Julian Hodge Bank Limited

Pillar 3 Disclosures
as at 31 October 2017

Our Mission

We make life better for our customers, colleagues and communities by providing specialist lending, savings and retirement solutions in a manner that is fair, friendly and personal.

Our Values

Doing the right thing is what we aim to do in all areas of our business – it guides our decisions.

Both as a lender and as a savings bank, at Hodge Bank we take a steady and controlled approach to doing business. This long-term view – avoiding short-termism – is coupled with a solid reputation for looking after our clients. Hodge Lifetime is a business dedicated to the retirement market since 1965 and, throughout that time, we've been at the forefront of innovation in our core retirement lending markets.

Our depth of experience, values and reputation means we are a business that you can rely on.

We do the right thing with regard to having a social responsibility too. The Hodge Foundation, a charity supporting welfare, medical, academic and educational causes owns 79% of our business. This drives us, knowing that by helping our customers to achieve their goals, we are also helping good causes that are important to us.

Our Strategy

Our strategy is focused on the retirement lending and Commercial real estate markets. These markets complement each other well, and we have a depth of experience in these fields. At the heart of the Bank's philosophy is a wish to protect its capital base for the benefit of its depositors and shareholder by conducting business in those areas where it has the greatest expertise and experience and best understands the risks that it is taking.

Glossary

ALCO	Assets and Liabilities Committee
CCoB	Capital Conservation Buffer
CCyB	Countercyclical Capital Buffer
CET1	Common Equity Tier 1
CRDIV	Capital Requirements Directive and Regulation
CRR	Capital Requirements Regulation
EBA	European Banking Authority
FLS	Funding for Lending Scheme
FPC	Financial Policy Committee
FRS 101	Financial Reporting Standard 101 Reduced Disclosure Framework
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Individual Liquidity Adequacy Assessment Process
IRB	Internal Ratings Basis
LIBOR	London Interbank Offered Rate
LTIP	Long-Term Incentive Plan
MRT	Material Risk Taker
PRA	Prudential Regulation Authority
RICS	Royal Institution of Chartered Surveyors
RWA	Risk Weighted Asset
SREP	Supervisory Review and Evaluation Process

Contents

1. Introduction

This document constitutes the Pillar 3 disclosures of Julian Hodge Bank Limited ("the Bank") as required under the Basel III 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 numerical disclosures about the Bank's assets, liabilities and capital resources over and above those shown in its financial statements.

1.1. Background

The document has been prepared in accordance with the Capital Requirements Directive and Regulation (collectively known as CRDIV) which is the legislative package for implementing the Basel III framework within the EU. This came in to effect from 1 January 2014 and was enforced in the UK, together with local implementing rules and guidance, by the Prudential Regulatory Authority ("PRA").

CRDIV is a means of regulating banks, and provides a common framework for the assessment of the individual risk profile of each financial institution. This includes 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 potential future losses incurred by the Bank, in order that the Bank's depositors and other stakeholders are protected.

The requirements of the 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 PRA, on an Internal Ratings Basis (IRB). IRB allows banks to use their own risk models to determine minimum capital requirements, as opposed to using the standardised values set out within the rules.

The Pillar 1 capital requirement is calculated for the Bank using the following approach:

- Credit Risk - Standardised Approach
- Operational Risk - Basic Indicator Approach
- Market Risk - Standardised Approach

Pillar 2 – builds on Pillar 1 and incorporates the Bank's own assessment of additional capital resources needed to cover specific risks that are not covered by Pillar 1. The amount of additional capital required is also considered by the PRA as part of the Supervisory Review and Evaluation Process (SREP) and this determines the overall level of capital required to be held by the Bank.

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

1.2 Basis and Frequency of Disclosure

All numerical disclosures within this document have been prepared as at 31 October 2017, which is the Bank's most recent financial year-end. Pillar 3 disclosures are issued on an annual basis, based on year-end financial information, and will be made available concurrently with the financial accounts, as required by the CRR.

1.3 Summary of Key Capital Ratios

	31 October 2017	31 October 2016
Common Equity Tier 1 (CET1) ratio	21.1%	19.2%
Total Capital Ratio	21.2%	19.2%
Risk Weighted Assets (£m)	706.3	672.8
Leverage Ratio	11.4%	9.5%

1.4 Verification of Information

The Bank's Pillar 3 disclosures are subject to internal verification and have been reviewed by the Bank's Audit Committee and are published on the Bank's website:

http://www.hodgebank.co.uk/group/financial.html.

These disclosures are not subject to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the group's audited Annual Report and Financial Statements.

2. Scope of Pillar 3 Disclosures

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

The Bank has 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 residential mortgages, lifetime mortgages and commercial lending. Residential and lifetime mortgages, which are offered through the Hodge Lifetime brand, involve the provision of loan facilities to enable people to use their homes as security to raise money. Commercial lending involves the provision of finance to clients operating within the property and renewable energy sectors. The Bank also invests in other financial instruments for investment purposes (for example corporate bonds) and as a means of managing its liquidity profile.

The Bank's lending is primarily 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 CRDIV. 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.

This Pillar 3 disclosure covers Julian Hodge Bank Ltd only. A separate document is prepared under the Solvency II regime for HLAC, the Solvency Financial Condition Report (SFCR), and is available alongside the HLAC annual accounts.

3. Risk Management Objectives and Policies

3.1 Risk Management Objectives

Risk is inherent in all aspects of the 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 monitored and mitigated to an acceptable degree.

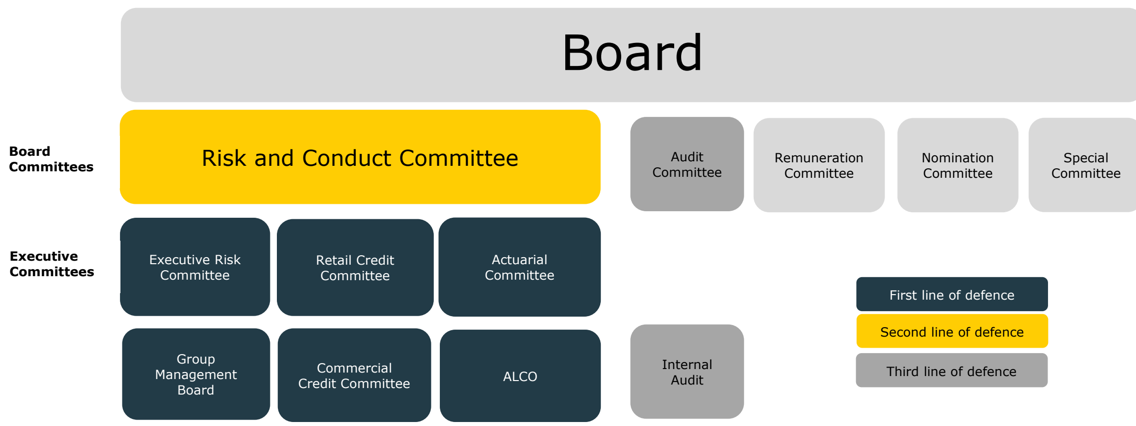
The risk management framework is also a key input into the Bank's strategic planning processes to ensure that the future development of the Bank's business does not expose it to an excessive level of risk.

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

- Board and management committees to approve initial risk appetite limits and policies, and to monitor adherence to these limits and 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 under different economic situations;
- 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 the 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 assurance review, acting as a 'second line of defence' to ensure that internal policies, procedures and controls have been complied with;
- Independent internal audit coverage to act as a 'third line of defence' to ensure that appropriate internal controls are in place to mitigate risk.

3.2 Risk Governance Structures

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



The Bank regards the monitoring and controlling of risk as a fundamental part of the management of the business and accordingly involves its most senior people in developing risk policy and monitoring its application. The Board has an approved risk management policy and a risk management framework in place.

The three lines of defence model

The Bank operates a three lines of defence model for risk management and oversight. This structure defines the roles and responsibilities of risk management, risk oversight and risk assurance separately from those of commercial and operational activities undertaken by the Bank. This model comprises the following elements:

First line of defence has responsibility for implementation of the Bank's strategy and for the management of risk across the organisation and comprises executive committees, management and staff.

Second line of defence monitors and facilitates the implementation of effective risk management practices by first line by providing risk oversight and independent challenge. The Board has delegated oversight of risk management to the Risk and Conduct Committee. An internal assurance team is responsible for undertaking a monitoring programme to enable the Risk and Conduct Committee to assess whether the first line of defence is operating effectively.

The **third line of defence** provides objective assurance on the effectiveness of the Bank's governance and risk management processes and controls. This assurance is obtained via the use of internal audit services provided by PwC. The Board retains ultimate responsibility for risk management in the Bank.

Committee structures

Board – The Board of Hodge Bank meets regularly throughout the year at which strategy and risk appetite are challenged and agreed, operational performance is reported and reviewed against plan, strategic reviews of segments of the business are reviewed and challenged, and new developments are considered against the Group's corporate and strategic objectives.

A Board Control Manual has been implemented 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.

Risk and Conduct Committee – The Board has delegated the oversight of risk and the conduct of the business to the Risk and Conduct Committee to ensure that significant risks are identified, understood, assessed and managed and that good customer outcomes are achieved. It is responsible for the second line of defence of the business, ensuring that the level of assurance available to the Board is sufficient and appropriate. The committee comprises five non-executive directors and meets on a quarterly basis.

Audit Committee – The Audit Committee is responsible for the third line of defence. Its role is to monitor and review the effectiveness of the internal audit function in providing independent assurance on internal controls and to monitor the integrity of the financial statements, ensuring the independence and objectivity of the external auditor.

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 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 committee consists of executive management and is responsible for the formulation and execution of the Bank's strategy, and the day-to-day management of the Bank, subject to specific limitations and constraints imposed by the Board. The committee is also responsible for formulating the IT strategy and policy, and monitors and authorises IT activities throughout the Bank.

Executive Risk Committee – Chaired by the Managing Director, the committee meets quarterly and monitors the Bank's risk management framework. It also monitors and co-ordinates the activities of compliance, risk assurance and internal audit throughout the Bank.

Commercial Credit Committee – Chaired by the Managing Director, the committee's principal responsibility is the implementation and maintenance of the overall risk management framework relating to commercial credit risk. The committee is also responsible for reviewing, challenging and if appropriate, approving credit proposals for new commercial lending deals that are within its remit as set by the Board.

Retail Credit Committee – Chaired by the Managing Director, the committee's principal responsibility is to monitor and control retail credit risk throughout the group and ensure risk underwriting is appropriate. The primary credit risk arises from loans to customers through the Hodge Lifetime division.

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.

Actuarial Committee - Chaired by the Managing Director – Hodge Lifetime, the committee is responsible for monitoring the insurance risk exposure of the Bank including longevity risk, liquidity risk, house price risk and interest rate risks. It also monitors and provides input to the methods and assumptions used to undertake actuarial valuations of the Bank's assets and liabilities.

The committee meets as required but, as a minimum, will meet four times per annum.

3.3 Principal Risk Categories

Credit risk

Credit risk is the risk that a counterparty will be unable or unwilling to meet a commitment that it has entered into with the Bank. The Bank manages its credit risk through the Retail Credit Committee, Commercial Credit Committee and the Assets and Liabilities Committee (ALCO). Regular credit exposure reports are produced which include information on credit and property underwriting, large exposures, asset concentrations, industry exposure and levels of bad debt provisioning.

Liquidity risk

Liquidity risk is defined as the inability of the Bank to meet its liabilities as they fall due, due to shortfalls in cash flows arising from the daily operation of its business, the sale of assets or the raising of finance.

An Individual Liquidity Adequacy Assessment Process (ILAAP) 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 mitigations 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. The Bank also undertakes stress testing of its liquidity position to ensure it is holding the appropriate level of liquidity buffer.

Market risk

Market risk can be defined as the impact on the earnings and economic value of the Bank that arises from adverse movements in market prices.

The Bank is 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 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 the Bank's derivative transactions are undertaken by the Bank's treasury function, and are subject to review and approval at the dealing stage.

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

House price risk

House price risk is the risk that arises when there is an adverse mismatch between actual house prices and those implicit in the costing of the Bank's lending into retirement products, such that the ultimate realisation of the property would not yield the expected return to the Bank and could, in certain circumstances, result in a capital loss.

Conduct risk

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

Operational risk

Operational risk is defined as the risk of direct or indirect loss (including opportunity cost) resulting from inadequate or failed internal processes and controls, 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 and maintenance of a Group risk register that ranks each risk using a 'probability/impact' matrix and assesses the effectiveness of the respective control environments. 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 Risk and Conduct Committee receives a report of all the losses or near-miss events that have taken place in the quarter and any mitigating actions undertaken, in addition to monitoring emerging risks.

The Bank plans to have a greater digital presence, this combined with the growth plans of the Bank increases the inherent risk exposure to cyber risk.

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, though this has reduced appreciably over recent years. 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 are used to ensure that any emerging concentration risks are identified and addressed through future business development initiatives. A policy has been approved by the Board in relation to the permitted large exposure limits for each portfolio. Concentration risk is also assessed as part of the Pillar 2 framework.

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 may arise as a result of increasing longevity, a fall in asset values or low 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 when 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. Key Capital Metrics

As at 31 October 2017, and throughout the period to 31 October 2017, 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 2017:

	31 October 2017	31 October 2016
Regulatory Capital		
Common Equity Tier 1 ("CET1") Capital	149.3	129.1
Total Tier 1 Capital	149.3	129.1
Total Tier 2 Capital	0.2	0.2
Total Capital	**149.5**	**129.3**
Risk Weighted Assets		
Total Risk Weighted Assets ("RWAs")	706.3	672.8
Regulatory Capital as % of RWAs		
CET1 Capital Ratio	21.1%	19.2%
Tier 1 Capital Ratio	21.1%	19.2%
Total Capital Ratio	21.2%	19.2%

5. Capital Resources

The table below summarises the composition of regulatory capital. The Bank has complied with all the externally imposed capital requirements to which it is subject for the years ended 31 October 2016 and 31 October 2017.

£m	31 October 2017	31 October 2016
CET1 Capital		
Share Capital	105.0	100.0
Retained Earnings	62.3	46.3
Accounting Capital	**167.3**	**146.3**
Regulatory Adjustment to CET1:		
Intangible Assets (1)	(1.7)	(1.2)
Prudent valuation adjustment (2)	(0.3)	-
Investment in Subsidiary (3)	(16.0)	(16.0)
CET1 Capital	**149.3**	**129.1**
Collective Impairment Allowance (4)	0.2	0.2
Tier 2 Capital	**0.2**	**0.2**
Total Capital	**149.5**	**129.3**

Tier 1 Capital

The Bank's Tier 1 capital comprises issued shared capital, accumulated accounting profits and other reserve balances.

(1) A regulatory adjustment is required to be made to the Bank's Common Equity Tier 1 capital in respect of intangible assets, as set out in CRDIV. For accounting purposes, computer software is treated as an intangible asset and is deducted from capital under the regulatory rules.

(2) A regulatory adjustment is required to be made to the Bank's Common Equity Tier 1 capital in respect of the Prudent Valuation Adjustment.

(3) This represents the investment in Hodge Life Assurance Company Limited, a wholly owned subsidiary of Julian Hodge Bank Limited, which is excluded from the regulatory capital of the Bank.

(4) This represents the collective provision which is eligible to be added back as Tier 2 capital.

Tier 2 Capital

The Bank currently has no Tier 2 instruments but is allowed to adjust for collective impairment allowance.

(5) The collective impairment allowance, added to Tier 2 capital, must not exceed 1.25% of risk weighted assets for banks using the Standardised Approach. The Bank did not exceed this limit at 31 October 2017.

The following table shows the movement in CET1 capital during the year:

£m	2016	2016
CET1 capital at 1 November	129.1	116.1
Restatement of prior year	7.2	-
Issue of ordinary shares	5.0	-
Profit in the period attributable to shareholders	10.2	17.6
Other movements in retained reserves	(1.4)	(4.6)
Movement in Regulatory adjustments	(0.8)	-
CET1 Capital at 31 October	**149.3**	**129.1**

6. Capital Adequacy

The Pillar 1 capital requirement 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.

6.1 Pillar 1 Capital Requirement

The table below sets out the Pillar 1 capital requirements. The Pillar 1 requirement in respect of credit risk is based on 8% of the risk weighted exposure for each of the following standardised exposure classes. The exposure and risk weighted assets can be seen below in table 8.1.

£m	31 October 2017	31 October 2016
Credit Risk – Standardised Approach		
Government and Central Banks	0.0	0.0
Multi-lateral development banks	0.0	0.0
Financial Institutions	1.7	1.8
Corporate	1.4	1.1
Mortgages on residential/commercial real estate	37.6	37.1
Covered bonds	0.2	0.2
Items with particularly high risk	2.5	1.6
Other items	11.8	11.0
Total Credit Risk	**55.2**	**52.9**
Operational risk – standardised approach	1.3	0.9
Total Pillar 1 Requirement	**56.5**	**53.8**

6.2 Capital Management

Pillar 1 capital adequacy is monitored by ALCO and reviewed by the Risk and Conduct Committee, and is reported to the PRA 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 reviewed by the Board to take into account the effects of events that were not reflected in the original budget.

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 into account capital required to support future growth.

6.3 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 increases resulting from the Bank's proposed strategy and any additional risks that might entail.

The ICAAP is presented to the Board for challenge and approval with the most recent review being completed in April 2017.

In addition to the ICAAP stress, there is enterprise-wide stress testing on capital, liquidity, operational risk and reverse stress testing.

7. Regulatory Capital Buffers

In 2016, CRR introduced regulatory capital buffers of which the following apply to the Bank:

Capital Conservation Buffer (“CCoB”)

The CCoB is a buffer for all banks that can be used to absorb losses while avoiding breaching minimum capital requirements. The buffer has been phased in from 1 January 2016 at the rate of 0.625% per annum to reach 2.5% by 1 January 2019. As of 31 October 2017, the buffer was 1.250% of RWA.

Countercyclical Capital Buffer (“CCyB”)

On 27 June 2017, the UK Financial Policy Committee (“FPC”) increased the UK CCyB rate from 0% to 0.5% of banks’ UK exposures with effect from June 2018 and has announced it will increase the CCyB further to 1% in November 2018. As at 31 October 2017, the buffer was 0% of RWA.

8. Credit Risk

8.1 Summary of the Bank's Credit Risk Exposures

The exposures are summarised as follows:

£m	31 October 2017	31 October 2016
Credit Risk – Standardised Approach		
Government and Central Banks	174.2	252.7
Multi-lateral development banks	13.2	23.0
Financial Institutions	124.4	145.8
Corporate	21.0	18.2
Mortgages on residential/commercial real estate	732.9	687.9
Covered bonds	28.4	30.3
Items with particularly high risk	23.6	19.9
Other items	132.1	121.9
Total	**1,249.8**	**1,299.6**

The geographic distribution of these exposures as at 31 October 2017 is shown below:

£m	UK	Europe	USA	Other	Total
Credit Risk – Standardised Approach					
Government and Central Banks	171.1	3.1	-	-	174.2
Multi-lateral development banks	-	13.2	-	-	13.2
Financial Institutions	117.5	2.5	3.1	1.3	124.4
Corporate	18.1	1.9	1.0	-	21.0
Mortgages on residential/commercial real estate	732.9	-	-	-	732.9
Covered bonds	28.4	-	-	-	28.4
Items with particularly high risk	23.6	-	-	-	23.6
Other items	132.1	-	-	-	132.1
Total	**1223.7**	**20.7**	**4.1**	**1.3**	**1,249.8**

Credit Risk by Residual Maturity

The residual maturity of the exposures as at 31 October 2017 is shown below:

£m	Within 1 year	After 1 year but within 5 years	More than 5 years	Undated	Total
Credit Risk – Standardised Approach					
Government and Central Banks	97.7	66.1	10.4	-	174.2
Multi-lateral development banks	8.9	1.2	3.1	-	13.2
Financial Institutions	117.0	4.8	2.6	-	124.4
Corporate	2.4	7.2	11.4	-	21.0
Mortgages on residential/commercial real estate	37.1	54.6	346.7	294.5	732.9
Covered bonds	14.4	1.7	12.3	-	28.4
Items with particularly high risk	22.1	1.5	-	-	23.6
Other items	-	-	-	132.1	132.1
Total	**299.6**	**137.1**	**386.5**	**426.6**	**1,249.8**

Residual maturity has been defined as the contractual maturity of the loan. In the case of lifetime mortgages, the contractual maturity is determined based on the life expectancy of the customers. Reversionary interests in property are classified within other items.

8.2 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 Financial Reporting Standard 101 Reduced Disclosure Framework ("FRS 101"). 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. Details of the accounting policy in respect of the basis of preparation are provided in Note 1 of the 2017 Annual Report and Financial Statements.

For accounting purposes, bad debts, doubtful debts, impairment, exposures that are past due and provisions are defined as follows:

- **Bad debts** - those accounts where loss is considered virtually certain, where the client has failed to meet the terms of their loan, or where insolvency proceedings have been commenced against the client.

- **Doubtful debts** - 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.

- **Impairment** - one or more events that have occurred after the initial recognition of the asset (an incurred loss event or events) which has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

- **Exposures past due** - where, having been subject to an individual impairment assessment and review, it has been determined that the asset no longer remains impaired and has now become irrecoverable. Management applies overlays to assumptions where there is a lack of past experience, to reflect the level of loss expected.

- **Provisions** - recognised when there is a present obligation as a result of a past event and it is probable that the obligation will be settled and the amount can be estimated reliably. The expense relating to any increase in provision is charged to the Income Statement.

Specific provisions have been made against all bad and doubtful debts, based on the expected loss measured on a case by case basis. Collective provisions have been made in respect of the risk of losses inherent in the portfolio that are not covered by specific provisions.

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.

Details of the accounting policy in respect of impairment of financial assets and provisions are provided in Note 1 of the 2017 Annual Report and Financial Statements.

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

8.3 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 by which the Bank is alerted to potential problem accounts is a common risk rating system, developed in 2014. The system is designed to link directly to procedures for identifying, sanctioning and management of deteriorating risk positions. A defined set of criteria has been approved by the Board to determine the risk grade of a loan.

The risk rating system is used to demonstrably review and re-classify the risk characteristics of an exposure at least annually through the annual facility review process, or more frequently if relevant new information comes to light. The system also facilitates regular and consistent oversight by Commercial Credit Risk Committee as movements in individual account level ratings and weighted portfolio risk position are reviewed and challenged quarterly by this forum.

Where exposures enter the highest risk grade, a recovery strategy is approved by the Commercial Credit Risk 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.

8.4 Credit Risk on Mortgages Secured on Residential Property

Borrowers are not required to make any repayments on roll-up 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 the Retirement Mortgage and 55+ Mortgage.

Therefore, the Bank's credit risk for roll-up lifetime mortgages, and the capital element of the Retirement Mortgage and 55+ Mortgage, crystallises at the point of maturity. A loss would be incurred if the value of the property is lower than the value of the debt. By virtue of the 'no negative equity' guarantee offered to borrowers of roll-up lifetime mortgages and the Retirement Mortgage, the Bank is not able to recover any shortfall from the client's estate for these products.

Credit risk also arises with respect to the regular payment of interest amounts for the interest-only Retirement Mortgage and 55+ Mortgage.

The maximum amount that the Bank will lend to borrowers of roll-up lifetime mortgages is age-related. For borrowers of the Retirement Mortgage and 55+ Mortgage, the maximum amount the Bank will lend is linked to the customers' ability to service the loan requested. These measures minimise the extent to which the Bank is exposed to loss risk.

Retail Credit Risk Committee monitors the potential exposure that arises from property risk by tracking house price indices, and comparing the performance of its own property portfolio against these indices.

8.5 Reversionary Interests in Property

Reversionary interests in property are included in the financial statements within investment properties. They are initially recognised at cost, being the amount of cash advanced to the customer, plus any associated costs, and subsequently fair value. Any change therein is recognised in the Income Statement within other income. The property will be sold when the customer dies or moves into long term care, at which point the Bank will recognise any gains or losses in the Income Statement.

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

The Bank monitors all rating agencies' ratings of investments. However, it uses the ratings issued by the ratings agency, Moody's for its capital calculations, and the Bank's exposures at 31 October 2017, analysed by credit rating, are summarised in the tables below:

Central governments or central banks

Moody's rating	31 October 2017	31 October 2016
Aaa to Aa3	174.2	252.7
Total	**174.2**	**252.7**

Multi-lateral development banks

Moody's rating	31 October 2017	31 October 2016
Aaa to Aa3	13.2	23.0
Total	**13.2**	**23.0**

Financial institutions

Moody's rating	31 October 2017	31 October 2016
Aaa to Aa3	42.4	107.1
A1 to A3	76.2	28.7
Baa1 to Baa3	3.4	7.4
Ba1 to Ba3	2.4	2.6
Total	**124.4**	**145.8**

Corporates

Moody's rating	31 October 2017	31 October 2016
Aaa to Aa3	2.6	0.6
A1 to A3	9.6	6.9
Baa1 to Baa3	7.7	9.9
Ba1 to Ba3	1.1	0.8
Total	**21.0**	**18.2**

Covered bonds

Moody's rating	31 October 2017	31 October 2016
Aaa to Aa3	28.4	30.3
Total	**28.4**	**30.3**

Counterparty credit risk also arises through the Bank's use of financial derivatives to manage interest rate risk. It is the Bank's policy to enter into master netting agreements and margining agreements with all counterparties. In general, under master netting agreements the amounts owed to each counterparty on a single day are aggregated into a single net amount to be payable by one counterparty to another.

The following table shows the exposure to counterparty credit risk for derivative contracts as at 31 October 2017 and 31 October 2016:

£m	31 October 2017	31 October 2016
Negative fair value (inclusive of potential future exposure)	(131.1)	(144.6)
Less collateral held	133.3	151.7
Net derivative exposure	**2.2**	**7.1**

The net derivative exposure represents the credit exposure to derivative transactions after considering legally enforceable netting arrangements and after including the potential future credit exposure as required in the calculation of the exposure.

8.7 Impairment Provisions on Loans and Advances to Customers

The table below summarises the bad debt provisions held against each of the Bank's portfolios at 31 October 2017:

£m	Specific	Collective	Total
2017			
At 1 November 2016	9.8	0.2	10.0
Utilised on redemption	(2.0)	-	(2.0)
Amounts written back during the year	(2.4)	-	(2.4)
Charge for loan impairment	0.8	-	0.8
At 31 October 2017	**6.2**	**0.2**	**6.4**

£m	Specific	Collective	Total
2016			
At 1 November 2015	6.9	0.7	7.6
Amounts written back during the year	(0.5)	(0.5)	(1.0)
Charge for loan impairment	3.4	-	3.4
At 31 October 2016	**9.8**	**0.2**	**10.0**

2017 £m	Commercial Lending	Residential Lending	Residential Lending classed at fair value	Total
Loan book	310.3	159.8	294.5	764.6
Of which neither past due or impaired	295.4	159.8	294.5	749.7
Impaired assets	14.9	-	-	14.9
Charge for loan impairment	(6.4)	-	-	(6.4)
Loan fee deferral	(2.5)	-	-	(2.5)
Total loans and advances to customers net of impairment	**301.4**	**159.8**	**294.5**	**755.7**

2016 £m	Commercial Lending	Residential Lending	Residential Lending classed at fair value	Total
Loan book	297.6	88.8	331.0	717.4
Of which neither past due or impaired	272.8	88.8	331.0	692.6
Impaired assets	24.8	-	-	24.8
Charge for loan impairment	(10.0)	-	-	(10.0)
Loan fee deferral	(2.3)	-	-	(2.3)
Total loans and advances to customers net of impairment	**285.3**	**88.8**	**331.0**	**705.1**

8.8 Credit Risk Mitigation

For Treasury credit risk, ALCO is responsible for the review and management of the Bank's cash portfolio and must approve all counterparties in advance (based on their credit rating and ALCO's own assessment of future prospects). The Bank's Treasury Credit Risk policy sets exposure limits for each approved counterparty and this is reviewed regularly in light of market developments.

For both commercial lending and roll-up 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. Additionally, there is a rolling review programme whereby valuations are updated on a regular cycle at c. 4 years on average. 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 residential, 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.

Summary of Credit Exposures

As at 31 October 2017 £m	Exposure Value	RWAs	Pillar 1 Capital
Credit Risk – Standardised Approach			
Government and Central Banks	174.2	0.0	0.0
Multi-lateral development banks	13.2	0.0	0.0
Financial Institutions	124.4	20.6	1.7
Corporate	21.0	17.7	1.4
Mortgages on residential/commercial real estate	732.9	469.6	37.6
Covered bonds	28.4	2.8	0.2
Items with particularly high risk	23.6	31.8	2.5
Other items	132.1	147.3	11.8
Total Credit Risk	**1,249.8**	**689.8**	**55.2**
Operational risk	-	16.5	1.3
Total	**1,249.8**	**706.3**	**56.5**

As at 31 October 2016 £m	Exposure Value	RWAs	Pillar 1 Capital
Credit Risk – Standardised Approach			
Government and Central Banks	252.7	0.0	0.0
Multi-lateral development banks	23.0	0.0	0.0
Financial Institutions	145.7	23.1	1.8
Corporate	18.4	13.9	1.1
Mortgages on residential/commercial real estate	687.9	463.9	37.1
Covered bonds	30.3	3.0	0.2
Items with particularly high risk	19.9	20.2	1.6
Other items	121.9	137.3	11.0
Total Credit Risk	**1,299.6**	**661.4**	**52.8**
Operational risk	-	11.4	0.9
Total	**1,299.6**	**672.8**	**53.7**

9. Interest Rate Risk in the Banking Book

Interest rate risk is the risk that arises when there is an imbalance between the maturity dates of interest rate sensitive assets, liabilities and off-balance sheet items. Interest rate risk is monitored closely and regularly reported to ALCO. The Bank's policy is to maintain interest rate risk at a controlled level within limits set by the Board.

Basis Risk

Basis risk is the risk of loss arising from changes in the relationship between interest rates which have similar but not identical characteristics. An example is the relationship between London Interbank Offered Rate (LIBOR) and the Bank of England Base Rate (Bank Rate). This is monitored closely and regularly reported to ALCO. The Bank's policy is to maintain basis risk at a controlled level within limits set by the Board.

Interest Rate Sensitivity Gap

Interest rate risk exposures are measured weekly, and reported to ALCO. The monthly position is also reported to the Board. The net present value sensitivity of the interest rate risk exposures to a 200 basis point shift in the yield curve are as follows:

£m	31 October 2017	31 October 2016
+200 basis points increase	-1.2	5.7
-200 basis points decrease	-0.8	-4.9

In addition, the effect of a 100 basis point shift in the yield curve is applied to the balance sheet at year-end, to determine how the net interest income may change on an annualised basis for one year, as follows:

£m	31 October 2017	31 October 2016
+100 basis points increase	1.8	2.8
-100 basis points decrease	2.1	2.1

In preparing the sensitivities above, the Bank makes certain assumptions regarding the expected and contractual re-pricing behaviour as well as behavioural repayment profiles, under the two stress scenarios, of the underlying balance sheet items. The results also include the impact of derivative transactions.

10. Leverage

The leverage ratio is a capital ratio not affected by risk weightings. It is calculated as Tier 1 capital divided by an adjusted balance sheet exposure.

Table LRSum: Summary reconciliation of accounting assets and leverage ratio exposures

£m	31 October 2017	31 October 2016
Total assets as per published financial statements	1,267.4	1,316.8
Adjustment for derivative financial instruments	5.6	5.2
Adjustment for off-balance sheet items (conversion to credit equivalent amounts of off-balance sheet exposures)	54.2	54.5
Other adjustments	(17.7)	(17.2)
Total leverage exposure	**1,309.5**	**1,359.3**

Table LRCom: Leverage ratio common disclosure

£m	31 October 2017	31 October 2016
Total assets as per published financial statements	1,267.5	1,316.8
Asset amounts deducted in determining Tier 1 Capital	(17.7)	(17.2)
Total on-balance sheet exposures	1,249.8	1,299.6
Derivative exposures		
Replacement cost associated with all derivative transactions (i.e. net of eligible cash variation margin)	5.6	5.2
Total derivative exposures	5.6	5.2
Other off-balance sheet exposures		
Off-balance sheet exposures at gross notional amount	226.0	194.8
Adjustment for conversion to credit equivalent amounts	(171.9)	(140.3)
Total other off-balance sheet exposures	54.1	54.5
Capital and total exposures		
Total leverage ratio exposure	1,309.5	1,359.3
Tier 1 capital	149.3	129.1
Leverage ratio	**11.4%**	**9.5%**

Table LRSpl: Split of on-balance sheet exposures (excluding derivative and exempted exposures)

£m	31 October 2017	31 October 2016
Total assets as per published financial statements	1,267.5	1,316.8
Asset amounts deducted in determining Tier 1 Capital	(17.7)	(17.2)
Total on-balance sheet exposures	**1,249.8**	**1,299.6**
Of which		
Exposures treated as sovereigns	187.4	275.7
Institutions	124.4	145.7
Secured mortgages of immovable property	732.9	687.7
Retail exposures	-	-
Corporate	21.0	18.4
Covered bonds	28.4	30.3
Items with particularly high risk	23.6	19.9
Other exposures	132.1	121.9
Total	**1,249.8**	**1,299.6**

11. Asset Encumbrance

Asset encumbrance is the process by which assets are pledged to secure, collateralise or credit-enhance a financial transaction from which they cannot be freely withdrawn.

The Pillar 3 asset encumbrance disclosure templates, shown below, have been compiled in accordance with PRA and EBA regulatory reporting requirements, specifically the PRA's supervisory statement SS11/14 ("CRDIV: Compliance with the EBA's Guidelines on the disclosure of encumbered and unencumbered assets").

31 October 2017 £m	Carrying amount of encumbered assets	Carrying amount of unencumbered assets	Fair value of encumbered assets	Fair value of unencumbered assets
Assets of the reporting institution	257.6	1,009.9		
Debt securities	50.2	147.3	50.4	149.2
Other assets	207.3	862.3		
31 October 2016 £m[1]	**Carrying amount of encumbered assets**	**Carrying amount of unencumbered assets**	**Fair value of encumbered assets**	**Fair value of unencumbered assets**
Assets of the reporting institution	288.1	1,028.7		
Debt securities	73.0	152.9	73.3	153.2
Other assets	213.7	875.8		

Information on the importance of encumbrance

The Bank encumbers assets by positioning loans as collateral to support access to the Bank of England's Funding for Lending Scheme (FLS) and in relation to derivative transactions.

[1] Calculated based on the October 2016 position

12. 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), variable remuneration 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.

Fixed Remuneration

Base salary is designed to align to the value an 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.

Variable Remuneration

Variable remuneration awards are non-contractual discretionary benefits based on company and individual performance. Both short and long term incentives are in place:

Short term	• The annual cash bonus is a performance-based remuneration plan designed to reward achievement of agreed budgets and short term objectives. This includes financial and non-financial results and measures. This applies to all employees with the exception of certain senior employees, to which the LTIP below applies.
Long-term incentive plan (LTIP)	• The purpose of the LTIP is to align the interests of senior employees with the long-term interests of the Bank. • The Board has a strategy to achieve strong yet sustainable growth. It also recognises that the achievement of that strategy is heavily dependent on senior employees within the Bank and rewards them for the part they play in achieving that strategy. • Whilst senior employees may have specific business unit responsibilities, the Board wishes to foster a "single entity" culture, such that overall performance of the combined entity is the driving factor. It believes that the provision of an LTIP achieves this aim.

The Remuneration Committee may, at its discretion, award bonuses to individuals/categories of employees, without reference to specific qualifying financial criteria, if it feels that performance warrants a bonus.

The Bank does not offer share options or shares and, as a matter of principle, does not enter into supplementary arrangements, unless exceptional circumstances dictate.

The Remuneration Committee approves all retention or termination payments which are not contractual.

The Code and European regulatory technical standards require the Bank to identify Material Risk Takers (MRTs), being those staff whose activities have a material impact on the firm's risk profile.

The Board has determined that, as at 31 October 2017, in addition to the two executive directors, 20 other members of staff, including those in control functions, are designated as being MRTs. Remuneration for the year ended 31 October 2017 for the staff subject to the remuneration code was:

£m	31 October 2017
Fixed	2.0
Variable	0.2
Total	**2.2**