HODGE

BANK
Pillar 3 Disclosures
Year ended 31 October 2018

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 Business

We are a privately-owned bank making 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.

We offer a full range of later life products assisting our customers prior to, at and post-retirement. Having been in this market since 1965 we have unrivalled expertise which allows us to develop products for customers based on a clear understanding of their needs.

Within our commercial lending business, we create value by providing a bespoke, tailored service in niche markets which are under-served by major banks and the emerging "challenger" banks.

We fund ourselves from the retail savings market, raising funds through either our on-line channel or in the traditional manner depending on the way our customers wish to do business with us.

We use our considerable experience to ensure that we have ample liquidity and capital to safeguard our customers' savings and to meet all regulatory requirements.

Our Strategy

The Board has adopted a strategic plan with the long-term aim of achieving strong and sustainable returns for our shareholder. 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 which it is taking.

A rolling five-year strategy is approved by the Board annually, complemented by a detailed business plan for the forthcoming financial year. The Board sets aside specific time during the year to review its strategy and to gauge progress towards its achievement. The current strategy is based on a continuing involvement in the Bank's commercial lending business and later life lending activities; both of which it believes will enable it to achieve its strategic objectives.

Social Responsibility

Being a socially responsible business is part of our DNA. 79% of the Group is owned by the Hodge Foundation, the charitable trust established by our late founder, Sir Julian Hodge.

The Foundation's aim is to support projects that have effective solutions to helping those most in need. It is exclusively grant-making and does not raise funds from the public. All its income is derived from its investments, most significantly its shareholding in our parent, The Carlyle Trust Limited.

Our aim is to create a sustainable long-term business, generating profits that can assist the Foundation in achieving its aims of supporting projects in the medical, education, welfare and religious sectors.

We believe that our two primary businesses, commercial and later life lending are suitable activities to deliver that sustainability.

Contents

1. Introduction

This document constitutes the Pillar 3 disclosures of Julian Hodge Bank Limited ("the Bank") as required under the Capital Requirements Directive and Regulation (CRD IV).

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, capital resources and liquidity over and above those disclosed in its financial statements.

This document should be read in conjunction with the 2018 Annual Report and Financial Statements.

1.1. Background

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.

1.2 Basis and Frequency of Disclosure

The document has been prepared in accordance with the Capital Requirements Directive and the Capital Requirements Regulations (CRR) 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, to ensure 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.

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 Bank has calculated the amount of capital that it considers necessary to cover these risks within its Internal Capital Adequacy Assessment Process (ICAAP). 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 Bank's key risk exposures and their adequacy of the Bank's risk management processes to mitigate these risks.

All numerical disclosures within this document have been prepared as at 31 October 2018, 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 audited financial statements, as required by the CRR.

1.3 Summary of Key Regulatory Metrics

	31 October 2018	31 October 2017
Total capital (£m)	168.0	149.5
Total risk-weighted assets (RWA) (£m)	754.6	706.3
Common Equity Tier 1 ratio (%)	22.3%	21.1%
Basel III leverage ratio (%)	11.9%	11.4%
LCR ratio (%)	236.9%	168.8%

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 Bank's audited Financial Statements.

1.5 Regulatory Changes

In December 2016, the European Banking Authority (EBA) published its final guidelines on regulatory disclosure requirements (amended June 2017) following an update of the Pillar 3 requirements by the Basel Committee in January 2015 (update March 2017 and further consultation February 2018). These guidelines apply from 31 December 2017. As stated in the EBA guidelines however the scope of application is limited to global systemically important institutions (G-SIIs) and other systemically important institutions (O-SIIs). The Board aims to implement the EBA guidelines in terms of quantitative and qualitative disclosures in this report in line with best practice. This document also includes additional qualitative and quantitative disclosures that the Board considers useful to the users of this document.

1.6 New Financial Reporting Standards

The Bank has completed its assessment of the day one impact of IFRS9 and the Bank has confirmed to the PRA that it plans to use the transitional arrangements. The Bank has now finalised the implementation of IFRS9. These disclosures do not include any impact from the transition to IFRS9, however a section on IFRS9 pre-transition disclosures has been included within the Bank's Financial Statements. The first set of financial statements which include the full impact of the transition to IFRS 9 will be the financial statements for the year ended 31 October 2019.

2. Scope of Pillar 3 Disclosures

During 2018, the Bank sold its subsidiary, Hodge Life Assurance Company Limited to its parent, Hodge Limited, at its book value. The Bank does not hold any other investments in subsidiary undertakings. This document contains the Pillar 3 disclosures of Julian Hodge Bank Limited as a standalone separate entity. A summary of the main differences between the Financial Statements carrying amounts and the regulatory exposures has been included within Appendix 1.

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 level.

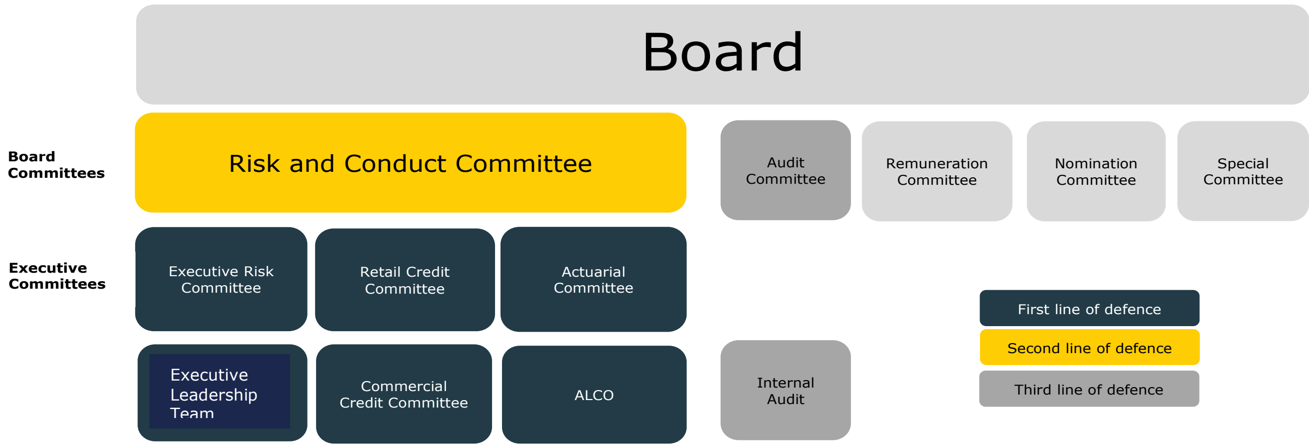
The risk management framework is also a key input into the Bank's strategic planning processes to ensure that the future development of the Bank's business does not expose it to an excessive level of risk.

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 prices its products appropriately with consideration of 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 is responsible for the identification and assessment of risks and for implementing appropriate controls. Significant operational processes and controls are in place across the organisation as part of the risk management framework. The first line of defence comprises executive committees, management and employees.

Second line of defence focuses on the oversight of first line risk management. The purpose of the second line is to review, challenge and monitor the risk identification, assessment and mitigation plans within the Bank.

A Risk Assurance team with a direct reporting line to the Risk and Conduct Committee provides the oversight of the first line through an agreed risk assurance plan. The team achieves oversight by way of on-going monitoring and a programme of risk assurance reviews, drawing on technical expertise as required.

The **third line of defence** provides independent review and objective assurance in respect of overall effectiveness of the risk management framework to the Board. Internal audit services are undertaken by PwC under an outsourcing arrangement; reporting directly to the Audit Committee. 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.

Executive Management Team – Chaired by the Chief Executive Officer, 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 Executive Management Team 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 Chief Executive Officer, 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 Chief Executive Officer, 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 Chief Executive Officer, the committee's principal responsibility is to monitor and control retail credit risk throughout the Bank 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 Chief Executive Officer, 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 of 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.

The Bank manages its liquidity risk through its Assets and Liabilities Committee and monitors its liquidity position on a daily basis and has adopted a policy to ensure that it has adequate resources to enable it to conduct its normal business activities without interruption.

An Internal 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. Interest rate risk is the risk that arises when there is an imbalance between the maturity dates of rate sensitive assets, liabilities and off-Balance Sheet items. The Bank manages its interest rate risk through its Assets and Liabilities Committee. The Bank's policy is to maintain interest rate risk at a controlled level within limits set by the Board.

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. The Company mitigates house price risk by setting and monitoring maximum Loan to Value at inception of the loan.

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. The Executive Risk Committee has overall responsibility for implementing and monitoring principles, frameworks, policies and limits.

Operational risk
Operational risk is defined as the risk of direct or indirect loss 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 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 Regulatory Metrics

As at 31 October 2018, and throughout the period to 31 October 2018, the Bank maintained its capital resources, leverage ratio, and liquidity coverage ratio at a level above the minimum requirements.

The following table provides a summary the capital, leverage ratio and liquidity coverage ratio for the Bank as at 31 October 2018:

Key metrics	31 October 2018	31 October 2017
Available capital (amounts)		
Common Equity Tier 1 (CET1) (£m)	168.0	149.3
Tier 1 (£m)	168.0	149.3
Tier 2 (£m)	-	-
Total capital (£m)	**168.0**	**149.5**
Risk weighted assets (amounts)		
Total risk-weighted assets (RWA) (£m)	754.6	706.3
Risk-based capital ratios as a percentage of RWA		
Common Equity Tier 1 ratio (%)	22.3%	21.1%
Tier 1 ratio (%)	22.3%	21.1%
Total capital ratio (%)	**22.3%**	**21.2%**
Additional CET1 buffer requirements as a percentage of RWA		
Capital conservation buffer requirement (%)	1.88%	1.25%
Countercyclical buffer requirement (%)	0.50%	-%
Total of bank CET1 specific buffer requirements (%)	**2.38%**	**1.25%**
Basel III leverage ratio		
Total Basel III leverage ratio exposure measure (£m)	1,412.2	1,309.5
Basel III leverage ratio (%)	**11.9%**	**11.4%**
Liquidity Coverage Ratio		
Total HQLA (£m)	245.2	219.6
Total net cash outflow (£m)	103.5	130.1
LCR ratio (%)	**236.9%**	**168.8%**

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 2018 and 31 October 2017.

Composition of regulatory capital (£m)	31 October 2018	31 October 2017
CET1 capital		
Share capital	105.0	105.0
Retained earnings	72.8	66.8
Accumulated other comprehensive income	(6.0)	(4.5)
CET1 capital before regulatory adjustments	**171.8**	**167.3**
Regulatory adjustment to CET1:		
Intangible assets (1)	(3.1)	(1.7)
Prudent valuation adjustment (2)	(0.7)	(0.3)
Investment in subsidiary (3)	-	(16.0)
CET1 and Tier 1 capital (T1)	**168.0**	**149.3**
Tier 2: provisions		
Collective impairment allowance (4)	-	0.2
Tier 2 capital (T2)	**-**	**0.2**
Total regulatory capital (TC = T1 + T2)	**168.0**	**149.5**
Total risk-weighted assets	**754.6**	**706.3**
Common Equity Tier 1 (as a percentage of RWA)	22.3%	21.1%
Tier 1 (as a percentage of RWA)	22.3%	21.1%
Total capital (as a percentage of RWA)	**22.3%**	**21.2%**
Institution specific buffer requirement	**2.38%**	**1.25%**
Of which: capital conservation buffer requirement	1.88%	1.25%
Of which: bank specific countercyclical buffer requirement	0.50%	-%
Amounts below threshold for deduction		
Deferred tax assets arising from temporary differences	6.5	7.3
Applicable caps on the inclusion of provisions in Tier 2		
Provisions eligible for inclusion in Tier 2	-	0.2
Cap on inclusion of provisions eligible for inclusion in Tier 2	9.4	8.8

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 until its disposal in 2018, 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.

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

£m	2018	2017
CET1 capital at 1 November	149.3	136.3
Issue of ordinary shares	-	5.0
Disposal of subsidiary	16.0	-
Profit for the year	5.5	10.2
Movement in other reserves	(1.1)	(1.4)
Movement due to regulatory adjustments	(1.7)	(0.8)
CET1 Capital at 31 October	**168.0**	**149.3**

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 2018 or 31 October 2017.

6. Capital Adequacy

6.1 Capital Management

The Bank's policy is to maintain a strong capital base to maintain investor and market confidence and to sustain the future development of the business.

Pillar 1

The Pillar 1 capital requirements set out the minimum capital requirement that the Bank must adhere to.

The Pillar 1 capital requirement consists of the following components:

- **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 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** – is the risk of direct or indirect loss resulting from inadequate or failed internal processes and controls, people or systems, or from external events. The Bank has adopted the basic indicator approach to determine its Pillar 1 operational risk capital. This calculation is based on the Bank's average income for the past three years.
- **Market risk –** is the risk of loss that arises from adverse movements in market prices. The Bank has adopted the standardised approach to determine its Pillar 1 market risk capital.

Pillar 1 capital adequacy is monitored by ALCO, 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.

Pillar 2

The Bank must set also set aside additional 'Pillar 2' capital to provide for additional risks.

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 has calculated the amount of capital that it considers necessary to cover these risks within its Internal Capital Adequacy Assessment Process (ICAAP). The Bank's Pillar 2 requirements consider the capital required to support future growth.

6.2 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 2018. In addition to the ICAAP stress, enterprise-wide stress testing on capital, liquidity, operational risk and reverse stress testing is performed.

6.3 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 Pillar 1 capital requirement is calculated as follows:

Credit risk capital required = Exposure value x Risk weighting x 8%

As at 31 October 2018 £m	Exposure Value	RWAs	Pillar 1 Capital
Government and central banks	234.4	-	-
Multi-lateral development banks	12.4	-	-
Financial institutions	114.7	14.1	1.2
Corporate	25.8	20.1	1.6
Mortgages on residential/commercial real estate	840.3	528.2	42.3
Covered bonds	40.9	4.1	0.3
Exposures in default	20.7	29.2	2.3
Other items	114.1	124.0	9.9
Total credit risk	**1,403.3**	**719.7**	**57.6**
Operational risk – basic indicator approach	-	29.9	2.4
CVA – standardised approach	**-**	5.0	0.4
Total	**1,403.3**	**754.6**	**60.4**

As at 31 October 2017 £m	Exposure Value	RWAs	Pillar 1 Capital
Government and central banks	174.2	-	-
Multi-lateral development banks	13.2	-	-
Financial institutions	129.2	14.9	1.2
Corporate	22.3	17.7	1.4
Mortgages on residential/commercial real estate	774.2	469.6	37.6
Covered bonds	28.4	2.8	0.2
Exposures in default	23.6	31.8	2.5
Other items	135.4	147.3	11.8
Total credit risk	**1,300.5**	**684.1**	**54.7**
Operational risk – basic indicator approach	-	16.5	1.3
CVA – standardised approach	-	5.7	0.5
Total	**1,300.5**	**706.3**	**56.5**

Credit valuation adjustment

The Bank holds additional capital in the form of the CVA to address the risk of loss as a result of a deterioration in the creditworthiness of counterparties to derivative transactions.

A breakdown of the exposure value by on and off-Balance Sheet exposures is shown in section 8.1.

The following tables break down the Bank's risk exposure by asset class and risk weighting.

Overview of RWA £m	31 October 2018	
	RWA	Pillar 1
Credit risk (excluding counterparty risk)		
Standardised approach	699.4	56.0
Counterparty credit risk (CCR)		
Standardised approach	4.0	0.3
Credit valuation adjustment (CVA)		
Standardised approach	5.0	0.4
Market risk		
Standardised approach	-	-
Operational risk		
Basic indicator approach	29.9	2.4
Amounts below thresholds for deduction (250% risk weight)		
Deferred tax asset	16.3	1.3
Total	**754.6**	**60.4**

Overview of RWA £m	31 October 2017	
	RWA	Pillar 1
Credit risk (excluding counterparty risk)		
Standardised approach	661.5	52.9
Counterparty credit risk (CCR)		
Standardised approach	4.3	0.3
Credit valuation adjustment (CVA)		
Standardised approach	5.7	0.5
Market risk		
Standardised approach	-	-
Operational risk		
Basic indicator approach	16.5	1.3
Amounts below thresholds for deduction (250% risk weight)		
Deferred tax asset	18.3	1.5
Total	**706.3**	**56.5**

Counterparty credit risk adjustment

The Bank holds additional capital in the form of the CCR to address the risk of loss as a result of a default of a counterparty to a derivative transaction before the final settlement of the cash flows.

The following table provides a summary of the risk weightings applied to the exposure value to calculate the RWA.

6.4 Summary of risk weightings applied to the exposure value to calculate the RWA

As at 31 October 2018 £m	Risk Weightings								Exposure Value
	0%	10%	20%	35%	50%	100%	150%	250%	
Government and central banks	234.4	-	-	-	-	-	-	-	234.4
Multi-lateral development banks	12.4	-	-	-	-	-	-	-	12.4
Financial institutions	81.7	-	17.3	-	12.0	3.7	-	-	114.7
Corporate	-	-	2.3	-	9.0	11.2	3.3	-	25.8
Mortgages on residential/ commercial real estate	-	-	-	504.6	-	304.2	31.5	-	840.3
Covered bonds	-	40.9	-	-	-	-	-	-	40.9
Exposures in default	-	-	-	-	-	3.5	17.2	-	20.7
Other items	-	-	-	-	-	107.5	-	6.6	114.1
Total	**328.5**	**40.9**	**19.6**	**504.6**	**21.0**	**430.1**	**52.0**	**6.6**	**1,403.3**

As at 31 October 2017 £m	Risk Weightings								Exposure Value
	0%	10%	20%	35%	50%	100%	150%	250%	
Government and central banks	174.2	-	-	-	-	-	-	-	174.2
Multi-lateral development banks	13.2	-	-	-	-	-	-	-	13.2
Financial institutions	102.4	-	8.0	-	11.9	6.9	-	-	129.2
Corporate	-	-	2.8	-	8.3	7.9	3.3	-	22.3
Mortgages on residential/ commercial real estate	-	-	-	481.4	-	276.1	16.7	-	774.2
Covered bonds	-	28.4	-	-	-	-	-	-	28.4
Exposures in default	-	-	-	-	-	7.2	16.4	-	23.6
Other items	-	-	-	-	-	128.1	-	7.3	135.4
Total	**289.8**	**28.4**	**10.8**	**481.4**	**20.2**	**426.2**	**36.4**	**7.3**	**1,300.5**

7. Regulatory Capital Buffers

In 2016, the 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 2018, the buffer was 1.875% of RWA. The table below shows the CCoB requirement:

£m	31 October 2018	31 October 2017
Total RWA	754.6	706.3
Institution specific CCoB rate (%)	1.88	1.25
Institution specific CCoB requirement	**14.2**	**8.8**

Countercyclical Capital Buffer ("CCyB")

In 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 2018, the buffer was 0.5% of RWA.

The table below shows the CCyB requirement:

£m	31 October 2018	31 October 2017
Total RWA	754.6	706.3
Institution specific CCyB rate (%)	0.5	-
Institution specific CCyB requirement	**3.8**	**-**

The Bank allocates all non-UK exposures to the UK for the purposes of calculating the countercyclical buffer, due to the fact that the Bank has a non-material foreign exposure.

The table below shows the geographical distribution of credit exposures relevant for the calculation of the CCyB requirement:

	Exposure values	RWA	CCyB rate	CCyB amount
	£m	£m	%	£m
2018				
United Kingdom	1,403.3	754.6	0.5	3.8
2017				
United Kingdom	1,300.5	706.3	-	-

8. 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 follows the Standardised Approach in relation to credit risk.

8.1 Summary of the Bank's Credit Risk Exposures

The exposures are summarised as follows at 31 October 2018:

£m	Exposures		
	On-Balance Sheet	Off-Balance Sheet	Total
Credit Risk – Standardised Approach			
Government and central banks	234.4	-	234.4
Multi-lateral development banks	12.4	-	12.4
Financial institutions	114.7	-	114.7
Corporate	24.6	1.2	25.8
Mortgages on residential/commercial real estate	805.3	35.0	840.3
Covered bonds	40.9	-	40.9
Exposures in default	20.7	-	20.7
Other items (1)	114.1	-	114.1
Total	**1,367.1**	**36.2**	**1,403.3**

The exposures are summarised as follows at 31 October 2017:

£m	Exposures		
	On-Balance Sheet	Off-Balance Sheet	Total
Credit Risk – Standardised Approach			
Government and central banks	174.2	-	174.2
Multi-lateral development banks	13.2	-	13.2
Financial institutions	129.2	-	129.2
Corporate	20.9	1.4	22.3
Mortgages on residential/commercial real estate	732.9	41.3	774.2
Covered bonds	28.4	-	28.4
Exposures in default	23.6	-	23.6
Other items (1)	135.4	-	135.4
Total	**1,257.8**	**42.7**	**1,300.5**

(1) The 'Other items' include items such as reversionary interests in properties, deferred tax assets, fixed assets and other debtors.

8.2 Credit Risk by Geographic distribution

The geographic distribution of these exposures as at 31 October 2018 is shown below:

£m	UK	Europe	USA	Other	Total
Credit Risk – Standardised Approach					
Government and central banks	231.3	3.1	-	-	234.4
Multi-lateral development banks	-	12.4	-	-	12.4
Financial institutions	108.6	2.2	2.2	1.7	114.7
Corporate	23.2	1.6	1.0	-	25.8
Mortgages on residential/commercial real estate	840.3	-	-	-	840.3
Covered bonds	40.9	-	-	-	40.9
Exposures in default	20.7	-	-	-	20.7
Other items	114.1	-	-	-	114.1
Total	**1,379.1**	**19.3**	**3.2**	**1.7**	**1,403.3**

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	122.1	2.2	3.1	1.8	129.2
Corporate	19.6	1.7	1.0	-	22.3
Mortgages on residential/commercial real estate	774.2	-	-	-	774.2
Covered bonds	28.4	-	-	-	28.4
Exposures in default	23.6	-	-	-	23.6
Other items	135.4	-	-	-	135.4
Total	**1,274.4**	**20.2**	**4.1**	**1.8**	**1,300.5**

8.3 Credit Risk by Residual Maturity

The residual maturity of the exposures as at 31 October 2018 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	155.8	68.5	10.1	-	234.4
Multi-lateral development banks	1.0	8.3	3.1	-	12.4
Financial institutions	104.3	4.9	5.5	-	114.7
Corporate	3.3	7.2	15.3	-	25.8
Mortgages on residential/commercial real estate	81.2	241.3	517.8	-	840.3
Covered bonds	5.6	23.4	11.9	-	40.9
Exposures in default	20.7	-	-	-	20.7
Other items	-	-	-	114.1	114.1
Total	**371.9**	**353.6**	**563.7**	**114.1**	**1,403.3**

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	100.3	66.2	7.7	-	174.2
Multi-lateral development banks	8.9	1.2	3.1	-	13.2
Financial institutions	115.2	8.2	5.8	-	129.2
Corporate	2.4	6.1	13.8	-	22.3
Mortgages on residential/commercial real estate	62.4	246.8	465.0	-	774.2
Covered bonds	6.1	10.8	11.5	-	28.4
Exposures in default	23.6	-	-	-	23.6
Other items	-	-	-	135.4	135.4
Total	**318.9**	**339.3**	**506.9**	**135.4**	**1,300.5**

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.

8.4 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 2018 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 after costs 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 Income Statement 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 2018 Annual Report and Financial Statements.

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

8.5 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. 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.

8.6 Impairment Provisions on Loans and Advances to Customers

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

£m	Specific	Collective	Total
2018			
At 1 November 2017	6.2	0.2	6.4
Utilised on redemption	(1.7)	-	(1.7)
Amounts written back during the year	(1.3)	(0.1)	(1.4)
Charge for loan impairment	0.4	-	0.4
At 31 October 2018	**3.6**	**0.1**	**3.7**
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**

2018 £m	Commercial Lending	Residential Lending	Residential Lending Fair Value	Total
Of which neither past due or impaired	324.6	208.0	269.9	802.5
Impaired assets	12.8	-	-	12.8
Past due	16.9	-	-	16.9
Loan book	**354.3**	**208.0**	**269.9**	**832.2**
Charge for loan impairment	(3.7)	-	-	(3.7)
Loan fee deferral	(2.3)	-	-	(2.3)
Total loans and advances to customers net of impairment	**348.3**	**208.0**	**269.9**	**826.2**
2017 £m	**Commercial Lending**	**Residential Lending**	**Residential Lending Fair Value**	**Total**
Of which neither past due or impaired	295.4	159.6	294.7	749.7
Impaired assets	14.9	-	-	14.9
Past due	-	-	-	-
Loan book	**310.3**	**159.6**	**294.7**	**764.6**
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**	**159.6**	**294.7**	**755.7**

8.7 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, 55+ Mortgage and 55+ Retirement Interest Only (RIO) Mortgage.

Therefore, the Bank's credit risk for roll-up lifetime mortgages, and the capital element of the Retirement Mortgage, 55+ Mortgage and 55+ RIO 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, 55+ Mortgage and 55+ RIO 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, 55+ Mortgage and 55+ RIO 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.

8.8 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.

8.9 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.

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 table below provides a summary of the External Credit Assessment Institutions credit assessments to credit quality steps:

Credit Quality Step	Moody's rating	Fitch's rating	S&P's rating
1	Aaa to Aa3	AAA to AA-	AAA to AA-
2	A1 to A3	A+ to A-	A+ to A-
3	Baa1 to Baa3	BBB+ TO BBB-	BBB+ TO BBB-
4	Ba1 to Ba3	BB+ to BB-	BB+ to BB-
5	B1 to B3	B+ to B-	B+ to B-
6	Caa1 and below	CCC+ and below	CCC+ and below

The Bank's exposures at 31 October 2018, analysed by credit rating, are summarised in the tables below:

Central governments or central banks

Rating	31 October 2018	31 October 2017
Aaa to Aa3	204.9	174.2
Total	**204.9**	**174.2**

Financial institutions

Rating	31 October 2018	31 October 2017
Aaa to Aa3	15.7	34.4
A1 to A3	91.6	84.8
Baa1 to Baa3	4.2	6.7
Ba1 to Ba3	2.6	2.7
Unrated	0.6	0.6
Total	**114.7**	**129.2**

The Bank uses financial derivatives to manage interest rate risk. A collateral asset is held by the corresponding counterparties as collateral against derivatives in a net liability position.

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. In the event of default, the collateral asset would be offset against the corresponding derivative liability.

The following table shows the exposure to counterparty credit risk for derivative contracts as at 31 October 2018 and 31 October 2017:

£m	31 October 2018	31 October 2017
Negative fair value (inclusive of potential future exposure)	(107.8)	(131.1)
Add: collateral held in the form of treasury bills	29.5	30.0
Add: cash collateral held by financial institutions	82.6	103.3
Net derivative exposure	**4.3**	**2.2**

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.

The Bank holds additional capital in the form of the CVA and CCR adjustments to protect against either the risk of the deterioration in the creditworthiness or default by the counterparties.

Multi-lateral development banks

Rating	31 October 2018	31 October 2017
Aaa to Aa3	12.4	13.2
Total	**12.4**	**13.2**

Corporates

Rating	31 October 2018	31 October 2017
Aaa to Aa3	1.9	2.0
A1 to A3	11.4	9.1
Baa1 to Baa3	6.7	6.1
Ba1 to Ba3	1.1	1.1
Unrated	4.7	4.0
Total	**25.8**	**22.3**

Covered bonds

Rating	31 October 2018	31 October 2017
Aaa to Aa3	40.9	28.4
Total	**40.9**	**28.4**

8.10 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 mortgage, 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.

9. 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 positions. The Bank's assets and liabilities are denominated in Sterling; therefore, the Bank has no foreign exchange risk exposure. The Bank is exposed to one component of market risk, being interest rate risk.

Interest Rate Risk in the Banking Book

Interest rate risk is the risk that arises when there is an mismatch between the maturity dates of interest rate sensitive assets, liabilities and off-Balance Sheet items. This risk is managed through the appropriate use of financial instruments, mainly derivatives within the established risk limits set by the Board.

Derivatives are only used to limit the extent to which the Bank will be affected by changes in interest rates or other indices which affect the fair values or cash flows. Derivatives are therefore used exclusively to hedge risk exposures. The principal derivatives used by the Bank are interest rate exchange contracts, commonly known as interest rate swaps. The Bank's forecasts and plans take into account of the risk in interest rate changes and are prepared and stressed accordingly.

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 monthly and reported to ALCO and 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 2018	31 October 2017
+200 basis points increase	0.3	(1.2)
-200 basis points decrease (floored at zero)	(2.9)	(0.8)

The movement in sensitivity of the Bank's Balance Sheet to interest rate movements has been caused by changes to the interest rate environment and changes to the Bank's Balance Sheet.

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 2018	31 October 2017
+100 basis points increase	2.1	1.8
-100 basis points decrease (floored at zero)	(1.2)	2.1

The movement in sensitivity of the Bank's Balance Sheet to interest rate movements has been caused by changes to the interest rate environment and changes to the Bank's Balance Sheet.

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.

Summary comparison of accounting assets against leverage ratio exposures

£m	31 October 2018	31 October 2017
Total assets as per published financial statements	1,363.4	1,267.5
Adjustment for derivative financial instruments	5.6	5.6
Adjustment for off-Balance Sheet items (conversion to credit equivalent amounts of off-Balance Sheet exposures)	46.3	54.1
Other adjustments	(3.1)	(17.7)
Total leverage exposure	**1,412.2**	**1,309.5**

Leverage ratio common disclosure

£m	31 October 2018	31 October 2017
Total assets as per published financial statements	1,363.4	1,267.5
Asset amounts deducted in determining Tier 1 Capital	(3.1)	(17.7)
Total on-Balance Sheet exposures	**1,360.3**	**1,249.8**
Derivative exposures		
Replacement cost associated with all derivative transactions (i.e. net of eligible cash variation margin)	5.6	5.6
Total derivative exposures	**5.6**	**5.6**
Other off-Balance Sheet exposures		
Off-Balance Sheet exposures at gross notional amount	193.7	226.0
Adjustment for conversion to credit equivalent amounts	(147.4)	(171.9)
Total other off-Balance Sheet exposures	**46.3**	**54.1**
Capital and total exposures		
Tier 1 capital	**168.0**	**149.3**
Total leverage ratio exposure	**1,412.2**	**1,309.5**
Leverage ratio		
Basel III leverage ratio	**11.9%**	**11.4%**

Breakdown of on-Balance Sheet exposures (excluding derivative and exempted exposures)

£m	31 October 2018	31 October 2017
Total assets as per published financial statements	1,363.4	1,267.5
Asset amounts deducted in determining Tier 1 Capital	(3.1)	(17.7)
Total on-Balance Sheet exposures	**1,360.3**	**1,249.8**
Of which		
Exposures treated as sovereigns	246.8	187.4
Institutions	110.7	124.4
Secured mortgages of immovable property	804.1	732.9
Corporate	23.0	21.0
Covered bonds	40.9	28.4
Exposures in default	20.7	23.6
Other exposures	114.1	132.1
Total	**1,360.3**	**1,249.8**

11. Liquidity

The Liquidity Coverage Ratio (LCR) refers to the amount of highly liquid assets a firm must hold to meet liquidity outflows during a 30-calendar day stress event. The aim of the LCR is to ensure that the Bank can survive a 30-calendar day stress event by identifying the quantum of unencumbered, high quality liquid assets held to offset the net cash outflows the Bank could encounter in this stress event.

Approach to management of high quality liquid assets

The Bank maintains a portfolio of unencumbered high-quality liquid assets (HQLA) meeting the eligibility criteria specified by the LCR regulations. Assets pledged as collateral for secured funding transactions or derivative credit risk mitigation purposes are specifically excluded from the Bank's HQLA portfolio.

The Treasury Credit Risk Management Policy contains a series of risk limits intended to limit exposures to individual counterparties and classes of assets, thereby ensuring diversification of risk to minimise material credit or concentration risks.

The Bank maintains lines with counterparty banks providing the ability to monetise liquid assets through secured funding transactions. In addition, the Bank has access to the Bank of England Discount Window Facility, allowing monetising of eligible assets held in collateral pools. A sample of the assets held is tested through repurchase agreements on at least an annual basis.

The major portion of cash resources are held in the Bank's Bank of England reserve account. Other, smaller, balances are held with relationship banks and money market funds. Exposures to individual counterparties (excluding the Bank of England) are limited as per the Liquidity Risk Management Policy to avoid excessive deposits held with any one firm.

Liquidity outflows

Liquidity outflows are calculated by multiplying the outstanding balances of various categories or types of liabilities and off-Balance Sheet commitments by the rates at which they are expected to run off or be drawn down as indicated by the regulations.

Liquidity inflows

Liquidity inflows are assessed over a 30-calendar day period and comprise only contractual inflows from exposures that are not past due. No inflows are recognised from commercial lending or retail mortgage cash flows. Inflows are limited to relationship bank cash balances and securities maturing within the 30-calendar day period.

Liquidity Coverage Ratio £m	31 October 2018	
	Total unweighted value	**Total weighted value**
High-quality liquid assets		
Total HQLA		245.2
Cash outflows		
Retail deposits and deposits from small business customers, of which:		
Stable deposits	(262.5)	(13.1)
Less stable deposits	(246.3)	(30.5)
Unsecured wholesale funding, of which:		
Non-operational deposits	(39.5)	(15.8)
Secured wholesale funding	-	-
Additional requirements, of which:		
Outflows related to derivative exposures and other collateral requirements	(35.2)	(33.9)
Credit and liquidity facilities	(192.3)	(24.3)
Other contractual funding obligations	-	-
Other contingent funding obligations	-	-
Total cash outflows		**(117.6)**
Cash inflows		
Other cash inflows	14.4	14.1
Total cash inflows		**14.1**
Total HQLA		**245.2**
Total net cash outflows		**103.5**
Liquidity Coverage Ratio (%)		**236.9%**

12. 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.

31 October 2018 £m	Carrying amount encumbered assets	Carrying amount unencumbered assets
Assets of the reporting institution		
Treasury bills	56.2	25.0
Debt securities	19.4	68.1
Loans and advances to credit institutions	82.6	13.6
Loans and advances to customers	139.6	688.3
Other assets	-	270.6
Total	**297.8**	**1,065.6**

31 October 2017 £m	Carrying amount encumbered assets	Carrying amount unencumbered assets
Assets of the reporting institution		
Treasury bills	30.0	57.3
Debt securities	18.2	58.8
Loans and advances to credit institutions	103.3	4.3
Loans and advances to customers	76.3	681.6
Other assets	-	237.6
Total	**227.8**	**1,039.6**

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), the Bank of England's Term Funding Scheme (TFS) and in relation to derivative transactions.

13. Remuneration

As a Bank with less than £15bn of assets, the Bank is classified as a "Tier 3" firm for the purposes of the disclosure of remuneration under the Capital Requirements Regulations (CRR). In compliance with the requirements, the Bank has taken note of the regulator's guidance on materiality and proportionality.

The remuneration policy of the Bank is managed by the Remuneration Committee. All members of the Remuneration Committee are non-executive.

The function of the Remuneration Committee is 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.

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 2018, in addition to the two executive directors, 24 (2017:20) other members of staff, including those in control functions, are designated as being MRTs. Remuneration for the year ended 31 October 2018 for the staff subject to the remuneration code was:

£m	31 October 2018	31 October 2017
Fixed	2.3	2.0
Variable	0.3	0.2
Total remuneration	**2.6**	**2.2**

No special payments were made to MRTs during either the year ended 31 October 2018 or the year ended 31 October 2017.

Appendix 1: Main sources of differences between regulatory exposure amounts and carrying amounts in the Financial Statements

£m	31 October 2018				
	Financial Statements	Regulatory Exposure	Credit Risk Framework	Counterparty Risk Framework	Market Risk Framework
Assets					
Cash balances held at central banks	**153.2**	**153.2**	-	153.2	-
Treasury bills	**81.2**	**81.2**	-	81.2	-
Debt securities	**87.5**	**87.5**	-	87.5	-
Advances to credit institutions	**96.2**	**96.2**	-	96.2	-
Loans and advances to customers	**827.9**	**829.1**	829.1	-	-
Intangible assets (1)	**3.1**	**-**	-	-	-
Property, plant & equipment	**2.2**	**2.2**	2.2	-	-
Investment properties	**100.3**	**100.3**	100.3	-	-
Deferred tax assets	**6.5**	**6.5**	6.5	-	-
Derivative financial instruments (2)	**-**	**5.6**	-	-	5.6
Other assets	**5.3**	**5.3**	5.3	-	-
Total assets	**1,363.4**	**1,367.1**	**943.4**	**418.1**	**5.6**
Liabilities					
Deposit from banks	**72.5**	**-**	-	-	-
Deposits from customers	**994.6**	**-**	-	-	-
Derivative financial instruments	**107.8**	**-**	-	-	-
Other liabilities	**1.2**	**-**	-	-	-
Accruals and deferred income	**2.7**	**-**	-	-	-
Other provisions	**0.1**	**-**	-	-	-
Pension liabilities	**12.8**	**-**	-	-	-
Total liabilities	**1,191.7**	**-**	-	-	-
Share capital and reserves					
Called-up share capital	**105.0**	**-**	-	-	-
Other Reserves	**66.7**	**-**	-	-	-
Total equity	**171.7**	**-**	-	-	-
Total equity and liabilities	**1,363.4**	**-**	**-**	**-**	**-**

(1) The intangible asset has a exposure value of £nil from a regulatory perspective. The Bank deducts the intangible asset in calculating the Bank's Common Equity Tier 1 capital, as set out in CRDIV.

(2) The deferred tax regulatory adjustment consists of:

- £1.6 million of derivatives in an asset position which are disclosed within the net derivative liability position within the financial statements
- £4.0 million CCR adjustment to address the risk of loss as a result of a default of a counterparty to a derivative transaction before the final settlement of the cash flows.

Appendix 2: Glossary of terms used

ALCO	Assets and Liabilities Committee
CCR	Counterparty Credit Risk
CCoB	Capital Conservation Buffer
CCyB	Countercyclical Capital Buffer
CET1	Common Equity Tier 1
CRDIV	Capital Requirements Directive and Regulation
CRR	Capital Requirements Regulation
CVA	Credit Valuation Adjustment
EBA	European Banking Authority
FLS	Funding for Lending Scheme
FPC	Financial Policy Committee
FRS 101	Financial Reporting Standard 101 Reduced Disclosure Framework
HQLA	High Quality Liquid Assets
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process
IRB	Internal Ratings Basis
LCR	Liquidity Coverage Ratio
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
TFS	Term Funding Scheme

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