end of the previous reporting period	70,138
Loans and debt securities that have defaulted since the last reporting period	1,325
Returned to non-default status	(2,398)
Amounts written off	(3,211)
Other changes	1,766
Defaulted loans and debt securities at the end of the reporting period	**67,620**

7.7.2 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 and future macroeconomic 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 losses within the loan, mortgage and credit card portfolios. The allowance for credit losses consists of stage 1-3 loan loss allowances as determined under the IFRS 9 accounting standard. The 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.

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 derived from actual loss experience.

The following tables show the past due and impaired loans as at June 30, 2018 for the Bank, as well as the movement on provisions for the six months ended June 30, 2018.

	Commercial Mortgage	Residential Mortgage	Retail & Other	Total Loans Jun 30, 2018
Past due, but not individually impaired	**$'000**	**$'000**	**$'000**	**$'000**
Up to 90 days	-	16,284	1,021	**17,305**
More than 90 Days	4,949	9,810	855	**15,614**
Individually impaired loans				
Up to 90 days	-	13,265	3,634	**16,899**
More than 90 Days	4,500	36,636	9,807	**50,943**
Total	**9,449**	**75,995**	**15,317**	**100,762**
Net impairment loss on financial assets for the period ending June 30, 2018 as recorded in the Banks Profit and Loss Statement	111.73	898.57	181.11	1,191.41

Amounts in $'000	Stage 1	Stage 2	Stage 3	Total
Balance at January 1, 2018	2,875.95	3,420.57	25,588.71	**31,885**
Net Write offs	-	-	(3,211.31)	**(3,211)**
Recoveries	-	-	704.76	**705**
Provision for credit losses	(780.91)	(2,861.17)	4,833.49	**1,191**
Balance at June 30, 2018	**2,095**	**559**	**27,916**	**30,570**

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

7.8 Credit Risk Mitigation

7.8.1 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 CRM, 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 CRM.

The following table reflects the split between the Banks secured and unsecured exposures, as at June 30, 2018.

CR3 CRM techniques	a	b	c	d	e	f	g
Amounts in $000	Exposures unsecured: carrying amount	Exposures secured by collateral	Exposures secured by collateral of which: secured amount	Exposures secured by financial guarantees	Exposures secured by financial guarantees, of which: secured amount	Exposures secured by credit derivatives	Exposures secured by credit derivatives, of which: secured amount
Loans	565	741,900	741,900	-	-	-	-
Debt securities	413,281	-	-	-	-	-	-
Total	413,847	741,900	741,900	-	-	-	-
Of which defaulted	112	67,508	67,508	-	-	-	-

7.8.2 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.

7.8.3 Financial Collateral

The overall value of financial collateral used as credit risk mitigation within the Pillar 1 calculations was $10.8 million against loans and advances to customers, predominately retail loans, as incorporated in the determination of RWA values in Section 5.2 above.

The tables that follow demonstrate the effects of the CRM techniques as at June 30, 2018.

CR4 Credit Mitigation Effects amounts in $000s	Exposures before CCF and CRM		Exposures post-CCF and CRM		RWA and RWA density	
Asset classes	**On-balance sheet amount**	**Off-balance sheet amount**	**On-balance sheet amount**	**Off-balance sheet amount**	**RWA**	**RWA density**
Sovereigns and their central banks	331,753	-	331,753	-	3,298	0.99%
Non-central government public sector entities	25,721	-	25,721	-	9,881	38.41%
Multilateral development banks	-	-	-	-	-	-
Banks	67,529	-	47,944	-	9,589	20.00%
Securities firms	53	-	53	-	114	216.67%
Corporates	62,540	-	61,451	-	45,675	74.33%
Regulatory retail portfolios	29,892	-	23,935	-	18,600	77.71%
Secured by residential property	533,883	-	531,854	-	196,258	36.90%
Secured by commercial real estate	74,765	-	73,077	-	73,077	100.00%
Equity	641	-	641	-	641	100.00%
Past-due loans	67,620	-	67,598	-	101,397	150.00%
Higher-risk categories	-	-	-	-	-	-
Other assets	34,435	46,001	34,435	10,044	42,788	124.26%
Total	**1,228,833**	**46,001**	**1,198,463**	**10,044**	**501,316**	**41.83%**

CR5 Exposures by class and RWA amounts in $'000s										
Risk weight* / Asset classes	0%	10%	20%	35%	50%	75%	100%	150%	Others	Total credit exposures amount (post CCF and post-CRM)
Sovereigns and their central banks	257,324	-	16,488	-	-	-	-	-	-	273,812
Non-central government public sector entities	-	-	9,933	-	15,789	-	-	-	-	25,721
Multilateral development banks	57,942	-	-	-	-	-	-	-	-	57,942
Banks	-	-	67,529	-	-	-	-	-	-	47,944
Securities firms	-	-	-	-	-	-	28	-	25	53
Corporates	-	-	12,251	-	11,952	-	38,337	-	-	61,451
Regulatory retail portfolios	-	-	-	-	-	27,298	2,594	-	-	23,935
Secured by residential property	-	-	-	508,610	-	25,273	-	-	-	531,854
Secured by commercial real estate	-	-	-	-	-	-	74,765	-	-	73,077
Equity	-	-	-	-	-	-	641	-	-	641
Past-due loans	-	-	-	-	-	-	-	67,620	-	67,598
Higher-risk categories	-	-	-	-	-	-	-	-	-	-
Other assets	-	-	-	-	-	-	34,435	-	-	34,435
Total	315,266	-	106,200	508,610	27,741	52,571	150,800	67,620	25	1,198,463

7.9 Counterparty Credit Risk for Derivative Contracts *

The Bank may use 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 table below shows the Banks exposures to CCR for derivative contracts as at June 30, 2018.

CCR1 Counterparty Credit Risk amounts in $'000	Replacement cost	Potential future exposure	EEPE	Alpha used for computing regulatory EAD	EAD post-CRM	RWA
SA-CCR (for derivatives)	132	1		1.4	4	1
Total						**1**

** Includes unsettled spot transactions*

7.10 Securitizations

The Bank's only exposure to securitizations is through investment in third party securities, the holding at June 30, 2018 amounted to $53k.

SEC2 Securitizations amounts in $'000	Bank acts as originator			Bank acts as sponsor			Bank acts as investor		
	Traditional	Synthetic	Sub-total	Traditional	Synthetic	Sub-total	Traditional	Synthetic	Sub-total
Retail (total) - of which	-	-	-	-	-	-	**53**	-	**53**
residential mortgage			-			-	53		53

SEC4 Capital Requirements amounts in $'000	Exposure values (by RW bands)					Exposure	RWA	Capital Charge
	≤20% RW	>20% to 50% RW	>50% to 100% RW	>100% to <1250% RW	1250% RW	SA/SSFA	SA/SSFA	SA/SSFA
Total exposures	-	-	-	-	-	-	-	-
Traditional securitisation	-	-	-	-	-	-	-	-
Of which securitisation	-	-	28	25	-	53	86	6.88
Of which retail underlying	-	-	28	25	-	53	86	6.88
Of which wholesale	-	-	-	-	-	-	-	-
Of which re-securitisation	-	-	-	-	-	-	-	-
Of which senior	-	-	-	-	-	-	-	-
Of which non-senior	-	-	-	-	-	-	-	-

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.

8.1 Liquidity coverage ratio (LCR)

The objective of the LCR is to promote the short term resilience of the liquidity risk profile of the bank. It ensures that the bank has an adequate stock of unencumbered high-quality liquid assets that could be converted easily to meet its liquidity needs for a 30 day liquidity stress scenario. Currently, the requirement is 90% for 2018, rising to 100% by 2019.

The banks HQLA is comprised predominantly of US sovereign debt.

LIQ01 LCR disclosure template amounts in $'000	Total unweighted value (average)	Total weighted value (average)
High-quality liquid assets		
Total HQLA		394,101
Cash outflows		
Retail deposits and deposits from small business customers, of which:		
Stable deposits	-	-
Less stable deposits	742,914	41,899
Unsecured wholesale funding, of which:		
Operational deposits (all counterparties) and deposits in networks of cooperative banks	38,744	3,224
Non-operational deposits (all counterparties)	326,952	238,122
Secured wholesale funding		
Additional requirements, of which:		
Credit and liquidity facilities	16,366	1,493
Other contractual funding obligations	3,970	3,970
Other contingent funding obligations	566	28
TOTAL CASH OUTFLOWS		288,736
Cash inflows		
Inflows from fully performing exposures	41,209	36,814
TOTAL CASH INFLOWS	41,209	36,814
		Total adjusted value
Total HQLA		394,101
Total net cash outflows		251,922
Liquidity coverage ratio (%)		156%

8.2 Net Stable Funding Ratio (NSFR)

The NSFR requires bank's to maintain a stable funding profile in relation to the composition of their assets and off balance sheet activities, looking over a one year horizon. The BMA requirement is 100% coverage.

LIQ2 NSFR disclosure template amounts in $'000	Unweighted value by residual maturity				Weighted value
	No maturity*	<6 months	6 months to 1 year	≥1 year	
Available stable funding (ASF) item					
Capital:	-	-	-	112,807	112,807
Regulatory capital	-	-	-	112,807	112,807
Retail deposits and deposits from small business customers:	-	476,616	108,842	196,200	723,112
Less stable deposits	-	476,616	108,842	196,200	723,112
Wholesale funding:	-	277,716	16,661	32,574	105,243
Operational deposits	-	277,716	16,661	32,574	105,243
Other liabilities:	-	18,873	-	-	-
All other liabilities and equity not included in the above categories	-	18,873	-	-	-
Total ASF					941,162
Required stable funding (RSF) item					
Total NSFR high-quality liquid assets (HQLA)					-
Performing loans and securities:	-	9,205	10,093	657,042	485,192
Performing loans to non-financial corporate clients, loans to retail and small business customers, and loans to sovereigns, central banks and PSEs, of which:	-	8,211	9,577	241,638	214,286
With a risk weight of less than or equal to 35% under the Basel II standardised approach for credit risk		994	515	414,710	270,316
Securities that are not in default and do not qualify as HQLA, including exchange-traded equities	-	-	-	694	590
Other liabilities:		211,698	15,056	292,377	158,556
All other assets not included in the above categories	0	211,698	15,056	292,377	158,556
Off-balance sheet items				30,717	297
Total RSF					**644,046**
Net Stable Funding Ratio (%)					**146%**

9. 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 can be 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.

9.1 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 may at its option hedge 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, this includes the completion of stress testing on a monthly basis of the impact of an immediate shift in interest rates of +/- 200 basis points on Net Interest Income over the next twelve months. 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.

10 OPERATIONAL RISK

10.1 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.

10.2 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 (β) assigned to that business line. Audited gross income is averaged over 3 years, with β 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.

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