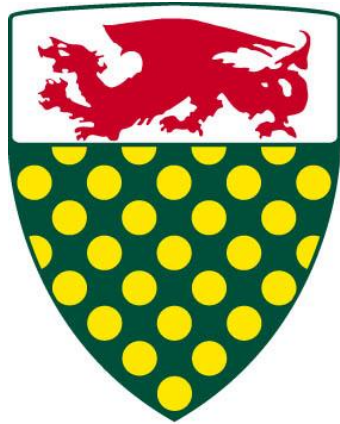
Julian Hodge Bank

Julian Hodge Bank Limited

Pillar 3 disclosures
as at 31 October 2013

Approved by the Board on 21st March 2014

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1. Introduction

This document constitutes the Pillar 3 disclosures of Julian Hodge Bank Limited ("the Bank") as required under the Basel II Capital Requirements Directive.

The purpose of this document is to provide information and disclosure to the Bank's depositors, borrowers and other stakeholders in relation to the internal procedures and policies adopted by the Bank to manage and mitigate its key risks. The Pillar 3 disclosures also provide additional numerical disclosures of the Bank's assets, liabilities and capital resources over and above those shown in its financial statements.

1.1. Overview of the Basel II framework

The Basel II framework came into effect on 1 January 2007 as a means of regulating banks, and determining the level of capital that banks must hold having regard to the individual risk profile of each bank. The purpose of a bank's capital resources is to act as a buffer to absorb losses incurred by the bank, in order that the bank's depositors are protected.

The requirements of the Basel II framework are divided into three 'pillars' as described below:

Pillar 1 – these requirements set out the minimum capital requirements that each bank must adhere to, and the rules can be applied on a 'standardised' basis, or if additional permissions are granted by the Prudential Regulatory Authority ("PRA"), on an advanced basis. Advanced bases allow banks to use their own risk models to determine minimum capital requirements, as opposed to using the standardised values set out within the rules.

Pillar 2 – these rules require that each bank perform an 'Individual Capital Adequacy Assessment Process' ("ICAAP") to assess its own risk profile, and determine the level of additional capital required over and above the Pillar 1 requirements having regard to those risks.

Pillar 3 – these rules are designed to promote market discipline by enhancing the level of disclosure made by banks to its stakeholders by allowing them to assess the bank's key risk exposures and the adequacy of the bank's risk management process to mitigate these risks.

1.2 Adoption of the Basel II framework

The Bank adopted the Basel II framework on 1 January 2008, and uses the standardised approach in measuring its capital resources requirements on a Pillar 1 basis.

1.3 Capital Requirement Directive IV (CRD IV)

On 1 January 2014 CRD IV comes into force; this is the legislative package intended to implement the Basel III agreement in the EU. The changes mark a significant change to capital and liquidity requirements and an enhancement to regulatory reporting across Europe. The enhanced reporting requirements include the introduction of a leverage ratio, liquidity coverage ratio and net stable funding ratio as well as COREP and FINREP regulatory returns.

Whilst this is a significant change to the regulatory landscape and a major piece of work to ensure full compliance, the business impact is mitigated for the Bank due to the quantum and quality of capital and liquidity which the Bank holds.

1.4 Basis of disclosure

The Bank's Pillar 3 disclosure document has been prepared in accordance with the requirements of Chapter 11 of the BIPRU Sourcebook, and in accordance with an internal policy agreed by the Bank's Board.

All numerical disclosures within this document have been prepared as at 31 October 2013, which is the Bank's last financial year-end. Future disclosures will be issued on an annual basis, based on year end financial information, and will be made available within 6 months of the end of each financial year.

1.5 Verification of information

The Bank's Pillar 3 disclosures are not subject to external audit or review.

2. Scope of Pillar 3 disclosures

This section of the document provides an outline of the structure of the Julian Hodge Bank group, and the nature of its businesses. It also explains how each entity within the group has been treated within the Pillar 3 disclosures.

The Bank has only one trading subsidiary, being Hodge Life Assurance Company Limited. All other subsidiaries are dormant and have therefore been excluded from this document. These dormant subsidiaries are also excluded from the Bank's regulatory reporting.

Julian Hodge Bank Limited – the Bank's principal lending activities comprise lifetime mortgages and commercial lending. Lifetime mortgages, which are offered through the Hodge Lifetime brand, involve the provision of loan facilities to enable people to use their homes to raise money to fund their retirement. Commercial lending involves the provision of finance to clients operating within the property sector. The Bank also invests in other financial instruments for investment purposes (for example corporate bonds) and as a means of managing its liquidity profile (for example gilts and bank deposits).

The Bank's lending is funded using its own capital resources and customer deposits.

Hodge Life Assurance Company Limited ("Hodge Life") – Hodge Life is a long-term insurance undertaking and a wholly owned subsidiary of the Bank. The principal insurance products offered are annuities, which provide the policyholder with an income for life or a fixed term in return for the payment of a single premium.

As an insurance undertaking, Hodge Life is regulated under a different framework, and is therefore excluded from the scope of the Basel II framework. The Bank's investment in Hodge Life is deducted from its capital resources and is not reflected in the Bank's Pillar 3 disclosure document.

There are also restrictions on Hodge Life's ability to transfer capital to the Bank. Such transfers can only be made on the approval of the actuarial function holder, and provided that the distribution of capital from Hodge Life is not detrimental to its ability to meet its future liabilities to its policyholders.

3. Risk management objectives and policies

3.1 Risk management objectives

Risk is inherent in all aspects of the Bank's (and every other bank's) business. Within the Bank, a risk management framework is in place to ensure that all material risks faced by the Bank have been identified and measured, and that appropriate controls are in place to ensure that each risk is mitigated to an acceptable degree.

The risk management framework is also a key input into the Bank's strategic planning processes to ensure that the future development of the Bank's business does not expose it to an excessive level of risk.

The principal methods used to manage risks identified by the Bank include:

- Board and management committees to approve initial risk limits and policies, and to monitor adherence to those policies;
- Management information and statistical packs that analyse the level of risk exposure at relevant points in time;
- Stress testing and scenario analysis that measure the level of risk exposure at relevant points in time;
- Departmental policies, procedures and mandates to limit the extent to which individuals can commit the Bank to accepting additional risk;
- Modelling and analysis to ensure that the Bank charges a sufficient margin in return for borrower risks it accepts;
- Loss and near miss reporting to indicate events where the Bank has, or could have, suffered a loss as a result of the occurrence of a risk event;
- Independent internal audit coverage to act as a 'third line of defence' to ensure that policies and procedures have been complied with.

3.2 Risk governance structures

This section describes the committee and management structures in place within the Bank in order to identify and manage risk, and ensure that the appropriate standards of corporate governance are maintained.

Board – The Board has ultimate responsibility for the proper stewardship of the Bank in all its undertakings. It meets at least monthly throughout the year to discharge its responsibilities for all important aspects of the Bank's affairs, including monitoring performance, managing risk, considering major strategic issues and approving budgets and business plans.

A Board Control Manual has been adopted which describes the high-level policy and decision-making arrangements within the Bank. The manual includes a schedule of matters reserved to the Board together with those items delegated to directors, Board and executive committees.

Audit Committee – All members of the Audit Committee are non-executive directors. Executive members of the Board and other senior executives attend as required by the Chairman.

The function of the Audit Committee is to review the work of the internal audit function, to consider the adequacy of internal control and risk management systems and to consider the adequacy of regulatory and compliance systems, in addition to reviewing the financial statements and the relationship with the Bank's external auditors.

The Audit Committee meets at least four times per year.

Remuneration and Nomination Committee – The role of this committee is twofold:

- To consider remuneration policy and specifically to determine the remuneration and other terms of service of executive directors and senior managers. The executive directors decide fees payable to non-executive directors.
- To recommend the appointment of directors to the Board and Board committees and to ensure that the Bank has an appropriate succession plan for executive and senior management positions.

The committee meets as required.

Group Management Board – Chaired by the Managing Director, the Group Management Board meets monthly and is responsible for the execution of strategy, and the day-to-day management of the Bank, subject to specific limitations and constraints imposed by the Board. It is also responsible for formulating the IT strategy and policy.

Group Risk Committee – Chaired by the Managing Director, the Group Risk Committee meets quarterly, and is responsible for the monitoring of the Bank's risk management and compliance frameworks. The Committee is also responsible for authorising, prioritising and monitoring project-related activity.

Credit Committee – Chaired by the Managing Director, the committee's principal responsibility is to monitor and control counterparty risk in relation to the commercial lending portfolio, up to a certain limit. If the proposed deal exceeds this limit, it is referred to the Board for sanction.

The committee meets when required, to approve and monitor individual risks, including the level and type of security required, and to set and monitor acceptable concentrations of risk. All individual risks are reviewed at least annually and more frequently if closer monitoring is required.

Credit Committee also reviews and approves proposed recovery actions or exit strategies in relation to accounts on the Bank's default and watch lists.

Assets and Liabilities Committee ("ALCO") - Chaired by the Managing Director, the committee implements the policies of the Board with respect to liquidity and interest rate risk management and provides recommendations to the Board on strategies for managing these risks. The committee meets weekly.

The committee is also responsible for the monitoring of counterparty and credit risk in relation to the Bank's portfolio of treasury assets. The committee makes recommendations to the Board in relation to new institutions to be added to the Bank's list of approved counterparties for cash placement, hedging transactions gilts and covered, corporate and institutional bond exposures.

3.3 Principal risk categories

3.3.1 Credit risk

Credit risk is defined as the risk that a customer or counterparty will fail to meet their financial obligations to the Bank as they become due. The Bank is therefore exposed to credit risk within the following portfolios.

Commercial lending – Credit risk within the commercial lending portfolio is defined as a borrower's inability to repay or service their debt obligations. The primary drivers of credit risk in the Bank's case are therefore:

- Property price risk – a fall in the value of property may mean that borrowers cannot realise sufficient value to repay their debts in full;
- Tenant risk – a fall in rental income, or failure to secure rental income, may mean that borrowers are unable to service their debts.

A credit risk policy has been agreed by the Board which sets out the nature, location and size of commercial lending deals that can be contemplated by the Bank. A Credit Risk Management team is in place to review each application in great detail. If it is deemed suitable, a recommendation, together with supporting analysis, is made to the Credit Committee (or the Board) for approval.

The Bank's commercial lending portfolio is subject to monthly review at board level to ensure that all loans are performing in accordance with the agreed terms of sanction. In the case of loans for property construction or refurbishment, progress is overseen on the Bank's behalf by members of the Royal Institution of Chartered Surveyors.

To the extent that a borrower fails to meet the obligations of their loan, the Credit Risk Management team implements specific recovery strategies which are individual to each account.

<u>Lump sum lifetime mortgages and reversionary interests in property</u>

Under the terms of these plans, the customer is not obliged to make any repayments during the life of the plan. The Bank is repaid from the sale of the property on the earlier of the date on which the customer dies or vacates the property on a permanent basis as a result of moving into long-term care. In the case of a lifetime mortgage, the customer also benefits from a "no negative equity" guarantee such that, at the end of the loan, the customer is not obliged to repay more than the value of the property.

Therefore, the primary driver of credit risk within lump sum lifetime mortgages and reversionary interests in property is a fall in house prices, which would result in losses if house prices have fallen sufficiently in real terms at the date of redemption. Due to the long-term duration of these loans (up to 25 years) a short term fall in house prices is unlikely to have a significant effect on the Bank's credit risk profile.

With respect to a proportion of lifetime mortgages, the Bank has a continuing obligation to advance further capital to customers if requested. This obligation was calculated based on the value of the property and age of the customer at the date of the initial advance. Additional cash advances to these customers' increases the bank's exposure to credit. Any additional borrowing is at the discretion of the Bank and is subject to age and property-related criteria.

Retirement mortgages

With this type of lifetime mortgage there is also no obligation on the customer to repay the capital borrowed until death or entry into long term care, however the customer is required to make interest payments on a monthly basis. Customers with this product also benefit from a "no negative equity" guarantee with respect to their capital.

This introduces another element of credit risk for the Bank.

The drivers of credit risk within this portfolio are as follows:

- Borrower default risk – the risk that the customer is unable to make interest payments as they fall due.
- A fall in house prices – the Bank would incur credit losses should the value of the security taken in relation to the loan fall beneath the value of capital advanced plus any interest payments in arrears. The fall in house prices necessary for the Bank to suffer a credit loss would generally be less than for lump sum lifetime mortgages as interest does not roll-up.

A credit risk policy has been agreed by the Board which sets out the types of residential property eligible for a retirement mortgage loan, together with the maximum amounts the Bank will lend to borrowers of various ages. The credit risk policy further determines the method by which the Bank assesses that the customer is able to afford interest payments on the loan. No capital repayment vehicle is required as repayment is made from the estate of the borrower on death.

All applications are reviewed by specialist. Property and credit underwriting teams which are supported by a survey and valuation report on the property, conducted by a member of the Royal Institution of Chartered Surveyors and appropriate evidence as to the customer's ability to make interest repayments on the loan, where applicable.

Portfolio performance is reviewed on a monthly basis to ensure that no geographic or age concentrations are emerging. On an annual basis, a proportion of the Bank's residential properties are also selected for inspection, with the selection criteria being based on underlying risk factors.

Treasury assets – The primary driver of credit risk within this portfolio, which comprises deposits with other banks, gilts, and debt securities (issued by corporates and institutions), is the default of the counterparty, meaning it can no longer repay its obligations. The Bank intends to hold its treasury assets to maturity and is therefore not directly affected by market risk.

The Bank's portfolio of treasury assets is overseen by ALCO, which meets on a weekly basis. ALCO is also responsible for assigning a credit limit to each counterparty within the treasury asset portfolio.

3.3.2 Market risk

Market risk is defined as the risk arising from changes in the prices of, or income derived from, financial instruments or commodities and their impact on the earnings or economic value of the Bank.

The Bank is only exposed to one component of market risk, being interest rate risk. This is the risk arising as a result of movements in interest rates having a different or mismatched effect on the Bank's assets and liabilities, which in turn affects the Bank's profitability or economic value.

The principal risk management tool to mitigate interest rate risk is the use of derivatives to align the interest rate re-pricing profile of assets and liabilities. All of the derivatives used by the Bank are interest rate swap contracts of varying maturities and start dates.

The policy for, and use of, derivatives by the Bank is approved by the Board and overseen by ALCO. All of the Bank's derivative transactions are undertaken by the Bank's treasury function, and are subject to independent review and approval at the dealing stage.

The Finance Director, who is responsible for treasury matters on a day-to-day basis, prepares a monthly treasury report for the Board, which includes analysis of interest rate risk exposures.

3.3.3 Liquidity risk

Liquidity risk is defined as the inability of the Bank to meet its liabilities as they fall due, due to unanticipated shortfalls in cash flows arising from the daily operation of a business, the sale of assets or the raising of finance. Liquidity risk is not so much a risk of losses as a risk of not being able to continue in business.

An Individual Liquidity Adequacy Assessment (ILAA) has been approved by the Board in accordance with the PRA's liquidity guidelines. The Board is satisfied that the Bank has sufficient liquid assets at its disposal, even under stressed scenarios, to meet its liabilities as they fall due

The Board has approved a liquidity risk management policy that sets out the liquidity requirements with which the Bank must comply. The principal liquidity risk mitigants used by management are:

- A buffer of highly liquid assets (comprising high quality government and multi-lateral development bank securities) which can be realised to meet cash requirements;
- Cash reserves held with the Bank of England;
- Cash resources held at other financial institutions.

The Bank's liquidity position is monitored daily, reviewed weekly by ALCO, and is reported to the Board on a monthly basis. The Bank also undertakes stress testing of its liquidity position to ensure it is holding the appropriate level of liquidity buffer, which is also reviewed by the Board on a monthly basis.

3.3.4 Conduct risk

Conduct risk is defined as the risk that the Bank's behaviour will result in poor outcomes for customers.

The Board acknowledges the requirement to ensure that the Bank pays due regard to the interests of its customers and treats them fairly at all times recognising they are core to building a sustainable business. These principles are firmly embedded within the organisation's culture and work practices and on-going monitoring is in place to ensure that good customer outcomes are met.

3.3.5 Operational risk

Operational risk is defined as the risk of direct or indirect loss (including opportunity cost) resulting from inadequate or failed internal processes, people or systems, or from external events.

The Bank's risk management framework includes specific assessments for all significant operational risks faced by the Bank. Procedure manuals are also in place for each area of the business to set out the processes and controls all staff are expected to follow.

On a quarterly basis, the Board receives a report of all of the losses or near-miss events that have taken place in the quarter and any mitigating actions undertaken. Further, the Board monitors emerging risks on a quarterly basis.

3.3.6 Concentration risk

Concentration risk is defined as the risk of any single exposure or group of exposures with the potential to produce losses large enough to threaten an institution's health or ability to maintain its core operations. Credit risk concentrations, by their nature, are based on common or correlated risk factors, which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration.

As a regional property-based lending business, the Bank's commercial lending division has a geographic concentration in Wales and the West.

Hodge Lifetime operates on a national basis, and the distribution of its residential property portfolio follows the distribution of the retired population within the UK.

Portfolio performance statistics, which are reported monthly, are used to ensure that any emerging concentration risks are identified and addressed through future business development initiatives. A policy has also been approved by the Board in relation to the permitted large exposure limits for each portfolio.

3.3.7 Pension obligation risk

Pension obligation risk is the risk to a company's financial condition that arises from a funding deficit within its defined benefit pension plan. A deficit could arise as a result of increasing longevity, a fall in asset values or investment returns, or a change in the economic assumptions used to value long-term pension liabilities.

The Bank's defined benefit pension scheme remains open to existing and new employees. However, final pension benefits are based on career-average earnings as opposed to final salary. This gives an overall lower cost to the Bank as compared with operating a final salary scheme.

The financial condition of the pension scheme is reviewed on a quarterly basis, using the advice of independent actuarial advisors, and is subject to a formal triennial revaluation.

4. Capital resources

As at 31 October 2013, and throughout the period to 31 October 2013, the Bank maintained its capital resources at a level above the minimum Pillar 1 capital adequacy requirements as required by the regulator.

The following table shows the breakdown of the total available capital for the Bank as at 31 October 2013:

	Notes	£'m
Tier 1 capital		
Ordinary shares		100.0
Profit and loss reserve		29.7
		129.7
Deductions from Tier 1 capital		
Investments in subsidiaries	1	(16.0)
Total Tier 1 capital		**113.7**
Tier 2 capital		
Eligible general provisions	2	2.1
Revaluation reserve		(1.5)
Total capital resources		**114.3**

Note

1 This represents the investment in Hodge Life, which is excluded from the regulatory capital of the Bank.

2 The Bank is allowed to add-back its general provisions to its capital resources. The amount of the add-back is determined by a formula set out in the Financial Services handbook.

5. Capital adequacy

On 1 January 2008, the Bank adopted the requirements of the Basel II Capital Requirements Directive, as set out within the BIPRU chapter of the financial services handbook.

The Pillar 1 capital requirement, determined in accordance with the rules contained within BIPRU as applied to the Bank, consists of the following components:

- **Credit risk capital component** – the Bank has adopted the standardised approach to determine its Pillar 1 credit risk capital. This involves the application of standard rules to each exposure class.
- **Operational risk capital requirement** – the Bank has adopted the basic indicator approach to determine its Pillar 1 operational risk capital. This calculation is based on the Bank's income and expenditure for the past three years.

5.1 Pillar 1 capital requirement

The table below sets out the Pillar 1 capital requirements as at 31 October 2013 determined in accordance with the BIPRU chapter of the financial services handbook.

Description	Principal constituents	£'m
Governments and central banks	• Gilts	0.0
Multi-lateral development banks	• Bonds issued by multi-lateral development banks	0.0
Financial Institutions	• Bonds issued by financial institutions • Hedging exposures	1.1
Corporates	• Corporate bonds	1.0
Secured by mortgages on residential property	• Lifetime mortgages	10.7
Secured on real estate property	• Commercial lending	15.0
Covered bonds	• Covered bonds	0.1
Short term claims on institutions and corporates	• Cash deposits	0.4
Other items	• Reversionary interests in property • Fixed assets	6.6
Credit risk minimum capital requirement		34.9
Operational risk *(basic indicator approach)*		0.4
Pillar 1 capital requirement		**35.3**
Total capital resources		114.3
Excess of capital resources over Pillar 1 capital requirement		**79.0**

5.2 Capital management

As shown in the table above, the Bank benefits from a significant surplus of capital resources over and above its Pillar 1 regulatory capital requirement. The Bank has adopted the standardised approach to both credit and operational risk since 1 January 2008 in order to calculate the BASEL II Pillar 1 minimum capital requirement.

Pillar 1 capital adequacy is monitored by the Board, and is reported to the Bank's regulator on a quarterly basis. Capital forecasts are prepared on an annual basis, as part of the Bank's annual budgeting and forecasting cycle. During the year, additional re-forecasts are also reviewed by the Board to take into account the effects of events that were not reflected in the original budgets.

The Bank's Pillar 2 capital requirements are reviewed formally at least annually, and additional reviews are undertaken in the intervening periods if management become aware of a material issue or deviation. The Bank's Pillar 2 requirements take account of additional capital amounts required to support future growth.

5.3 Internal Capital Adequacy Assessment Process

On at least an annual basis, the Bank undertakes an Internal Capital Adequacy Assessment Process (ICAAP) which is an internal assessment of its capital needs. This internal process is designed to take account of other risks not covered by the minimum capital requirement.

Included within the ICAAP are capital projections covering a 5-year time horizon, which reflect not only the Bank's chosen strategy and potential growth prospects, but also the results of stress testing this strategic plan. This process is designed to ensure that adequate capital is retained by the Bank to meet not only its current requirements, but also to cover the near future.

The ICAAP is presented to the Board for challenge and approval with the most recent review being completed in March 2013.

6. Credit risk

6.1 Summary of the Bank's credit risk exposures

The exposures are summarised as follows:

Description	As at October 2013 £'m	Average to October 2013 £'m
Governments and central banks	114.0	89.2
Multi-lateral development banks	32.3	33.0
Institutions	41.8	84.3
Corporates	18.3	16.2
Secured on residential property	467.7	471.7
Secured on real estate property	225.2	206.9
Covered bonds	18.4	18.8
Short term claims on institutions and corporates	25.7	58.0
Other items	79.9	81.6
	1,023.3	**1,059.7**

The average balances represent the averages measured between 1 November 2012 and 31 October 2013.

The geographic distribution of these exposures as at 31 October 2013 is shown below:

Description	UK £'m	Europe £'m	USA £'m	Other £'m	Total £'m
Government and central banks	113.5	0.5	-	-	114.0
Multi-lateral development banks	-	27.3	-	5.0	32.3
Institutions	33.0	1.0	3.6	4.2	41.8
Corporates	11.3	6.7	0.1	0.2	18.3
Secured on residential property	467.7	-	-	-	467.7
Secured on real estate property	225.2	-	-	-	225.2
Covered bonds	18.4	-	-	-	18.4
Short term claims on institutions and corporates	25.7	-	-	-	25.7
Other items	79.9	-	-	-	79.9
	974.7	**35.5**	**3.7**	**9.4**	**1,023.3**

The residual maturity of the exposures above at 31 October 2013 is shown below.

Description	Up to 1 year £'m	1-5 years £'m	More than 5 years £'m	Non-interest bearing £'m	Total £'m
Governments and central banks	38.3	9.7	66.0	-	114.0
Multi-lateral development banks	-	30.3	2.0	-	32.3
Institutions	6.1	7.0	28.7	-	41.8
Corporates	0.8	4.2	13.3	-	18.3
Secured on residential property	19.7	52.6	395.4	-	467.7
Secured on real estate property	120.3	44.0	34.6	26.3	225.2
Covered bonds	-	6.3	12.1	-	18.4
Short term claims on institutions and corporates	25.7	-	-	-	25.7
Other items	1.0	4.6	53.8	20.5	79.9
	211.9	**158.7**	**605.0**	**46.8**	**1,023.3**

Residual maturity has been defined as the contractual maturity of the loan. In the case of lump sum lifetime mortgages and reversionary interests in property, the contractual maturity is determined based on the life expectancy of the customers.

6.2 Overview and terminology

The underlying drivers of credit risk have been described in section 3 of this document. The purpose of this section is to provide more detail in relation to the Bank's credit risk profile and specifically those loans where there may be doubt as to whether the amount loaned will be recovered in full.

The Bank prepares its financial statements in accordance with UK Generally Accepted Accounting Principles ("UK GAAP"). Thus, it is required to make specific provisions against bad or doubtful debts such that the carrying value of each loan is no higher than the amount the Bank expects to recover.

Bad debts are defined as those accounts in default, where the client has failed to meet the terms of their loan, or where insolvency proceedings have been commenced against the client.

Doubtful debts are defined as those accounts where the full recovery of the balance is not considered probable, either as a result of a client falling behind their repayment schedule, or the value of the security is impaired. Such impairment would therefore result in a shortfall between the sale price of the security and the client's balance outstanding.

Specific provisions have been made against all bad and doubtful debts, based on the expected loss measured on a case by case basis. General provisions have been made in respect of losses inherent in the portfolio.

If the collection of future interest is also considered doubtful, it is suspended and excluded from interest income in the profit and loss account and from the customer balance. Loans and advances are written off to the extent that there is no longer any realistic prospect of recovery.

The following sections explain how these general principles are applied in relation to the Bank's asset portfolios.

6.3 Commercial lending credit risk (secured on real estate property)

The nature of the Bank's commercial lending business is that, in some cases, a defined repayment plan is not in place. This is because, for loans made for the purposes of the construction or refurbishment of a property, the repayment of the loan is made from the sale proceeds of that asset, and the timing of these sales cannot be forecast exactly.

The principal mechanism used by the Bank to alert it to potential problem loans is the watchlist. A defined set of criteria has been approved by the Board which determines whether an account is included on the watchlist. The conditions include:

- The failure to pay interest accruing on the facility or loan;
- Significant delays or expected cost over-runs on a construction project;
- A deterioration in the demand for, or expected sales price of, a property;
- General evidence in relation to the on-going creditworthiness of the borrower.

All accounts on the watchlist are subject to individual monitoring by the Bank's Credit Risk Management team, and follow-up actions could include a site visit to assess progress, or a series of meetings to establish and agree an alternative course of action to mitigate any emerging risks.

The watchlist process is divided into 2 stages, where accounts demonstrating more prolonged or severe issues are escalated to the second stage. At this point, management considers the need for a bad or doubtful debt provision against each exposure on the second stage watchlist.

For exposures included on the second stage watchlist, an overall recovery strategy is developed by the Credit Risk Management team, and approved by the Credit Committee. The strategy is unique to each account, and is based on the nature of the project, the stage of completion and current market demand.

6.4 Credit risk on mortgages secured on residential property

Borrowers are not required to make any repayments on lump sum lifetime mortgages as the full amount of the debt is repaid either when the borrower dies or moves into long term care, at which point the property is sold. Borrowers are, however, required to make interest payments in respect of retirement mortgages.

Therefore, the Bank's credit risk for lump sum lifetime mortgages and the capital element of the retirement mortgages crystallises at the point of maturity, if the value of the property is lower than the value of the debt. By virtue of the 'no negative equity' guarantee offered to lifetime mortgage borrowers, the Bank is not able to recover any shortfall from the client's estate.

Credit risk also arises with respect to the regular payment of interest amounts for the interest-only retirement mortgage.

Given these exposures, the maximum amount that the Bank will lend to a client is age-related and linked to the customers' ability to service the loan requested in order to minimise the extent to which the Bank is exposed to credit risk.

The Bank monitors this potential exposure by tracking the Nationwide House Price Index, and comparing the performance of its own property portfolio against the index.

6.5 Reversionary interest in property

Reversionary interest in property is included in the financial statements at historic cost, being the amount of cash advanced to the customer. The property will be sold when the customer dies or moves into long term care, at which point the bank will recognise the difference between the net sales proceeds and cost. Therefore, the Bank's credit risk arises at the point of sale, if the value of the property is lower than the value of the cash sum advanced.

6.6 Treasury credit risk

The treasury portfolio contains a mix of debt securities issued by banks and corporates, gilts, and cash deposits with a maturity of three months or less. Treasury balances also comprise funds placed with, or received from, derivative counterparties for collateral.

All of the exposures within the treasury asset portfolio are rated by credit rating agencies, and the Bank is able to use the specific provisions within BIPRU to calculate the capital requirements determined by the credit rating of each individual counterparty for certain classes of assets.

The Bank uses the ratings issued by the ratings agency Moody's, and the Bank's exposures at 31 October 2013, analysed by credit rating, are summarised in the table below.

Central governments or central banks

Moody's rating	Credit quality step	Exposure values £'m
Aaa to Aa3	1	114.0
Total		**114.0**

Multi-lateral development banks

Moody's rating	Credit quality step	Exposure values £'m
Aaa to Aa3	1	32.3
Total		**32.3**

Long term exposure to financial institutions

Moody's rating	Credit quality step	Exposure values £'m
Aaa to Aa3	1	26.5
A1 to A3	2	6.0
Baa1 to Baa3	3	8.1
Ba1 to Ba3	4	1.3
Total		**41.8**

Corporates

Moody's rating	Credit quality step	Exposure values £'m
Aaa to Aa3	1	1.3
A1 to A3	2	8.2
Baa1 to Baa3	3	8.8
Total		**18.3**

Covered bonds

Moody's rating	Credit quality step	Exposure values £'m
Aaa to Aa3	1	18.4
Total		**18.4**

Short term exposures to financial institutions

Moody's rating	Credit quality step	Exposure values £'m
Aaa to Aa3	1	25.7
Total		**25.7**

6.7 Bad debt provisions

The table below summarises the bad debt provisions held against each of the Bank's portfolios at 31 October 2013.

	Commercial lending £'m	**Lump sum lifetime mortgages and reversionary interests in property £'m**	**Treasury assets £'m**	**Total £'m**
General provisions (1)	1.7	0.3	-	**2.0**
Specific provisions (2)	5.6	-	-	**5.6**
Total provision	**7.3**	**0.3**	**-**	**7.6**
Charge/(credit) for the period				
General provisions	(2.5)	(0.1)	-	**(2.6)**
Specific provisions	1.8	-	-	**1.8**
Charge/(credit) for the period	**(0.7)**	**(0.1)**	**-**	**(0.8)**

(1) General provisions cover the entire portfolio of performing loans which are not in arrears or default.
(2) Specific provisions are made against relevant bad and doubtful debts reported on the Bank's default list, to the extent that the balance is considered to be irrecoverable.

The table below summarises the movements in provisions during the year ended 31 October 2013.

	General provisions	**Specific provisions**	**Total £'m**
Balance at 1 November 2012	4.5	17.0	21.5
Charge/(credit) for the period	(2.5)	3.7	1.2
Recoveries	-	-	-
Write-offs	-	(15.1)	(15.1)
Balance at 31 October 2013	**2.0**	**5.6**	**7.6**

6.8 Credit risk mitigation

For both commercial lending and lump sum lifetime mortgages, the Bank takes security in the form of legal charges over the property against which funds are advanced. This is the primary method used by the Bank to mitigate credit risk.

For commercial lending, each security is valued at inception by a RICS-qualified surveyor. Further valuations are also requested by the Bank if evidence comes to light that the security may have become impaired, or where the value of the security has been enhanced as a result of development activity. In isolated cases, the Bank may also hold cash collateral in relation to certain commercial lending schemes, with the collateral used as security against any residual liabilities associated with a development scheme.

Properties subject to a lump sum lifetime mortgage and reversionary interest are also valued at inception of the loan by a RICS-qualified surveyor. Further inspections take place depending upon the inherent risk of the case to ensure that the Bank's security is maintained in an adequate state of repair.

The Bank does not use derivatives or other financial instruments (for example insurance) as a means of mitigating credit risk.

7. Market risk

7.1 Interest rate risk

As explained in section 3.4 above, the Bank is only exposed to one component of market risk, being interest rate risk. Interest rate risk arises within the Bank's lending portfolios as follows:

- **Commercial lending** – the majority of the Bank's commercial lending is at a variable rate, which can be linked to either base rate or LIBOR. Given that market convention is such that deposit funding rates are linked to money market LIBOR rates, this introduces a basis risk if LIBOR rate movements do not mirror base rate movements. The Bank also has a modest portfolio of fixed rate lending. Interest rate risk on this portfolio is mitigated using interest rate swaps;
- **Lump sum lifetime mortgages and reversionary interest in property –** management of interest rate risk on these assets is relatively complex, as they are fixed rate assets of indeterminate length, as life expectancy cannot be predicted exactly. Management uses probability-based mortality tables in order to derive an expected profile over which these assets will mature. A further adjustment to the profile is made to reflect the effects of morbidity (being the entry into long term care) and voluntary prepayments. Interest rate swaps of varying types and durations are used to mirror the derived asset maturity profile;
- **Treasury assets** – the majority of the Bank's cash deposits are for periods of no longer than three months, thus minimising any interest rate risk effects. The Bank could be exposed to value movements on its corporate, covered and institutional bonds and gilts resulting from movements in market interest rates, but as the Bank expect to hold these assets to maturity, this exposure is considered to be minimal.

Interest rate risk exposures are measured weekly, and reported to ALCO. The monthly position is also reported to the Board.

At 31 October 2013, the Bank's interest rate gap sensitivity, being the impact on the Bank's reported profit before tax over the next 12 months, resulting from a +/-100bps parallel shift in the yield curve was £1,225,000 and -£65,000 respectively.

8. Operational risk

Operational risk is described in section 3.6 of this document.

The Bank has the option of using the Basic Indicator Approach or the Standardised Approach in determining the operational risk capital requirement. The Bank has elected to adopt the Basic Indicator Approach.

9. Remuneration

The remuneration policy of the Bank is managed by the Remuneration Committee, which comprises the non-executive directors of the Bank.

The policy provides a framework to attract, retain and motivate employees to achieve the objectives of the Bank within its risk appetite and risk management framework. Remuneration may comprise of base salary, overtime (for certain employees), annual cash bonus and car allowance (for senior employees). Benefits may include holiday allowance, company car (for sales roles only), pension scheme, life assurance, private medical insurance and permanent health insurance.

Base salary is designed to align the value the individual provides to the Bank, including the skills and competencies required and the contribution to the Bank, in the context of the external market for staff. This is achieved through a job evaluation system based on job descriptions which assess the knowledge and skills required for the job, the level of thinking and problem solving involved and the degree of accountability or decision making required. Salaries are reviewed annually by the Committee. Non-executive directors are only entitled to fees, which are set by executive directors.

The annual cash bonus (which is non-contractual) is performance based remuneration, designed to drive and reward medium term results, reflecting the level and time horizon of risk. It considers financial and non-financial results and metrics at Bank, division and individual level. The Committee approves the bonus scheme rules in advance, and any subsequent proposed payment. A bonus cannot exceed 50% of base salary, and the amount of the bonus is determined by the achievement of personal objectives. The Committee may also award discretionary bonuses if it feels performance warrants it.

The Board have determined that as at 31st October 2013 in addition to the two executive directors six other members of staff, including those in control functions, are designated as being subject to the Remuneration Code, as set out in SYSC 19A. Remuneration for the year ended 31 October 2013 for the eight staff subject to the remuneration code was:

Remuneration	**Total £m**
Fixed	0.7
Variable	-
Total	**0.7**