



United National Bank Limited

**Capital Requirements Directive
Pillar 3 Disclosures**

as at 31 December 2010

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1) Introduction

The original Basel Accord was agreed in 1988 by the Basel Committee on Banking Supervision. The 1988 Accord, now referred to as Basel 1, helped to strengthen the soundness and stability of the international banking system as a result of the higher capital ratios that it required.

Basel 2 is a revision of the existing framework, which aims to make the framework more risk sensitive and representative of modern banks' risk management practices.

The new Basel Accord (Basel 2) has been implemented in the European Union via the Capital Requirements Directive (CRD). It affects banks and building societies and certain types of investment firms. The new framework consists of three 'pillars'. Pillar 1 of the new framework sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1 and must take action accordingly. The aim of Pillar 3 is to improve market discipline by requiring firms to publish certain details of their risks, capital, and risk management practices.

United National Bank Limited is a UK bank authorised and supervised by the Financial Services Authority. UNB is therefore subject to the Capital Requirements Directive, and has implemented it within its risk management practices since the start of 2008.

2) Principal activities

The Bank was formed in 2001 from the merger of the UK branches of two Pakistani banks, United Bank Limited and National Bank of Pakistan, who had been operating in the UK since the mid-1960's.

The principal activities of the Bank are to provide conventional and sharia compliant retail banking products through its branch network in major cities in the UK; wholesale banking, treasury and money transmission services to individuals, companies and Financial Institutions; and trade finance facilities to businesses of all sizes.

3) Governance

The Board of directors, which consists of both executive and non-executive members, has responsibility for the overall governance and risk management of the Bank. The Board is responsible for setting the Bank's risk strategy, establishing its risk appetite, and ensuring that all key risks are identified and effectively and efficiently controlled.

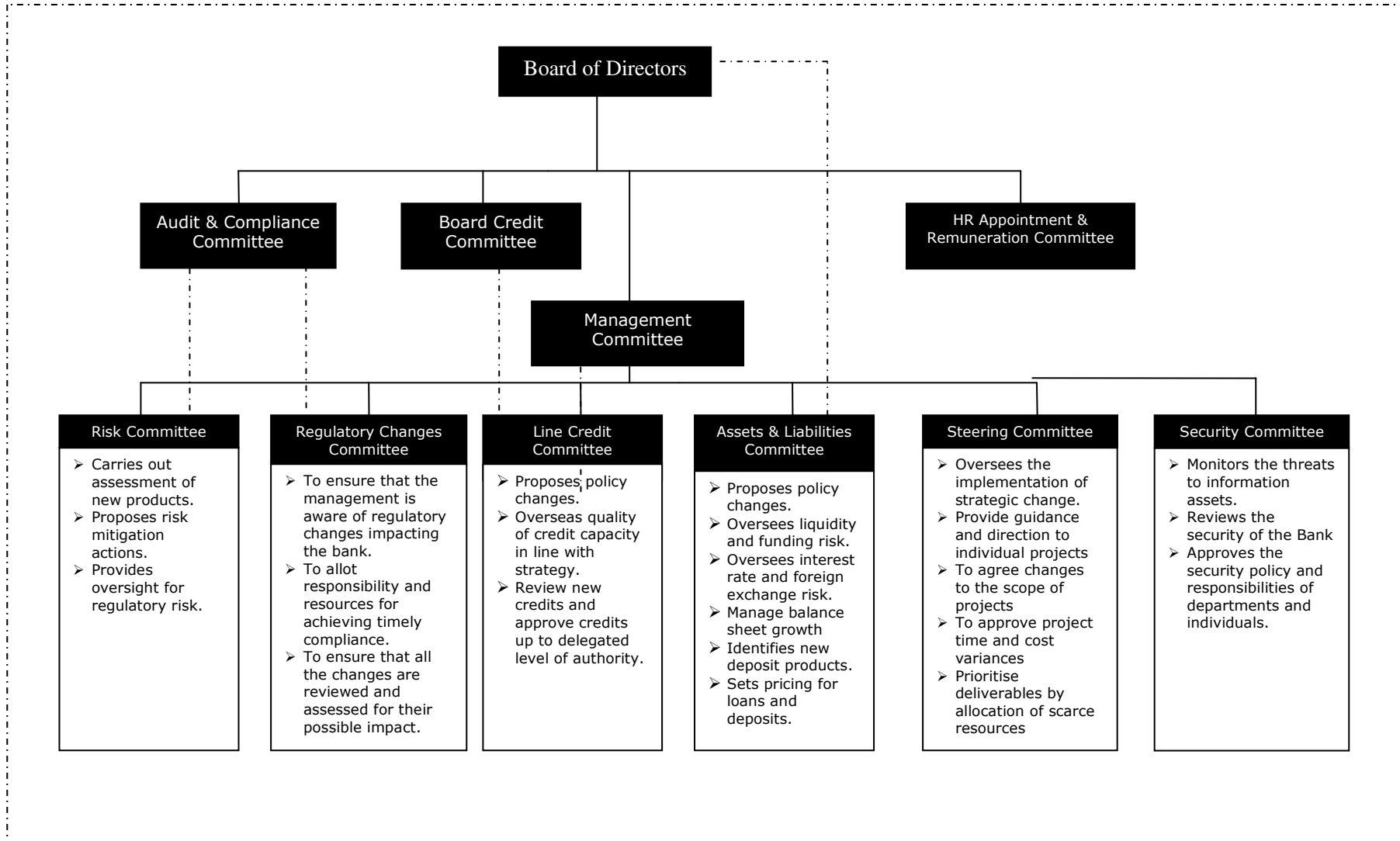
The largest risk that the Bank is exposed to is credit risk. The Board has constituted a separate Board Credit Committee (BCC) to oversee the management of credit risk. This sub-committee is responsible for formulating policy and overseeing compliance with procedures.

The Bank is also exposed to market risk and liquidity risk. An executive Assets and Liabilities Committee (ALCO) oversees these risks on a day to day basis, and reports directly to the Board on a quarterly basis.

The Board Audit & Compliance Committee (BACC) is responsible for the oversight of risk management within the Bank. The Risk Committee is an executive committee that assists the BACC in performing this role by making recommendations to the BACC on risk policy changes, as well as overseeing the monitoring and reporting by exception of the risk exposures faced by the Bank.

The diagram below shows the various Board and Management Committees and their reporting lines:

3.1) Board & Executive Committees



4) Capital resources

United National Bank is 55% owned by United Bank Limited and 45% owned by National Bank of Pakistan. Both parent banks are established and profitable banks in Pakistan, and committed to the future growth of the Bank. This is supported by their investment of £30 million of capital into the Bank.

The table below shows the breakdown of UNB's capital resources at 31 December:

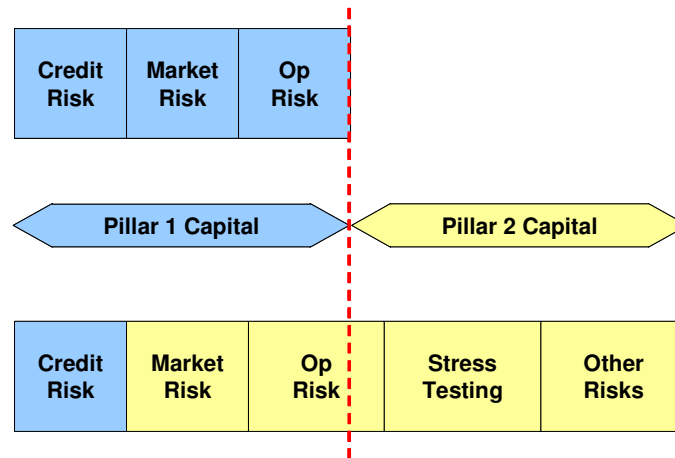
<u>Type of Capital</u>	<u>2010</u>	<u>2009</u>
Tier one capital		
Permanent share capital	£30,000,000	£30,000,000
Profit and loss account and other reserves	£6,625,402	£6,790,668
Total tier one capital	£36,625,402	£36,790,668
Tier two capital		
Revaluation reserves	£6,677,506	£3,252,847
Total capital	£43,302,908	£40,043,515

Tier one capital comprises of the permanent share capital. This is the core capital of the bank and acts as a buffer to absorb losses to protect depositors and other creditors of the bank.

Tier two capital is the supplementary capital and in UNB's case it comprises of the revaluation reserve resulting from the valuation of its property portfolio.

5) Capital adequacy

The diagram below illustrates the approach taken to formulate the Bank's internal capital requirements:



The boxes in blue represent the minimum regulatory allocations of capital for credit risk, market risk and operational risk i.e. Pillar 1 Capital. The boxes in yellow represent the bank's own capital assessments for market risk, operational risk, stress testing and other risks.

- **Credit Risk:** The Pillar 1 minimum capital requirement for credit risk, based on the Basel 2 framework under the Standardised Approach, is taken as the starting point in considering what internal capital may be required. The internal capital assessment includes consideration as to whether the Pillar 1 capital calculation fully captures the credit risk faced by the Bank.
- **Market Risk:** UNB does not operate a trading book but in terms of the regulatory framework, is required to hold capital against market risk in the non-trading book for foreign currency risk. The Bank's own assessment of market risk covers foreign exchange rate risk and interest rate risk.
- **Operational Risk:** Basel 2 sets out a simple means to calculate Pillar 1 capital required to meet operational risk requirements. Under the Basic Indicator approach (followed by the Bank) this is 15% of the Bank's average operating income taken over the last 3 years. The Bank's own assessment of operational risk covers all material risks that do not fall into the other elements shown in the diagram.
- **Stress Testing:** This element covers risks that have been assessed from stress tests, namely concentration risk, strategic risk and competitive risk.
- **Other Risks:** This element refers to the Bank's own assessment of pension obligation risk.
- **Pillar 2 Capital** is the Bank's internal capital assessment over and above Pillar 1 credit, market and operational risk capital requirements. This is arrived at by simply deducting the regulatory Pillar 1 capital requirement (shown in blue in the above diagram) from the Bank's overall internal assessment (shown in yellow above).

3.2) Risk assessment process

The Bank maintains a Risk Register for assessing risks, which is populated with risks from previous risk reviews and risk analysis exercises. Also, all employees of the Bank are responsible for notifying risk events to their line managers. These risk events are collated using an off the shelf risk management software solution, and analysed by management on a quarterly basis. Those risk events that represent a new risk are added to the risk register. The risks contained in the Risk Register are quantified by estimating the probability and likelihood of occurrence, which are then weighted for volatility and risk aggregation as explained below.

The Risk Register is subject to regular review at a frequency reflecting the nature of the risk and the degree of threat to the Bank's business.

There are a number of ways in which a risk is quantified in terms of capital allocation:

Approach	Description
Score-card Assessment	The probability of the threat and the estimated impact is assessed as outlined under Risk Quantification below.
Stress Tests	For assessing the impact of concentration risk, interest rate risk and strategic risk, stress test models have been used to determine best and worst outcomes, which form the basis for the capital assessment.
Standardised Approach Risk-weightings	For credit risk, internal capital is allocated according to the risk weightings used to calculate regulatory capital under the Standardised Approaches.
Capital Planning Models	Capital planning models are used to determine future capital requirements taking account of business plans and stress test outcomes.
Immaterial	A risk deemed immaterial is assessed to have an impact under £10,000 or has been assessed in conjunction with another risk and has been discounted to avoid duplication and double counting.

3.3) Risk quantification (excluding stress tests)

Risk is first assessed on its probability (likelihood) and impact using a scorecard method. The purpose of this initial assessment is to shortlist those threats which are significant. In some instances, threats of a similar nature are combined. During this analysis, previous loss events are discussed and noted.

The probability (likelihood) of a threat materialising is assessed on the basis of its expected frequency expressed in years:

Code	Expected to occur:
6	At least once a year.
5	In the next year or two
4	In next five years
3	In next ten years
2	In next twenty years
1	Very unlikely (not for thirty or more years)

For assessing internal capital requirements, the residual impact is estimated i.e. the impact of the event taking into account existing controls. The loss assessment is made in terms of the impact on anticipated earnings (profit) and capital (reserves).

The estimated loss is based on the total cost for the 'loss event', except in the case of events occurring once a year or more, in which case the annual cost is estimated, net of any accounting provisions. Estimates cover costs for both remedial work and preventative measures against re-occurrence.

The greatest possible impact on earnings and capital, regardless of controls in place, is entered under Maximum Value. This provides an indication of potential volatility - see below.

3.4) Risk aggregation & capital allocation method

Capital is allocated according to estimates which are assessed by the relevant risk owners.

Although estimates are based on current and past experience, these are further weighted according to their potential volatility i.e. the margin of possible error. For example, if the maximum possible impact of a threat is £100,000 and it is estimated to be £90,000, the margin of possible error is small. On the other hand, an estimate of £20,000 could be out by 500%, and is therefore weighted to reflect the higher volatility.

In arriving at an overall capital allocation, capital assessments are aggregated for all risks. It is reasonable to assume that in any one year, not all threats will materialise (although care must be taken to recognise any risks that are interrelated i.e. may trigger one another).

As noted above, in the risk assessment process the likelihood of a threat is expressed in terms of its expected frequency. An event may have a £100,000 impact, but if it is expected to occur once in 10 years, the 'average impact' spread over the 10 years is only £10,000.

Of course, in the real world the risk either does or does not materialise in any one year. Furthermore, some years may well suffer a higher than average number of occurrences than would be expected according to the statistical averages. For this reason, the 'average impact' must be further weighted to take these factors into account.

Low probability risks are given the highest weightings, since their unexpected occurrence will be far greater than the average. Any estimated costs that are expected to occur in the year will require no additional weighting, since their 'average impact' is in fact the same as the full assessment.

3.5) Stress testing

Not all risks can be readily assessed as described above. For assessing the impact of concentration risk, interest rate risk and strategic risk, stress test models have been used incorporating a set of assumptions for considering worse case scenarios.

Stress tests are also used to consider the impact of stressed conditions on meeting future capital requirements.

6) Capital requirements

UNB's Pillar 1 capital requirement is based on 8% of its risk-weighted assets. The Bank uses Standard & Poor's credit ratings in order to calculate the risk-weighted assets for its exposures to rated institutions. All of the Bank's other exposures are to unrated entities. The exposures and capital requirements within each exposure class at 31 December 2010 were:

Minimum Capital Requirement 8%	Exposure £000s	RWA £000s	Capital Requirement £000s
Central government or central banks	7,227	5,178	414
Regional Governments or local authorities	-	-	-
Administrative bodies and non-commercial undertakings	-	-	-
Multilateral development banks	-	-	-
International organisations	-	-	-
Institutions	66,924	18,697	1,496
Corporate	20,618	5,877	470
Retail claims	31,819	23,864	1,909
Secured on real estate property	9,803	3,431	274
Past due items	9,275	9,275	742
Regulatory high-risk categories	-	-	-
Covered bond claims	-	-	-
Securitisation positions	-	-	-
Short-term claims on institutions and corporate	-	-	-
Collective investment undertakings	-	-	-
Other items	15,648	15,648	1,252
Credit Risk Minimum Capital Requirement	161,314	81,970	6,557
Credit Risk (Standardised)	161,314	81,970	6,557
Market Risk(FX PRR)	-	-	9
Operational Risk (Basic Indicator Approach)	-	-	934
Pillar 1 Capital Resources Requirement	161,314	81,970	7,500

Minimum Capital Requirement 8%	Exposure £000s	RWA £000s	Capital Requirement £000s
Pillar 2 Capital Requirement			3,600
Total Capital Resources Requirement (ICG = 148%)			11,100
Pensions Risk add-on			4,000
Capital Planning Buffer			5,432
Total Capital Resources Requirement			20,532

As at 31 December 2010, the Bank had surplus capital over and above its capital resources requirement of £22.8 million.

The Bank's own overall internal capital assessment as calculated within its ICAAP report is approximately £17.4 million (2009: £16.4 million).

During 2010 the FSA undertook a risk assessment of UNB's governance, risk management and control framework using their ARROW methodology. At the same time, the FSA conducted a review of the Bank's Internal Capital Adequacy Assessment Process (ICAAP). The main difference between the FSA's assessment and the Bank's own assessment is the amount of capital required for the risks arising from the defined benefit pension scheme (see 13.1 below).

Currently, the Bank has more than twice the amount of capital required by the Financial Services Authority and by its own assessment, giving greater consumer protection and financial stability.

7) Credit risk

Credit risk is the risk of financial loss to the Bank if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the bank's loans and advances to customers and other banks. For risk management reporting purposes, the Bank considers and consolidates all elements of credit risk exposure (such as individual obligor default risk, sector and country concentration risk).

The Board of Directors has delegated responsibility for the management of credit risk to the Board Credit Committee. The main duties of the Board Credit Committee include the approval of credits and credit provisions, the approval of credit policy and subsequent amendments, and the delegation of credit approval and provisioning limits to the Line Credit Committee.

The Bank mitigates credit risk by:

- Focusing on business sectors it knows well or has an established connection.
- Limiting the size of exposures to any particular entity / group.

- Limiting the aggregate size of exposures to any particular sector and country.
- Obtaining security cover and where appropriate personal guarantees for the exposure.
- Regularly reviewing the credit risk grading of each exposure.

The bank's maximum exposure to credit risk, by class of financial instrument is shown in the table below:

	2010		2009	
	Carrying Value £000s	Maximum Exposure £000s	Carrying Value £000s	Maximum Exposure £000s
<u>Loans and advances to banks:</u>				
Loans and receivables	7,629	7,629	30,062	30,062
<u>Loans and advances to customers:</u>				
Loans and receivables	57,051	57,051	57,980	57,980
<u>Investments:</u>				
Held-to-maturity	61,549	61,634	18,889	18,889
Available for sale	3,049	3,049		
<u>Derivative financial assets:</u>				
Currency forwards	-	-	57	57
Total	132,401	132,486	106,988	106,988

The table below shows the residual maturity breakdown of all exposures by class as at 31 December 2010:

	Less than three months £000s	Between three and six months £000s	Between six months and one year £000s	Between one year and five years £000s	Over five years £000s	Total £000s
Cash, loans and advances to banks	10,752	-	-	-	-	10,752
Loans and advances to customers	14,356	8,246	3,149	19,148	12,152	57,051
Investments	11,773	22,156	11,029	14,987	4,653	64,598
Total			132,401	132,486	106,988	106,988

The table below shows the breakdown of the Bank's on-balance sheet credit exposure categorised by the degree of risk of financial loss:

	Loans and advances to customers		Loans and advances to banks	
	2010 £000's	2009 £000's	2010 £000's	2009 £000's
Carrying amount	57,051	57,980	7,629	30,062
Individually impaired	154	7,097	-	-
Allowance for impairment	(74)	(205)	-	-
Carrying amount	80	6,892	-	-

	Loans and advances to customers		Loans and advances to banks	
	2010	2009	2010	2009
	£000's	£000's	£000's	£000's
Past due but not impaired	-	-	-	-
30-60 days	-	-	-	-
60-90 days	-	-	-	-
90-180 days	-	-	-	-
180 days +	-	-	-	-
Carrying amount	-	-	-	-
Neither past due nor impaired	56,971	51,088	7,629	30,062
Carrying amount	57,051	57,980	7,629	30,062

8) Impaired loans

Impaired loans are loans for which the Bank determines that it is probable that it will be unable to collect all principal and interest due according to the contractual terms of the loan agreement.

8.1) Past due but not impaired

Loans where contractual interest or principal payments are past due, but the Bank believes that impairment is not appropriate on the basis of the level of security / collateral available and / or the stage of collection of amounts owed to the Bank.

8.2) Allowances of impairment

The Bank establishes an allowance for impairment losses that represents its estimate of incurred losses in its loan portfolio. The main component is a specific loss provision that relates to individually significant exposures and represents the amount remaining after deducting the expected discounted cash flows arising from the realisation of the collateral from the outstanding loan principal and accrued interest at the balance sheet date.

8.3) Write-off policy

The Bank writes off a loan balance (and any related allowances for impairment losses) when the Board Credit Committee determines that the loans are uncollectible.

This determination is reached after considering information such as the occurrence of significant changes in the borrower / issuer's financial position such that the borrower / issuer can no longer pay the obligation, or that proceeds from collateral will not be sufficient to pay back the entire exposure.

The Bank holds collateral against loans and advances to customers in the form of mortgage interests over property and liens over cash deposits. Collateral is not held

over loans and advances to banks. The table below shows a breakdown of the credit exposure by collateral type.

	Loans and advances to customers		Loans and advances to banks	
	2010	2009	2010	2009
	£000's	£000's	£000's	£000's
Individually impaired				
Property	-	6,700	-	-
Cash	80	192	-	-
Other	-	-	-	-
Past due but not impaired				
Property	-	-	-	-
Cash	-	-	-	-
Other	-	-	-	-
Neither past due nor impaired				
Property	54,098	49,643	-	-
Cash	-	-	-	-
Unsecured	1,550	1,445	7,629	30,062
Other	1,323	-	-	-
Carrying amount	57,051	57,980	30,062	30,062

The average loan to value ratio for customer loans secured by property is 58% (2009: 58%); calculated by dividing the balance owed to the Bank by the latest valuation held for the property. Independent property valuations are undertaken on a 3 yearly basis as a minimum where the loan to value ratio is greater than 50%, and more frequently where it is likely that there has been a material change in value.

8.4) Movement in the Bad Debt Provision

The table below shows the movement in the bad debt provision and the balance at the end of the year:

	2010	2009
At 1st January	204,900	35,300
Increase in specific provisions for impaired loans	265,550	169,600
Amounts written-off	(46,285)	
Transfers-out to investment property	(350,000)	
At 31st December	74,165	204,900

During 2010 the Bank took possession of two properties, which were part of the collateral for a loan that had become non-performing during the year. The properties were accounted for at the balance sheet as investment properties, and the loan balances and specific provisions were transferred out of customer advances.

9) Credit risk concentration

The Bank manages credit risk concentration by setting exposure limits to groups / individual counterparties, sectors, and countries.

The Bank monitors credit risk concentration against limits daily. Any excesses, actual or potential, are notified to the Line Credit Committee for ratification, approval and /or recommendation to the Board Credit Committee / Board for direction as to remedial action.

The table below summarises the sector and location concentration risk for the Bank at the 31 December:

Concentration by sector	Loans and advances to customers	Loans and advances to banks	Loans and advances to customers	Loans and advances to banks
	2010 £000's	2010 £000's	2009 £000's	2009 £000's
Central and local government	165	-	158	-
Food, beverage, tobacco	14,883	-	2,283	-
Textiles, leather, clothes	(81)	-	(92)	-
Other manufacturing	119	-	120	-
Retail	3,089	-	4,778	-
Wholesale including import and export	371	-	492	-
Transport, storage, communication	45	-	58	-
Real estate - buy, sell, develop and letting	15,749	-	29,999	-
Financial	488	7,629	361	30,062
Other service industry	192	-	299	-
Individuals	22,031	-	19,524	-
Total	57,051	7,629	57,980	30,062

Concentration by location	Loans and advances to customers	Loans and advances to banks	Loans and advances to customers	Loans and advances to banks
	2010 £000's	2010 £000's	2009 £000's	2009 £000's
Great Britain	51,853	5,500	52,823	30,062
Europe	-	2,129	-	-
Pakistan	-	-	3,880	-
Rest of world (excluding Pakistan)	5,198	-	1,277	-
Total	57,051	7,629	57,980	30,062

10) Market risk

Market Risk is the risk associated with changes in the level of interest rate, the rate of exchange between currencies or the price of securities or other financial contracts, including derivatives. Price movement on any of these may have an adverse impact on the results of normal banking business or the financial condition of the Bank. The principal market risks to which the Bank is exposed are interest rate risk, and foreign exchange (currency) risk.

Presently, the Bank does not operate a trading book but in terms of the regulatory framework is required to hold capital against market risk in the non-trading book for foreign currency risk.

The Bank does hold an investment portfolio in order to enhance the return from wholesale funds. All investments are designated as held to maturity, and accounted for on an amortised cost basis. Book values are compared to market values on a daily basis, and any permanent diminution in value is provided for through the profit and loss account.

Following the introduction of Individual Liquidity Adequacy Standards (ILAS) in 2010 (see 11 below) the Bank has created a Liquid Assets Buffer containing qualifying securities that are readily realisable. This portfolio is designated available for sale, and therefore marked-to-market with movements in value accounted for within the investment revaluation reserve.

10.1) Interest rate risk

The primary market risk faced by the Bank is interest rate risk. The varying rate features and maturities of products, together with the use of retail and wholesale funds to support these products, create interest rate exposure due to the imperfect matching of interest rates between different financial instruments (basis risk) and the timing differences on the re-pricing of assets and liabilities (gap exposure).

The Bank manages this risk through the use of appropriate financial instruments and does not normally enter into the derivatives markets but where such use is required appropriate Board approval is sought by the senior management of the Bank.

There are two sources of interest rate risk to earnings:

1. Mismatches in the characteristics of products offered by the Bank, including cash flows and repricing dates, with proprietary positions
2. Fluctuations in interest income funded by own funds and non-interest bearing deposits, assuming the spread margins on interest payable / receivable remain constant.

The policy of the Bank is to price all placements/exposures at floating rates or at fixed rates for fixed periods on appropriate rollover dates that allow for matching in the market.

The management of interest rate risk against interest rate gap limits is supplemented by monitoring the sensitivity of the Bank's financial assets and liabilities to various interest rate scenarios. The table below shows the impact on annual income of a 200 basis point rise or fall in the base rate of the main currencies traded by the Bank, and assumes a constant balance sheet position:

	2010				2009			
	200 basis points increase £'000	% of total capital resources	200 basis points decrease £'000	% of total capital resources	200 basis points increase £'000	% of total capital resources	200 basis points decrease £'000	% of total capital resources
GBP	775	1.79%	(775)	1.79%	812	2.03%	(774)	1.93%
USD	12	0.03%	(214)	0.49%	27	0.07%	(104)	0.26%
EUR	2	0.00%	(20)	0.05%	23	0.06%	-	-
JPY	-	-	-	-	-	-	-	-

10.2) Foreign exchange risk

Foreign exchange risk is the risk that changes in foreign currency rates will affect the Bank's income or the value of its holdings of financial instruments. The objective of foreign currency risk management is to manage and control foreign currency risk exposure within acceptable parameters while optimising the return on risk.

Foreign exchange exposure arises from normal banking activities, primarily from the receipt of deposits and the placement of funds. Future open positions in any currency are managed by means of forward foreign exchange contracts. It is the policy of the Bank that it will, at all times, adhere to the limits laid down by the FSA in respect of the "overall net open position". It is not the Bank's intention to take open positions on its own account (proprietary trading) but rather to maintain square or near square positions in all currencies.

The Bank does not currently deal, and has no plans to deal, in Foreign Exchange Futures, Foreign Exchange Options or Options on Foreign Exchange Futures.

Any foreign exchange forward swap transaction is either immediately covered or incorporated into the respective loan and deposit book (the banking book).

The Bank has no structural currency exposures.

11) Liquidity risk

Liquidity risk is the risk that a company will encounter difficulty in meeting obligations from its financial liabilities.

The policy of the Bank is to always maintain sufficient liquidity to meet all known and likely demands which could be made upon it by its customers and ensure that such liquidity is available on a day to day basis. In terms of "survival period" (the amount of time that the Bank can operate during a period of stress before running out of liquidity resources), this should be no less than 3 months.

The Bank's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Bank's reputation.

The liquidity position of the Bank is monitored daily, and regular liquidity stress testing is conducted under a variety of scenarios covering both normal and more severe market conditions, as well as those scenarios prescribed by the FSA in their handbook.

The Bank's Treasury Department is responsible for maintaining sufficient liquidity to meet the Bank's obligations and to meet the specific liquidity requirements of the UK supervisory authorities. The key measure used by the Bank for managing liquidity risk is the ratio of behaviourally adjusted net liquid assets (maturing in less than one month) to total deposits.

Under the Individual Liquidity Adequacy Standards (ILAS) regime the Bank has modelled the cash flows for three specific scenarios prescribed in the FSA's handbook:

1. an idiosyncratic stress test showing the impact of bank-specific scenarios, such as damage to reputation,
2. a market-wide stress test showing the impact of adverse market conditions, and
3. a combined idiosyncratic and market stress test.

The stress tests consider both the short-term (2 weeks) and protracted (3 months) impact and assess the Bank's survival period both before and after management actions to address shortfalls in liquidity requirements.

Assumptions are made about the behaviour of depositors and borrowers within each stress scenario in order to calculate the cash flows. The outcome from the model is a detailed liquidity profile under each scenario, which analyses the impact on the balance sheet and other key metrics resulting from the individual stress scenarios. Key pressure points are identified, and the amount of liquid assets necessary to ensure at least a 3 month survival period is calculated from the results.

In the unlikely event of a liquidity crisis the Treasury Department would immediately endeavour to sell the Bank's liquid assets, or if more expedient, seek additional funds from the shareholders or borrow in the market to alleviate the shortfall.

The Bank is funded mainly from retail deposits and shareholder funds. The Bank is not dependent on funding from the wholesale market, but may use interbank funding from time to time to provide additional funding when required.

The parent banks have confirmed their support to the Bank if there is a requirement for emergency funding.

12) Operational risk

Operational risk is the risk of loss arising from inadequate or failed internal processes, systems and people, or from external events.

The general categories of operational risk faced by the Bank are summarised below including controls and procedures that the Bank will consider to mitigate these risks. This list is not exhaustive and is merely indicative of the nature of risks faced.

12.1) Systems and processes

The Bank makes use of many different systems (both IT and manual), which, in turn involve a variety of processes. The design, implementation and operation of these processes and systems may affect our susceptibility to some types of operational losses e.g. processing errors, system failures, fraud etc.

The Bank will give consideration to the following areas when designing, implementing and operating any processes or systems:

- (i) the controls in place that help prevent system and process failures or identify and assist their prompt rectification e.g. pre-approval or reconciliations;
- (ii) indicators of process or system risk such as reconciliation exceptions, compensation payments, documentation errors etc.
- (iii) the importance and complexity of the processes and systems used including whether systems are sufficiently integrated;
- (iv) whether the design and use of a process and system allow us to comply adequately with regulatory, statutory and business requirements;
- (v) whether the responsibilities for designing, developing, maintaining and supporting any IT systems are clearly defined and performed; and
- (vi) the confidentiality, integrity, security and availability of information held in systems.

When implementing new systems the following overall procedures will be followed:

- (i) Full specification of requirements will be produced;
- (ii) Request for proposal will be provided to alternative suppliers with full and detailed analysis of responses;
- (iii) Full testing of the system and appropriate sign off before go-live.

All new procedures and policies shall be reviewed and approved by Compliance and Internal Audit.

12.2) People

The inappropriate management of the Bank's employees may affect the Bank's susceptibility to some types of operational losses. For example, operational losses may arise as a result of breaches of fiduciary duty by employees, internal fraud or human errors.

The Bank will effect the following controls to mitigate such risks:

- (i) appropriate segregation of duties and supervision of employees;
- (ii) effective and robust recruitment procedures;
- (iii) effective review procedures to consider an employee's honesty, integrity, competence, capability and financial soundness;
- (iv) appropriate systems and procedures manuals that employees should refer to at all times;
- (v) sound remuneration policies that support effective risk management,
- (vi) training processes that enable employees to attain and maintain competence; and
- (vii) appropriate disciplinary and termination of employment policies and procedures that are enforced.

12.3) Remuneration Policies

The Human Resources, Appointments & Remuneration Committee (HRARC) is responsible for the oversight of remuneration policies within the Bank. The Committee is normally chaired by an independent non-executive director, and consists of other the other non-executive directors as well as the Chief Executive Officer. The main objectives of the Committee are:

- Ensure that the Bank is in compliance with all relevant employment law
- Decide on total remuneration and benefits for senior staff and Executive Directors.

The Bank operates a discretionary bonus scheme that is related to both the Company's and individual's performance. Performance of the Bank is judged against financial targets agreed by the Board at the start of the year. Individuals' performance is assessed during an annual appraisal, and is dependent on the achievement of objectives set at the start of the year.

The allocation of the bonus pool is determined by the Management Committee in consultation with line managers. The bonus allocated to members of the Management Committee is agreed by the HR Committee, and the CEO's bonus is determined by the Board.

The table below shows the remuneration charged to the profit & loss account during 2010:

Staff Remuneration	Fixed £000s	Variable £000s	Total £000s
Wages & salaries	2,691,042	200,000	2,891,042
Social security costs	313,611	-	313,611
Other pension costs	160,568	-	160,568
Total	3,165,221	200,000	3,365,221
Average number of employees			72

The remuneration paid in 2010 was in respect of the principal activities of the Bank, which is retail banking.

12.4) External Events

The exposure of the Bank to operational risk may increase during times of significant change to the organisation, infrastructure and business operating environment e.g. the undertaking of a new business activity, the introduction or modification of processes and systems, changes in regulatory or legal requirements, the invocation of the business continuity plan etc.

The Bank will effect the following systems and controls to mitigate such risks:

- (i) the formulation of steering groups for managing change, reporting to the Management Committee;
- (ii) planning, approval, implementation and review processes for any changes;
- (iii) effective communication of changes to all staff; and
- (iv) an effective and robust business continuity plan.

12.5) Clients

A client, by the very nature of their circumstances or activities, may create a higher degree of operational risk in terms of increased reputational risk for the Bank, increased potential for financial crime for both the Bank and the client and increased compliance costs or risk for the Bank.

The Bank will effect the following controls to mitigate such risks:

- (i) the performance of a consistently high level of client verification across the entire client base.
- (ii) Increased monitoring and due diligence of high risk businesses.

12.6) Insurance

The Bank maintains insurance with the aim of reducing the monetary impact of operational losses. The level and nature of insurance maintained is assessed by the Executive Board on a timely basis to ensure it is adequate to protect the Bank's financial resources.

Whilst insurance should protect the financial resources of the Bank, consideration is also given to the following:

- (i) the financial strength of the insurer;
- (ii) the time taken for an insurer to pay claims which may be detrimental to the capital resources of the Bank;
- (iii) the effect of any limiting conditions and exclusion clauses;
- (iv) The impact of self insurance and claims in excess of the policy terms.

13) Other risks

13.1) Pension obligation risk

The Bank operates a defined benefit scheme of which about one-sixth of the Bank's employees are members. The scheme has been closed to new members for 10 years, and closed to future accrual from the start of 2010. Scheme members' average age is between 50-55 years.

The last actuarial triennial valuation was carried out with an effective date of 1 January 2008, and showed that the surplus had increased to £0.5 million (105% funded) since the previous valuation. However, the latest valuation update dated 1 January 2010 showed a deficit of £1.4 million. The funding position has weakened as a result of the reduction in yields on government securities.

The valuation of the pension fund is dependent on a number of assumptions. Varying these assumptions will affect the valuation results and the cost of providing future service benefits. Sensitivity analysis is performed on the adopted assumptions to identify the key parameters and their potential impact upon the funding of the scheme. The parameters that have the most significant impact upon the funding position are:

1. the life expectancy of members,
2. the assumed rate of future investment return in excess of pension increases after retirement, and
3. the assumed rate of future investment return in excess of salary increases and price inflation before retirement.

The life expectancy assumption adopted within the latest valuation was the standard actuarial table PA(92) with allowance made for the long cohort improvement factors.

The next triennial valuation will take place on 1 January 2011, and the results are expected mid-year.

These disclosures are updated annually unless there are in the meantime significant changes in the risk profile or governance structure of the Bank.