

HBL



Pillar III Disclosures

31 December 2010

1. Introduction

1.1 Ownership Structure

Habib Allied International Bank PLC ("the Bank") is a UK incorporated Bank authorised and regulated by the Financial Services Authority (FSA). The current shareholding of the Bank is set out below

- 90.5% owned by Habib Bank Limited, Pakistan ("HBL")
- 9.5% is owned by Allied Bank Limited, Pakistan

HBL, which is the principal shareholder, is in turn 51% owned by The Aga Khan Fund for Economic Development S.A. (AKFED), registered in Switzerland, the ultimate parent.

1.2. Bank Product / Activities

The principal activity of the Bank is the provision of a range of commercial banking services in the United Kingdom including a comprehensive service in all aspects of trade finance, short term finance through bills discounting, working capital finances, term loans and traditional deposit products, i.e., accepting deposits through current, saving and fixed account products. The Bank operates on a basic banking model and targets its niche market of South Asian Diaspora.

The Bank is a member of the Financial Services Compensation Scheme (FSCS) and eligible deposits are protected as per the terms of the scheme. Full details can be viewed on the FSCS website www.fscs.org.uk.

The key long term objectives of the Bank are:-

- To provide efficient and effective service to customers and thus be the preferred provider of banking service to its chosen target market segments;
- Be an employer of choice for its staff;
- To maintain the highest standards of corporate governance;
- To provide a suitable return on equity to the shareholders.

1.3. Background to Regulation

The FSA's Capital Requirement Directive (CRD) was designed to implement the European Commission's 'Capital Adequacy Directive' (the new Basel Capital Accord - Basel II) for UK regulated institutions by 31 December 2007.

The FSA Handbook chapter 'Prudential Sourcebook for Bank's ...' (BIPRU) 2.2 sets out guidance on GENPRU 1.2 (Adequacy of financial resources), and in particular, how a firm should carry out its 'Internal Capital Adequacy Assessment Process' (ICAAP).

The Basel Committee's revised framework known as Basel II was published in 2004 which replaced the previously accepted Basel Capital Accord of 1988. The Basel II Framework is intended to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they may face, today and in the future, and to develop and improve their ability to manage those risks.

The fundamental objective of Basel II has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks and will promote the adoption of stronger risk management practices by the banking industry.

It is intended to be more flexible and better able to evolve with advances in markets and risk management practices.

The Basel II Framework is based on three pillars which are:-

- **Pillar I** - Minimum capital requirements for credit, market and operational risks;
- **Pillar II** - (Supervisory review) - Establishing a constructive dialogue between a firm and the regulator on the risks, the risk management and capital requirements of the firm. The Board of Directors and senior management

of the Bank are required to adopt processes for assessing the resources and risk mitigation techniques to cover the major or supplementary sources of risks to which the Bank is or potentially could be exposed to, i.e. concentration, credit, liquidity, operational, people, strategic risks;

- **Pillar III** - (Market discipline) - Its aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on a firms' capital, risk exposures and risk assessment processes. The disclosures are to be made to the market for the benefit of the market.

The intention is designed to improve capital regulation which would take into account changes in banking and risk management practices while at the same time preserve the benefits of a framework that can be applied as uniformly as possible at the national level.

The Bank has adopted the Standardised Approach to credit risk, the Basic Indicator Approach ("BIA") to operational risk and the Standard Position Risk Requirement ("PRR") for market risk from 1 January 2008. The Bank also became subject to Pillar II and III from that date.

1.4. Basis and Frequency of disclosures

These Pillar III disclosures have been prepared for Habib Allied International Bank Plc in accordance with the rules of the FSA Handbook BIPRU Chapter 11.

Unless stated otherwise, all figures are as at 31 December 2010, which is the Bank's financial year end.

The Bank has not taken any exemptions from these disclosures in regard to confidential or proprietary information.

Future disclosures will be issued on an annual basis and published as soon as practicable after the publication of the Annual Report & Accounts.

1.5. Location and Verification

These disclosures have been reviewed internally by the Bank's senior management. On the recommendation of senior management, the Chairman of the Audit Committee and the CEO have approved the publication of disclosures on the Bank's website www.habibbankuk.com.

These disclosures have not been subjected to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Bank's Annual Report & Accounts as of 31 December 2010.

2. Risk Management Framework

2.1 Corporate Governance

One of the key corporate objectives of the Bank is 'to maintain the highest standards of corporate governance'. The Board of Directors ("the Board") oversees the Bank's business, strategic direction, policy formulation, organisational structure and its activities. The Bank's senior management seeks to realise the Bank's strategic goals which are to maximise long term shareholder value and to maintain the highest standards of integrity and transparency.

Governance of the business by both the Board and senior management and the ability to sustain the financial performance of the business during the period of recession has re-emphasised and validated the appropriateness of the Bank's business model.

The following Board and Management Committees ("the committees") have been established to conduct detailed analyses and reviews of the Bank's established policies and critical issues. The Committees have been constituted to assist the Board and Chief Executive Officer ("CEO") in monitoring the effective implementation of the policies, processes and procedures. All the significant matters discussed and decided at each meeting of the Board Committees are reported to the Board by the Chairman of the respective Committees.

Credit Policy Committee

This committee meets at every Board meeting and consists of at least two directors and the CEO. The Chairman of the Committee will be appointed by the Board of Directors and will be a Non Executive Director.

To comply with the guidelines of FSA to have an enterprise wide risk management and oversight responsibility, the existing Credit Policy Committee (CPC) which used to focus on credit and counterparty risks will be reinforced and renamed to Risk Management Committee and its terms of reference expanded to include Market, Operational and Reputational Risks. This resolution was passed in late 2010 to take affect from the beginning of 2011.

The Risk Management committee will consist of at least two directors, the CEO, the Head of Credit, the Head of Treasury, the Head of Operations and the Head of Financial Control Departments. The chairman of the Committee will be appointed by the Board of Directors. A description of the roles and responsibilities of this committee is covered in detail in Section 2.2.1 Credit Risk Management.

Human Resources Committee

The Committee will consist of at least two non-executive directors, including an Independent Non-Executive Director, and Chief Executive Officer, with Head of HR as Secretary of the Committee. The Chairman of the Committee will be appointed by the Board of Directors. The committee aims to ensure that staff compensation and benefits are appropriate to the individuals' performance and is aligned to the business and is in compliance with all relevant employment laws and regulations.

Audit & Compliance Committee

The Committee will be appointed by the Board, and will consist of at least three Non executive Directors including an independent Non Executive Director, who will be the chairman of the Committee. The Head of Internal Audit & Compliance will be Secretary of the Committee. The committee meets at every Board meeting. The committee oversees the financial management, internal audit and compliance functions to ensure that any related risks are evaluated and managed properly.

Assets and Liabilities Committee

This committee meets every month and is chaired by the CEO. The overall responsibility of this committee is to manage the assets and liabilities function within the Bank. The detailed description of the roles and responsibilities is given in Section 2.2.2 Liquidity Risk.

IT Steering Committee

The IT committee meets at least quarterly to discuss all IT related risks, projects and expenditures. The committee is responsible for the development and management of IT projects as well as to review and monitor internal controls and security procedures for all IT related products.

Business Review Committee

This committee meets fortnightly with the Deputy Chief Executive Officer (DCEO) and all the Business Managers, Senior Manager West Africa Region, Manager Treasury and Heads of Credit and Financial Control as Members to establish and discuss the business strategy for the Bank. The committee aims to review and monitor the performances on comparison to set targets and put forth new suggestions for products and marketing.

Operations Review Committee

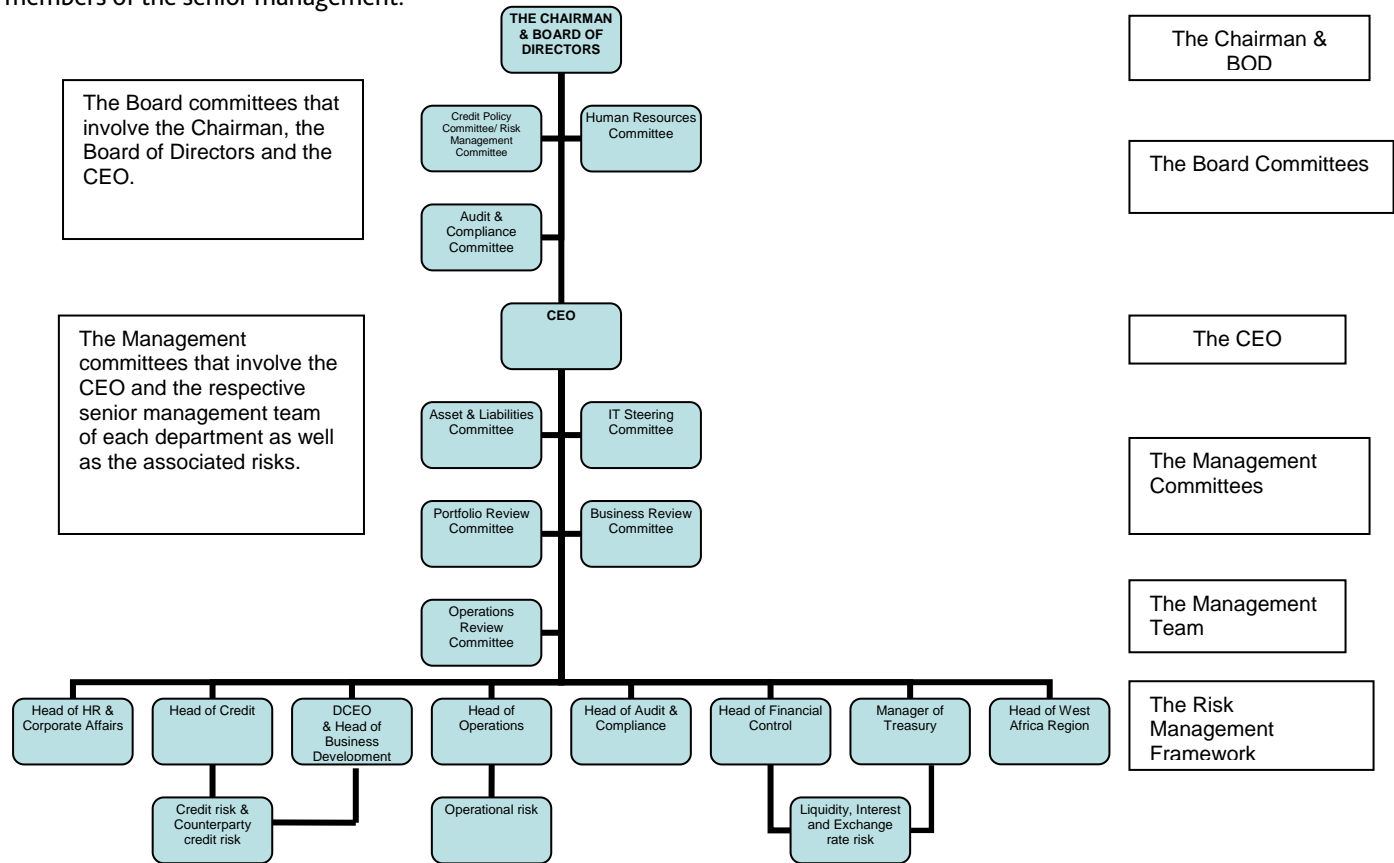
This committee meets fortnightly with the DCEO, senior managers and Head of Treasury. To discuss and review the issues relating to the operations of the Bank.

Portfolio Review Committee

This committee meets every month with the Head of Credit, the Head of Business Development and the relevant Business Managers to discuss, review and monitor the past dues in the credit portfolio. The aim of this committee is discussed in Section 2.2.1.4 Past Due and Impaired Assets.

Framework Structure

The following diagram provides a better understanding of the organisation and reporting lines within the Bank along with the different committee participants, it also shows the risk management framework assigned to the different members of the senior management:-



Since the Bank's inception in 2001, the Board has endeavoured to establish and maintain a robust risk management framework, which is designed to meet, not only its governance obligations and best practices, but also to identify and mitigate any potential risks to the business objectives as and when circumstances arise.

The continued growth in financial performance, retention of deposits, increased profitability, and the absence of large volumes of complaints indicate the success of this approach.

2.2 Risk Management - Risk Appetite & Risk Management Framework

The Board continue to maintain a 'Risk Averse' policy to risks. The risks identified in the Bank's risk register are all at an acceptable level for the current business operations and proposed strategic plan.

A close review of the risks facing the Bank and its business strategy is maintained to ensure that any new or changes to the existing risk profiles are identified at an early stage, and that appropriate mitigation tools are established as required.

The Bank uses a high level view of risk profiles that provide a subjective view of the impact of each risk on the Bank and the probability of the risk occurrence. They are not expressed in terms of expected losses and do not provide any loss tolerance thresholds. Since inception of the Bank the 'Risk Averse' policy has been successful.

The key material risks affecting the Bank are credit, operational, liquidity, interest and exchange rate risk. The Bank's strategies in managing these risks are set out below:-

2.2.1 Credit Risk Management

Credit risk is the risk of loss due to the failure of counterparty to meet their credit obligations in accordance with agreed contract terms.

Credit risk makes up the largest part of the Bank's risk exposures. The Credit risk policies will be established by the Risk Management Committee (RMC) from the beginning of 2011 and will be approved by the Board. The RMC will be responsible to ensure appropriate governance and oversight function relating to all the risks in the Bank i.e. credit risk, market risk, operational risk, and reputational risk. In terms of credit risk the RMC's responsibilities include:-

- To determine the policies and processes for credit approval, large exposures, country risk exposures and provisioning;
- To establish overall lending policies and guidelines;
- To monitor effective implementation of policies and consider any desirable amendments in the light of market conditions;
- To ensure credit exposures of the Bank are at all times in compliance with any legal or regulatory requirements or restrictions;
- To ensure portfolio performance is in line with the set benchmarks and determine that overall provisions remain at required level; and
- To review the Large Exposures portfolio.

The Bank's strategy to manage its different type of credit risks are set out below:-

2.2.1.1 Commercial Loans

Commercial loans are considered based on the following underlying criteria:-

- Borrowers and/or counterparties must be established UK or off shore entities with a good financial track record and the key directors or principals must be competent, knowledgeable and experienced in their line of business;
- Property collateral must be UK based;
- Borrowers must demonstrate the ability to deliver sufficient cash flow to service obligations.

Salient features of risk approval process are delineated below:-

- Every extension of credit to any counterparty requires centralized approval by Credit Department;
- All Business managers apply consistent standards in recommending their credit proposals and subsequent renewals;
- Every material change to a credit facility requires approval from the Credit Department.

The Bank uses a risk rating system to supplement the credit risk measurement procedure for exposures exceeding a certain threshold. The risk rating of counterparties is an essential requirement of the credit approval process.

Mitigation Techniques

The Bank's loan and advances product is a secured programme and in most cases collateralised by fixed charge on property assets, cash, and floating charge on company assets and guarantees to secure obligations. The cash flow is also analysed to ensure that the borrower has the debt servicing ability. With a concentration in property as collateral, market volatility is measured by reference to a standard quarterly index published by HBOS and Nationwide Building Society. The index tracks residential house prices on a regional basis and consolidated for the UK. Volatility is the percentage increase or decrease in the index. There is no index for commercial property, however residential property price movements generally have an effect on commercial property values. Commercial and retail property prices are monitored quarterly through specialist property websites.

To ensure continued enforceability of the Bank's security, all legal charge forms and supporting documentation have been produced with the guidance of the Bank's legal counsel.

The Bank's current 'Provisioning' Policy includes a requirement to instruct an independent firm of solicitors to undertake a review of the Bank's collateral to ensure its continued enforceability.

In addition, any new or revised security requirements are handled by the Credit department in conjunction with the Bank's approved panel of solicitors, who are responsible for ensuring the perfection of the security required for the advance.

General Provision

The Bank's 'Provisioning Policy' states that *"as a matter of prudence and because of the reason that probable loss due to impairment of credit portfolio cannot be predicted with 100% accuracy, the bank will carry a General Provision of 1.0% of the performing loans, overdrafts, bills discounted bearing customer's acceptances, and outstanding acceptances under our Letters of Credit. This reserve would be over and above the amount of specific provision required for any identified advance(s)."*

2.2.1.2 Investments and Placements

The Bank in its normal course of activity deploys its liquidity in Treasury securities with the intent to hold the instrument to maturity. This includes;

- Floating rate notes and Bonds purchased from the primary market and selected secondary market offerings through approved brokers;
- Investment grade, marketable paper only as categorised by the international ratings agencies – Moody's, Standard & Poor's and Fitch;
- Debt securities issued/guaranteed by Government;
- Prime bank or corporate paper with proceeds used by the issuer; government guaranteed bank is a plus factor;
- No exotic papers.

Investment decisions are taken considering efficient use of capital, risk weighting, market price and yield to maturity.

Formal credit assessment includes review of the financial status of the issuer, the issuer and proposed or traded paper rating, underlying collateral, if any, the offering document and legal agreement or trust deed document.

For managing short term liquidity and surplus cash, the Treasury makes money market placements and purchases short term certificate of deposits. The criteria established for these investments are set out below:-

- Placements to be for overnight and up to three months only and as an exception allowed for more than three months;
- CD's up to 3 - 6 months tenor only;
- Placement with or purchase of CDs of top 50 global banks by tier 1 capital.

The Bank complies with the Credit Quality assessment scale (CQS) and primarily uses ratings by Moody's for all type of exposures and where rating from Moody's is not available ratings by Standard and Poors and Fitch are used. The Bank uses CQS for all rated exposures.

2.2.1.3 Trade Finance (Funded and Unfunded)

The Bank has established a sound business which allows it to conduct trade finance business undertaking Letters of Credit confirmations, negotiations and discounting. The broad parameter for conducting this business includes:-

- Limits on banks and countries established through allocation from the global lines of the Parent Bank;
- Country limits set by a risk rating model based upon economic factors and political stability with modifiers to down grade or upgrade the rating;
- When setting limits, due consideration is given to country, bank and trade sector concentrations;
- The Bank's risk appetite and limits established through credit appraisal process locally;
- Country and banks trade exposures monitored daily with country exposures reviewed in ALCO on a monthly basis;
- Banks on constant watch with on-line links to ratings agencies to capture grading changes.

For the different types of credit risks that have been mentioned above the Bank has a documented asset underwriting strategy in place.

2.2.1.4 Past Due and Impaired Assets

Impaired Assets

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

Past Due Assets

Past due assets are assets where contractual interest or principal payments are past due, but based on evaluation by the Credit Department are not classified as impaired assets.

The Bank monitors its past due credit portfolio on a continuing basis through the portfolio review committee. The committee has been introduced in the Bank to closely monitor delinquent portfolio. Procedures are in place to identify, at an early stage, credit exposures for which there may be a risk of loss. The objective of an early warning system is to address potential problems while various options may still be available. Early detection of problem loans is a tenet of our credit culture and is intended to ensure that greater attention is paid to such exposure. Based on a review of the portfolio at regular committee meetings with the monitoring reports on advances, each and every individual advance would remain under constant watch by the Head of Credit and the concerned Business Manager, and the moment any account starts defaulting in repayment or deviating from the loan agreement, the concerned Business Manager and the Head of Credit would start monitoring the performance of that advance on a more regular basis.

Specific Provision Against Impaired Assets

For the purpose of classification and categorisation, evaluation and risk assessment of each Advance and Trade Bill will be done on the basis of determinant factors for each classification and categorisation. The evaluation will be carried out by the Head of Credit on the basis of counterparty's financial conditions, liquidity, earnings, adequacy of security inclusive of its realisable value, cash flow of the borrower, transactions in the account, documentation covering the advances and credit worthiness of the borrower and other factors that may require such evaluation to be carried out.

The Bank maintains three broad categories of classification i.e. risk ratings for regular accounts, watch list for past due accounts and classification categories (substandard, doubtful and loss) for impaired accounts. Provision requirement against impaired categories are ear-marked as 25% for substandard, 50% for doubtful and 100% for loss category after taking into account the realizable value of collateral.

2.2.2 Liquidity Risk

This is the risk arising from the maturity profile, and type and nature of the Bank's assets and liability mix. If not satisfactorily controlled the Bank could be faced with being unable to meet customer demands for repayment of deposits, which can lead to a run on Bank deposits.

The new liquidity regime introduced by the FSA has meant that the Bank has revised its liquidity management to be in compliance with the new rule set out in BIPRU 12. The new requirements include the overall liquidity rule, risk tolerances, thresholds, systems and controls, stress testing scenarios, contingency funding plan, quantitative reporting and the documentation of the internal liquidity adequacy assessment (ILAA).

The Bank's liquidity policy is to ensure the Bank 'at all times maintain **solvency** through a prudent funding profile and appropriate mix of assets to ensure compliance with the overall liquidity adequacy principle as defined in **BIPRU 12.2.1**. The Bank's **solvency** has to be achieved on a self-sufficiency basis, i.e. without recourse to support from either the principal shareholder ¹ - Habib Bank Limited, Pakistan (**HBL**) or the Central Bank.

¹ BIPRU specifically refers to 'Parent', which in our case is the principal shareholder

The policy document sets out the Bank's liquidity management framework and sets out the overall liquidity policy, liquidity risk appetite, thresholds and tolerance levels, and system and controls. **Senior management** is responsible to regularly review this policy document and recommend changes, if any required, to the Board in a timely manner.

The Bank will continue to evolve liquidity risk management arrangements based on feedback from the FSA, experiences, and from developments in market and industry best practices. The Bank has completed its Individual Liquidity Adequacy Assessment (ILAA) documentation as required under the new liquidity regime. This will be reviewed by the FSA under the Supervisory Liquidity Review Process (SLRP) based on which the new Individual Liquidity Guidance (ILG) will be provided to Bank.

The Assets and Liabilities Committee ("ALCO") has the responsibility for the formulation of the overall strategy and oversight of the asset liability management function. Roles and responsibilities of "ALCO" include but are not limited to:-

- Establishing the Liquidity and Interest Rate policies including changes in the Bank's Base Rate and deposit interest rates;
- Monitoring liquidity and market exposure limits;
- Review of the Treasury market trends and forecasts on interest rates and FX rates and to decide on the Bank's strategy;
- Developing the sterling and currency interest rate forecasts to be used for planning and budgeting purposes;
- Review of the breaches if any of the FSA guidelines on the liquidity position of the Bank and deciding on the action to restore/bring the position within the mismatch guidelines agreed with the FSA;
- To review market valuations of the Bank's portfolio of Floating Rate Notes and Fixed Income Securities and to approve further courses of action if any investment individually fell by 5% or more or is downgraded in its external rating to below the investment grade;
- Review of exchange profits and FX income trends of the Bank and plan for future;
- Review of the Bank's liquidity position in the sight to 1 month band and Capital Adequacy Ratio;
- Management of Liquidity during stringent conditions and abnormal circumstances;
- Review and monitor warning indicators and funding sources;
- Providing a forum for the exchange of views on liquidity related matters;
- Management of thresholds and compliance with the liquidity policy;
- Review of stress testing results and to consider the impact of stress results on the appropriateness of assumptions relating to the;
- Effectiveness of diversification across the Bank's chosen sources of funding;
- Estimates to future balance sheet growth;
- Ability to access unsecured funding;
- Ability to convert currencies through use of foreign exchange swap markets;
- Regular review of the Bank's contingency funding plan (CFP) and to incorporate changes if any required based on experience;
- Review of large exposures; and
- Review of the reports.

2.2.3. Market Risk

It is the risk of loss due to adverse movements in market rates or prices, such as foreign exchange rates, interest rates and equity prices. The Bank does not maintain an active trading book and hence carries limited market risk which emanates from mismatches in structural assets and liabilities positions.

2.2.3.1 Interest Rate Risk

Interest rate risk arises when there is a mismatch between positions which are subject to interest rate adjustments within a specific period. Substantial part of the Bank's assets and liabilities are subject to floating rates and hence are re-priced simultaneously. However, the Bank is exposed to interest rate risk as a result of mismatches on a relatively small portion of its assets and liabilities and assets funded through equity. The major portion related to this risk is reflected in the banking book.

The Bank manages its interest rate exposure through an interest rate gap report whereby assets and liabilities are allocated into an appropriate time band, based on the next interest re-fix date.

The interest risk is then calculated as a 2% impact on earnings of the resulting net position for each time band, in line with the Basel Committee's recommendation.

INTEREST RATE PRR	DEC 31, 2010	DEC 31, 2009
GBP	-1011	-731
USD	-23	-58
EURO	-98	-7
OTHERS	-13	-31
TOTAL INTEREST RATE PRR	-1145	-827
A Negative number represents a decline in earnings due to reduction in interest rates by 2%		

2.2.3.2. Foreign Exchange Risk

The Bank's assets are typically funded in the same currency as that of the business transacted to eliminate foreign exchange exposure. Foreign currency transactions are undertaken only on behalf of customers who are covered from the market on the same day.

The Foreign exchange risk appetite is defined by ALCO and monitored on a daily basis.

The Foreign exchange position risk is calculated as 8% higher of the net overbought or oversold position in foreign currencies.

2.2.4. Operational Risk

Operational risk is the risk of loss resulting from weaknesses in systems, procedures and people or from external events. The Bank has adopted the 'Basic Indicator Approach', which as the BIPRU sourcebook states is 'The Operational Risk Capital Requirement' (ORCR) under the Basic Indicator Approach equal to 15% of the three-year average of the sum of (a) A firm's net interest income; and (b) A firm's net non-interest income.

The Bank has established a robust Risk Management Framework with an objective to ensure that a strong control environment is maintained and evidenced in every area of the business. This will reduce any operational risk to a minimum, although in view of the number of unknown external factors, the framework is regularly reviewed and overall risk management is kept at a high profile within the business to ensure any unmitigated operational risk is identified at an early stage.

The data available to the bank since its inception shows that the bank has made insignificant operational losses during the period to date. The level of complaints received is minimal, and insufficient to identify any particular trends of weaknesses.

To supplement the updated risk profiles, a micro review of operational risks, which included all operational areas, products and processes has been undertaken and documented in the 'Operational Risk Framework'.

2.2.5. Counterparty Risk

Counterparty credit risk (CCR) is the risk to the Bank that a counterparty to a transaction could default before the final settlement of the transaction's cash flows. In the normal course of business the Bank enters into foreign exchange contracts on behalf of its customers which are generally covered by entering into reciprocal transactions with other banks in the market on a daily basis to avoid position risk. Counterparty credit risk emanating from these transactions is managed by maintaining sufficient collateral from customers to mitigate customer default exposure at the time of settlement. Further, all customers are required to sign-off a FX trading agreement with the Bank before executing any transactions with the bank. Exposures on Banks which are other counterparties to these transactions are managed within overall limit allocations determined as part of the Banks credit assessment of such institutions.

3. ARROW Review

The Financial Services Authority (FSA) is a risk based regulator. The FSA's risk assessment process is a high level review aimed at assessing the significance of a particular risk posing a threat to the statutory objectives.

The five statutory objectives that were established by the Financial Services and Markets Act 2000 are:

- “**market confidence**” – maintaining confidence in the financial system;
- “**public awareness**” – promoting public understanding of the financial system;
- “**financial stability**” – contributing to the protection and enhancement of the UK financial system;
- “**consumer protection**” –securing the appropriate degree of protection for consumers; and
- “**the reduction of financial crime**” – reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

The associated frame work used by the FSA to assess the risk posed by a firm to meet the statutory objectives is known as **ARROW** (Advanced, Risk-Responsive Operating FrameWork). This framework covers all the risks in the three main components firm-specific, thematic and internal, and the FSA uses the ARROW process to consider the particular risk a firm might pose by assessing:

- The **impact** on the FSA’s statutory objectives if the particular risk actually materialised; and
- The **probability** that the particular risk will materialise.

In undertaking the ARROW assessment in May 2010 the FSA reviewed information requested prior to the on-site visit and interviewed key members of the Bank’s senior management. Overall the FSA found the Bank and senior management to be responsive and co-operative at all times.

During the ARROW review the FSA found that the existing governance structures are broadly effective and stated that there is a low probability of the firm not treating its customers fairly.

4. FSA Thematic Review of Anti-Money Laundering High Risk Areas

During the year, the Bank was selected to be a part of the FSA’s thematic review of Money Laundering High Risk Area. The review team’s initial feedback was positive and confirmed the controls in this area were proactive and appropriate for the Bank’s customers and services. Once the FSA has issued the thematic review report, a gap analysis will be produced to assess and ensure the Bank’s current policies and procedures comply with the highest standards and industry’s best practice.

5. Capital Management

The Bank is managing and monitoring its capital resources as per the Individual Capital Guidance (ICG) as set out by the FSA. The Bank’s capital resources consist of paid-up capital, retained earnings and general provision. There are no terms and conditions attached to the Bank’s capital resources except of capital gearing rules prescribed by the FSA.

The firms own assessment of the capital required to hold against its risks is known as ICAAP (Internal Capital Adequacy Assessment Process) and the SREP (Supervisory Review and Evaluation Process) that is the assessment conducted alongside the ARROW review to assess the overall risks of the firm are the two main parts of the Supervisory Review Process. The SREP also includes a qualitative and a quantitative assessment of the ICAAP. The Bank’s ICAAP document, approved by the Bank’s Board of Directors (BOD) has been reviewed by the Regulators in May 2010.

The FSA conducted the pillar 2 SREP alongside the ARROW assessment for the risks posed to meet the FSA’s statutory objectives. Overall the FSA were satisfied with the ICAAP process that has been well-embedded within the Bank.

The approach adopted by the Bank in its ICAAP is summarized below:-

5.1 Internal Capital Adequacy Assessment Process (ICAAP)

The ICAAP document summaries to the Board of Directors, senior management and to external parties, including the FSA, the Bank’s capital adequacy assessment process, and demonstrates the Bank’s sound and effective Risk Management Framework, i.e. risk management, capital planning and communication processes. The ICAAP has been structured to evidence the ongoing processes established to ensure existing and new risks to the Bank’s corporate

objectives and that operations are promptly identified and the impact assessed to ensure the Bank has sufficient capital to meet these risks.

The Bank has defined its Pillar II requirement under ICAAP with the objective of ensuring availability of adequate capital resources at all times and to capture the capital charge against all possible risks under stress scenarios. These scenarios have been defined as per subjective evaluations by senior management based on their expectation of the stress scenarios and the capital requirement arising from occurrence of such events. Further, the Bank's business strategy depicts a sufficient capital buffer after accounting for Pillar II add-ons. This capital buffer has been maintained to account for such losses or events which are not captured under the Bank's ICAAP. The following is the summary of Bank's approach in assigning the Pillar II add-ons against various risks.

5.1.1 Credit Exposures

Exposure	ICAAP Approach
Large Loan Exposures	Additional capital charge allocated based on the management view on the probability of an impairment %age and loss on such impairment. This is based on the management assessment of worst case scenarios.
Mark-to-Market (MTM) loss on Marketable Securities	<p>Liquidity Risk The Bank's marketable securities portfolio is classified as Held to Maturity. In the event of a revaluation gain/loss it is not recognised in the books of accounts as the Bank has the intention and ability to hold such securities till maturity. However in the worst case scenario if the Bank has to opt for liquidation of such securities, MTM loss, if any, has to be realised against the reversal of a capital charge against Risk Weighted Assets (RWA). As a matter of prudence management has set the capital requirement as the higher of the capital charge against RWA or MTM losses.</p> <p>Credit Risk Additional capital charge allocated as defined in the large loan exposures.</p>
Short term exposure on rated banks	Additional capital charge allocated based on the assumption that 10% of the rated counterparties will be downgraded to next Credit Quality Steps (CQS).
Foreign Currency Asset Base	As referred above that the Bank's assets are funded in the same currency as that of the business transacted to eliminate foreign currency position risk. FX contracts executed on behalf of the customers are covered on the same day from the market with other counterparties to eliminate position risk and to maintain a square position to the maximum possible extent. However the Bank is exposed to movements in sterling against other currencies particularly the dollar in its foreign currency banking book. Such movement significantly impacts the balance sheet size and RWA and therefore the management has allocated additional capital to cater for 10% depreciation of the sterling against other currencies.

5.1.2 Business / Strategic Risk

The Bank's business plan is designed to ensure the continued growth of the business within a robust control environment, which includes appropriate management oversight, and in line with one of the key corporate objectives, a high standard of corporate governance.

The Bank's ability to sustain its performance during the credit crunch period has validated the appropriateness of the Bank's business model. No additional capital charge is allocated under Pillar II.

5.1.3 Regulatory Risks

The Bank's approach to risk management and the resultant Risk Management Framework, policies, governance, etc. are designed to ensure the Bank meets the provisions of the FSA handbook and industry best practices. No additional capital charge is allocated under Pillar II.

5.1.4 Principal Shareholder / Home Country Exposure Risk

The shareholders of the Bank as well as their supervisors have and continue to be very supportive of the Bank's operations.

With an objective to maintain a high standard of corporate governance, the constitution of the Board ensures the Bank's interest is always at the forefront. The role of the Independent Non Executive Director is essential for ensuring this risk is fully mitigated.

In addition, with the Bank's parent origin being in Pakistan, a change in the political, economic or environmental arena within Pakistan could have an adverse affect on the Bank's activities and performance. The Board approved Country Exposure Policy including Home Country risk to mitigate any risk of this nature.

A capital charge on this risk is considered within 5.1.1.

5.1.5 Other Risks

Further to the above the Bank has also assessed the following specific risks and the appropriate capital charge has been allocated where considered necessary as per the management's subjective evaluation:-

- Business continuity risk;
- Information technology risk;
- People risk.

5.1.6 Residual Risk

In view of the nature of the Bank's business and products, and the Board and Management's appetite for risk, once risk mitigation techniques and tools are taken into account, the residual risk to the Bank, its strategy and corporate objectives is considered minimal.

Where any residual risk is identified, an appropriate risk assessment is undertaken by Senior Management to enable an informed decision as to what action is to be taken, i.e. increase controls, insurance, transfer of risk, etc.

Also, where the controls established to mitigate an already identified risk are proved to be too onerous, a decision is taken to re-assess the Bank's appetite to the concerned risk and this may result in the level of controls being reduced to a more prudent level.

No additional capital allocation is ear-marked under Pillar II.

6. CAPITAL ADEQUACY RESOURCES

	Dec 31, 2010 (£ 000)	Dec 31, 2009 (£ 000)
Tier I capital		
Permanent share capital	25,000	25,000
Retained earnings	24,233	19,913
	<u>49,233</u>	<u>44,913</u>
Tier II capital	21,178	-
General provision	1,033	1,058
Total Tier I and Tier II capital after deductions	71,444	45,971

6.1. CAPITAL REQUIREMENT UNDER BASEL II

	(As at Dec 31, 2010) (£ 000)			(As at Dec 31, 2009) (£ 000)		
	RWA	Capital charge at 8%	Average balances	RWA	Capital charge at 8%	Average balances
Credit Risk						
Central Governments or Central Bank	7,700	616	7,744	14,030	1,122	16,309
Institutions	90,640	7,251	96,609	112,349	8,988	101,451
Corporates	6,735	539	3,901	3,667	293	13,024
Retail	9,052	724	8,469	9,710	777	9,399
Secured on real estate property	53,223	4,258	57,053	57,433	4,595	63,366
Impaired assets	45,925	3,674	45,984	45,124	3,610	24,016
Other items	10,111	809	10,069	10,287	823	10,682
Total credit risk requirement	<u>223,386</u>	<u>17,871</u>	<u>229,829</u>	<u>252,601</u>	<u>20,208</u>	<u>238,246</u>
Operational risk		1,891			1,600	
Market risk						
- Foreign exchange PRR		60			163	
Total capital requirement under Basel II		<u>19,822</u>			<u>21,971</u>	

The above requirement is based under standard Basel II capital requirement and does not represent the Bank's capital requirement under ICG as set by the FSA or ICAAP as referred in Note 3.

6.2. CREDIT EXPOSURES SUBJECT TO STANDARDISED APPROACH

AS AT DEC 31 2010
(£ 000)

	CQS	ECAI's	EXPOSURE	FINANCIAL COLLATERAL			NET EXPOSURE
				GUARANTEE	CASH	TOTAL	
Central Governments or Central Bank	1 & 5	Moody's	33,750	9,709	-	9,709	24,041
Institutions	1	Moody's	152,573	-	-	-	152,573
Institutions	2 & 3	Moody's	14,082	-	-	-	14,082
Institutions	5	Moody's	66,855	-	13,771	13,771	53,084
Corporates	5	Moody's	13,743	-	2,563	2,563	11,180
			<u>281,003</u>	<u>9,709</u>	<u>16,334</u>	<u>26,043</u>	<u>254,960</u>

AS AT DEC 31 2009
(£ 000)

	CQS	ECAI's	EXPOSURE	FINANCIAL COLLATERAL			NET EXPOSURE
				GUARANTEE	CASH	TOTAL	
Central Governments or Central Bank	1 & 5	Moody's	23,720	9,690	-	9,690	14,030
Institutions	1	Moody's	176,344	-	-	-	176,344
Institutions	2 & 3	Moody's	4,147	-	-	-	4,147
Institutions	5	Moody's	75,248	-	236	236	75,012
Corporates	5	Moody's	11,611	-	1,502	1,502	10,109
			<u>291,070</u>	<u>9,690</u>	<u>1,738</u>	<u>11,428</u>	<u>279,642</u>

The guarantees included above are all sovereign guarantees and are classified as CQS 1

7. CONCENTRATION OF CREDIT RISK

	AS AT DEC 31 2010 (£ 000)				Total
	Loans to customers (net)	Loans to banks	Debt securities	Contingencies	
Sectoral concentration:					
Chemicals and Pharmaceuticals	182	-	-	-	182
Textile	9,972	-	-	-	9,972
Automobile and transportation equipment	151	-	-	-	151
Financial	-	165,390	59,658	8,711	233,759
Government	7,700	-	26,151	-	33,851
Property Investments	31,799	-	-	-	31,799
Foods, tobacco and beverages	23,220	-	-	-	23,220
General traders	6,125	-	-	4,761	10,886
Individuals	16,230	-	-	-	16,230
Others	27,618	-	6,171	8,808	42,597
	122,997	165,390	91,980	22,280	402,647

Geographical concentration:

	AS AT DEC 31 2010 (£ 000)				Total	Break-up of debt securities to the asset class:			
	Loans to customers (net)	Loans to banks	Debt securities	Contingencies		Bank	Government	Corporate	Total
Europe	112,506	96,183	76,060	9,646	294,395	49,017	24,226	3,000	76,243
North America	363	8,343	13,995	818	23,519	10,641	-	3,171	13,812
Asia Pacific (including South Asia)	8,747	52,578	-	7,690	69,015	-	-	-	-
Africa and Middle East	1,381	8,286	1,925	4,126	15,718	-	1,925	-	1,925
	122,997	165,390	91,980	22,280	402,647	59,658	26,151	6,171	91,980

	AS AT DEC 31 2009 (£ 000)				Total
	Loans to customers (net)	Loans to banks	Debt securities	Contingencies	
Sectoral					
Chemicals and Pharmaceuticals	158	-	-	-	158
Textile	11,070	-	-	-	11,070
Automobile and transportation equipment	151	-	-	-	151
Financial	-	194,768	24,574	37,543	256,885
Government	7,395	-	16,333	-	23,728
Property Investments	35,297	-	-	-	35,297
Foods, tobacco and beverages	23,133	-	-	-	23,133
General traders	6,754	-	-	1,548	8,302
Individuals	15,752	-	-	-	15,752
Others	26,452	-	4,770	7,195	38,417
	126,162	194,768	45,677	46,286	412,893

Geographical concentration:

	AS AT DEC 31 2009 (£ 000)				Total	Break-up of debt securities to the asset class:			
	Loans to customers (net)	Loans to banks	Debt securities	Contingencies		Bank	Government	Corporate	Total
Europe	112,583	130,631	36,020	6,888	286,122	21,494	9,756	4,770	36,020
North America	4,183	30,601	3,080	2,631	40,495	3,080	-	-	3,080
Asia Pacific (including South Asia)	7,905	27,351	6,577	20,788	62,621	-	6,577	-	6,577
Africa and Middle East	1,491	6,185	-	15,979	23,655	-	-	-	-
	126,162	194,768	45,677	46,286	412,893	24,574	16,333	4,770	45,677

The information given in the sectoral analysis for the government and financial categories represent the Basel asset class for the Central Government and Bank's respectively

8. RESIDUAL MATURITY OF LOANS AND DEBT SECURITIES

AS AT DEC 31 2010 (£ 000)					
On Demand	3 months or less but not on demand	Over 3 months but less than 1 year	Over 1year but less than 5 years	Greater than 5 years	Total
Loans and advances to:					
Banks	12,561	121,554	31,267	-	165,390
Customers (net)	7,203	31,262	9,835	43,489	122,997
Debt securities	-	24,099	18,018	47,286	91,980
	<u>19,764</u>	<u>176,915</u>	<u>59,120</u>	<u>33,793</u>	<u>380,367</u>

AS AT DEC 31 2009 (£ 000)					
On Demand	3 months or less but not on demand	Over 3 months but less than 1 year	Over 1year but less than 5 years	Greater than 5 years	Total
Loans and advances to:					
Banks	6,714	160,620	27,426	-	194,768
Customers (net)	6,332	28,199	17,785	46,676	126,162
Debt securities	-	8,409	8,142	22,205	45,677
	<u>13,046</u>	<u>197,228</u>	<u>53,353</u>	<u>34,099</u>	<u>366,607</u>

9. IMPAIRED AND PAST DUE ANALYSIS

	AS AT DEC 31, 2010 (£ 000)				AS AT DEC 31, 2010 (£ 000)				
	Impaired Exposure	Loans to Customers (Gross) Past Due	Charges / Reversals	Specific Provision	Impaired Exposure	Past Due	Charges / Reversals	Debt Securities Capital Contribution	Specific Provision
Chemicals and Pharmaceuticals	11	-	-	12	-	-	-	-	-
Textile	3,741	-	54	54	-	-	-	-	-
Automobile and transportation equipment	151	-	-	51	-	-	-	-	-
Financial	-	-	-	-	-	-	(1,806)	(1,050)	-
Government	-	-	-	-	-	-	-	-	-
Property Investments	16,455	465	-	2,900	-	-	-	-	-
Foods, tobacco and beverages	75	156	-	50	-	-	-	-	-
General traders	173	4	147	167	-	-	-	-	-
Individuals	436	466	(1)	347	-	-	-	-	-
Others	4,568	3,221	20	1,267	-	-	-	-	-
Total	25,610	4,312	220	4,848	-	-	(1,806)	(1,050)	-
Europe	25,531	4,312	220	4,836	-	-	(1,806)	(1,050)	-
North America	-	-	-	-	-	-	-	-	-
Asia Pacific (including South Asia)	25	-	-	-	-	-	-	-	-
Africa and Middle East	54	-	-	12	-	-	-	-	-
Total	25,610	4,312	220	4,848	-	-	(1,806)	(1,050)	-

	AS AT DEC 31, 2009 (£ 000)				AS AT DEC 31, 2009 (£ 000)				
	Impaired Exposure	Loans to Customers (Gross) Past Due	Charges / Reversals	Specific Provision	Impaired Exposure	Past Due	Charges / Reversals	Debt Securities Capital Contribution	Specific Provision
Chemicals and Pharmaceuticals	10	-	12	12	-	-	-	-	-
Textile	3,727	-	-	-	-	-	-	-	-
Automobile and transportation equipment	150	-	50	50	-	-	-	-	-
Financial	-	-	-	-	4,260	-	(1,500)	-	3,000
Government	-	-	-	-	-	-	-	-	-
Property Investments	16,981	1,025	2,800	2,900	-	-	-	-	-
Foods, tobacco and beverages	75	160	-	50	-	-	-	-	-
General traders	173	-	-	19	-	-	-	-	-
Individuals	857	26	342	348	-	-	-	-	-
Others	4,353	1,636	859	1,249	-	-	-	-	-
Total	26,326	2,847	4,063	4,628	4,260	-	(1,500)	-	3,000
Europe	26,291	2,843	4,051	4,616	4,260	-	(1,500)	-	3,000
North America	-	-	-	-	-	-	-	-	-
Asia Pacific (including South Asia)	25	-	-	-	-	-	-	-	-
Africa and Middle East	10	4	12	12	-	-	-	-	-
Total	26,326	2,847	533	4,628	4,260	-	(1,500)	-	3,000

10. RECONCILIATION OF PROVISION (SPECIFIC AND GENERAL)

	AS AT DEC 31, 2010 (£000)	
	Specific	General
Balance as at 1 Jan 2010	7,628	1,058
charges for the year		
- loans to customers	223	(25)
- debt securities	-	-
recoveries		
- loans to customers	(3)	-
- debt securities	(1,806)	-
capital contribution	(1,050)	-
written off	(144)	-
Balance as at 31 Dec 2010	<u>4,848</u>	<u>1,033</u>

	AS AT DEC 31, 2009 (£000)	
	Specific	General
Balance as at 1 Jan 2009	5,065	1,162
charges for the year		
- loans to customers	4,063	(104)
- debt securities	-	-
recoveries		
- loans to customers	-	-
- debt securities	(1,500)	-
Balance as at 31 Dec 2009	<u>7,628</u>	<u>1,058</u>

In 2010, the Bank sold a debt security to its immediate parent for £2,736,000 giving rise to a capital contribution of £1,050,000 which has been included above.