YOUR PARTNER IN ARAB FINANCE WORLDWIDE

PILLAR 3 & REMUNERATION CODE DISCLOSURES

Approved by the Board April 2011

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1. OVERVIEW

1.1. Background

The European Union Capital Requirements Directive ("**the Directive**") came into effect on 1 January 2007. It introduced consistent capital adequacy standards and an associated supervisory framework in the EU based on the Basel II rules agreed by the G-10.

Implementation of the Directive in the UK was by way of rules introduced by the Financial Services Authority ("**the FSA**")[1]. The Basel II Framework is structured around three pillars: Pillar 1 (minimum capital requirements), Pillar 2 (supervisory review) and Pillar 3 (market discipline). The disclosure requirements of Pillar 3 are designed to promote market discipline by providing market participants with key information on a Firm's risk exposures and risk management processes. Pillar 3 aims to complement the minimum capital requirements described under Pillar 1 and the supervisory review process of Pillar 2.

British Arab Commercial Bank PLC ("**BACB**" or "**the Bank**") adopted the Standardised Approach to credit risk, the Basic Indicator Approach ("**BIA**") to operational risk and the standard Position Risk Requirement ("**PRR**") rules for market risk from 1 January 2008. BACB also became subject to Pillars 2 and 3 from that date.

1.2. Basis and Frequency of Disclosures

This disclosure document has been prepared for BACB in accordance with the requirements of Pillar 3 as set out in Chapter 11 of the BIPRU. These disclosures include those required by Chapter 11 of BIPRU with regard to remuneration.

Unless otherwise stated, all figures are as at 31 December 2010, our financial year-end.

Disclosures are issued on an annual basis and published as soon as practicable after the publication of the Annual Report and Accounts.

1.3. Scope

BACB is a UK registered bank that is regulated by the FSA.

BACB has a dormant subsidiary company (together referred to as "**the Group**").

BACB calculates and maintains regulatory capital ratios based on its own balance sheet. Capital held in the Bank's subsidiary company amounts to £1,000, and there is therefore no material difference between the amount of capital determined by, and available in support of the Bank's own activities, and the amount which would be determined if the subsidiary were included. While there would be no regulatory restriction to transferring this capital within the Group, in practice this would involve the winding up of that subsidiary company.

This document generally refers to the Group, and the information presented in this document is in respect of the Group except where it is relevant to consider the position of the Bank in isolation.

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[1] FSA Handbook – General Prudential sourcebook ("**GENPRU**") and Prudential sourcebook for Banks, Building Societies and Investment Firms ("**BIPRU**").

1.4. Location and Verification

These disclosures have been approved by the directors by circulation in April 2011, and are published on the Group's corporate website (www.bacb.co.uk). The disclosures have not been subjected to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Group's Annual Report and Accounts.

1.5. Post balance sheet events

The main part of the disclosures in this document relate to the position of the Group at 31 December 2010, and the procedures and controls in place at that time.

Political and social events have taken place since the Group's year end in several of the countries in which it undertakes its business. These events continue to unfold, with final outcomes uncertain. The impact of these events on the Group's procedures and controls, at the time this document is approved are considered below.

Political change in Egypt and Tunisia has taken place in a relatively orderly fashion with only limited implications for the Group.

By contrast the political events in Libya have resulted in international sanctions ("the Sanctions") introduced over the weekend of 26th and 27th February 2011, and targeted at Libyan individuals and the institutions over which they may be able to exercise control. The orders of most relevance to the Group were the following:-

- United Nations Security Council resolutions 1970 (2011) dated 26th February 2011 and 1973 (2011) dated 17th March 2011.
- The White House Executive Order dated 25th February 2011.
- The Libya (Financial Sanctions) Order 2011 implementing the UN resolution in the UK on 27th February 2011.
- Council Regulation (EU) No 204/2011 concerning restrictive measures in view of the situation in Libya.

The intention of the sanctions, as described in paragraph 17 of United Nations Security Council resolutions 1970 (2011) is, inter-alia, to "freeze without delay all funds, other financial assets and economic resources which are on … *(the member states)* territories, which are owned or controlled, directly or indirectly, by the individuals or entities listed….."

In the Council Implementing Regulation (EU) no 233/2011 of 10th March 2011 ("the Regulation") a number of Libyan institutions were specifically identified, including Libyan Foreign Bank, the Group's principal shareholder. On 15th March 2011 US authorities extended the list of specifically identified Libyan institutions, as did the United Nations Security Council on 17th March, both also including Libyan Foreign Bank; the Group's principal shareholder

By way of general licences attaching to the US and UK sanctions, permission has been given for third party institutions to continue to undertake transactions with Libyan owned financial institutions domiciled and regulated outside Libya (of which the Group is one). Accordingly, the Group is in the same position in relation to the Sanctions as other (non-Libyan) institutions.

The Group had entered into financial assets, financial liability, commitment and derivative transactions, and had provided financial facilities with and for institutions in and connected with Libya (including, but not limited to those specifically identified in the Regulation) before

the imposition of the Sanctions. The Group had not entered into any such transactions, nor had it provided facilities for any of the individuals, specifically identified in the Sanctions notices.

The Group has worked closely with the regulators responsible for the implementation of the Sanctions, including the Financial Services Authority and HM Treasury. It has taken careful advice, and has put in place changes in governance arrangements and appropriate due diligence procedures designed to ensure compliance with the various regulations set out in the Sanctions, and the interpretations placed thereon by the UK authorities. These arrangements, which have been embodied in a formal variation in the Group's regulatory permissions, have resulted in the following key amendments to the Group's procedures and controls:-

- All Libyan individuals, including Libyan directors, who are connected with Libyan institutions specifically identified in the various sanctions notices, have ceased to be involved in decision making within the Group.
- Additional due diligence procedures have been established designed to ensure that no funds are made available to the individuals and other institutions against whom the Sanctions are directed.
- An independent third party approved by the FSA, Grant Thornton UK LLP, has been introduced into the Group's approval processes to verify that no payments are made by the Group other than in full compliance with the enhanced due diligence procedures introduced by the Group in relation to transactions with Libyan Institutions (whether specifically identified or otherwise) in light of the various sanctions orders and any licences granted by the appropriate authorities in relation thereto.

The purpose of these arrangements included the need to provide comfort to counterparties who have dealings with the Group that they are not themselves at risk of making funds available to the persons who are targeted by the Sanctions as a result of those dealings. It is expected that these arrangements will remain in place until such time as the UN lifts or varies these Sanctions.

It is noted that, at the time this document is approved, the imposition of Sanctions, and these other post balance sheet events have not given rise to new material actual or contingent losses. Accordingly, the capital of the Group remains as described in Section 3 below.

One consequence of these Sanctions is that deposits held by the Group in the name of various Libyan institutions have become blocked in the Group's balance sheet, and cannot be paid away other than with licences granted. At close of business on 26th February 2011 the total deposits held by the Group in the names of the institutions listed in the Regulation was £1,496,779,000 (at the exchange rates ruling on that date). The group holds other deposits and accounts in the names of other affected Libyan institutions the operation of which are also significantly restricted in the light of the arrangements described above. See also paragraph 5.3 below.

It is noted that the Group held deposits from these Libyan institutions at 31st December 2010. The deposits at that date were not subject to any blockage, sanction or freezing until 26th February 2011.

The implications of these events on the matters considered in this document are described under the various headings.

2. RISK MANAGEMENT OBJECTIVES AND POLICIES

2.1. Background

The Group has an established risk management culture, long-standing written policies and procedures, and follows a documented control framework, the maintenance of which falls within the general responsibility of the Group's Audit & Risk Committee, a sub-committee of the Board of Directors ("the Board").

The Board has overall responsibility for the determination of the risk appetite of the Group. They determine the high level risk framework, monitor the utilisation of limits and the operation of the control processes. The Group maintains a cautious approach to risk management and overall risk appetite is conservative. Risks are measured, controlled and limited through clear governance structures, supported by written policies and procedures.

Key elements within this framework are the Risk Management and Internal Audit departments.

The Risk Management Department ("**RMD**") is responsible for identifying, monitoring and managing the risks faced by the Group. The RMD is also responsible for the implementation of appropriate policies and monitoring programmes to manage the Group's exposure to potential losses arising in all areas of risk. RMD also has responsibility for review and amendment of the Group's internal credit gradings, market and operational risk management practices.

The Internal Audit department undertakes an ongoing risk based review programme covering all areas of the Group's operations. The Head of Internal Audit reports to the Audit & Risk Committee and to the Chief Executive.

2.2. Governance

On 29th October 2010 a change in the ownership of the Group took place. Shares owned by some shareholders were sold both to existing shareholders, and to new shareholders such that the shareholdings changed as follows:-

	31 December 2010	31 December 2009
LIBYAN FOREIGN BANK	83.48%	26.29%
BANQUE EXTÉRIEURE D'ALGÉRIE	8.26%	8.26%
BANQUE CENTRALE POPULAIRE	8.26%	
HSBC BANK MIDDLE EAST LIMITED	0%	48.93%
CENTRAL BANK OF EGYPT	0%	8.26%
BANK AL-MAGHRIB	0%	8.26%
	100.00%	100.00%

Following the change in ownership, and as set out above, Libyan Foreign Bank, a company resident in the Socialist People's Arab Republic of Libya, became the majority owner of the Group.

As a part of this change in ownership the shareholders who remained entered into a new formal Shareholders' Agreement ("**SHA**") and, in a general meeting, they adopted new Articles of Association ("**Articles**"). These agreements mandate the governance arrangements which will be followed by the Board.

These documents and agreements provide that certain shareholders of the Bank may appoint directors in accordance with their shareholdings. They also provide for the appointment of the Chairman and the Chief Executive, and for the formation of certain committees to oversee the day-to-day running of the Group. A Schedule of Reserved Matters specifies matters which must be decided by the Board (rather than by Executive Management), with a separate schedule detailing matters reserved for approval and decision by shareholders. The Shareholders' Agreement sets out the arrangements for changes in shareholding.

The Shareholders' Agreement requires that the Board includes two independent non-executive directors ("**INEDs**"). The Group's accounts for the year ended 31 December 2010 disclose that the Chairman, Mr Robert Douglas Dowie, is an INED. Since the date of the approval of those accounts a second INED has been appointed: Mr Michael Stevenson.

The Group regards all of its directors other than the Chief Executive as being non-executive. Directors appointed by shareholders pursuant to their shareholding are however not "independent".

The Group's governance policies are set by the Board in accordance with the SHA and the Articles as described above, and are implemented by Executive Management. The Board normally meets 4 times a year. It approves plans and performance targets for the group, the appointment of senior executives and the delegation of authorities. The Board has constituted a number of high level committees governed by clear terms of reference, include the following:-

- Board Executive Committee ("**BExCo**"). Chaired by the Chairman, this committee carries the authority of the Board other than for a number of specified matters requiring consideration by the full Board. The BExCo normally meets 4 times a year, and exercises the powers and authorities of the Board in so far as they concern the management and day-to-day running of the Group in accordance with the policies and directions determined by the Board. The Chief Executive serves as a member of this committee, together with his deputy.
- Audit & Risk Committee ("**ARC**"). The Group's Non-Executive Directors are eligible to sit on the Audit & Risk Committee. The Committee normally meets 4 times a year to consider the Group's financial reporting, the nature and scope of audit reviews, and the effectiveness of the systems of internal control, compliance and risk management. The Group's external auditors are invited to attend the meetings of the Audit & Risk Committee, and normally will do so.
- External Credit Committee. ("**ECC**"). The Board have delegated authority to approve the granting of credit applications to the Executive Management subject to certain limits. Applications above those limits must be referred to the External Credit Committee for their consideration and approval. The Credit Committee comprises two directors appointed by shareholders together with the Chairman. The Committee does not have a regular cycle of meetings, rather it normally considers specific applications

as they arise by circulation of papers. Decisions of the Committee must be unanimous to be valid.

The directors who serve in ECC are designated as being non-Executive. However, it is recognised that the undertaking of credit approvals in this fashion could be regarded as being an executive function. Such directors stand aside from Board and other committee discussions where there is a conflict between this executive function, and their non-executive roles.

- Compensation Committee ("**CC**"). Determines the executive remuneration policies of the Group. This committee comprises non-executive directors. The Head of Human Resources is a member of the committee, and acts as its secretary, but does not carry a vote.

In light of the events described in 1.5 above directors representing Libyan Foreign Bank currently stand aside from the Group's governance. They currently do not attend meetings of the Board, and do not participate in, or seek to influence, the direction of the Group. This arrangement has resulted in a smaller number of directors serving in the board, and for the time being meetings of the BExCo have been designated as being meetings of the full Board.

The Board has also delegated powers to the Group's Executive Management, led by the Chief Executive. These Executives are empowered in writing through their job descriptions. Executive Management in turn have constituted a number of sub-committees to manage particular aspects of the Group's business. These include

- Asset and Liability Committee ("**ALCO**"). The Committee monitors the Group's performance within the framework of authorities handed down by Management Committee and the Board, and against the plans agreed with those committees. It is responsible for overseeing the Group's continuing compliance with law, regulations and market practices, and is responsible for considering the risks to which the Group is exposed (other than those relating to credit risk – see below), and for directing the Group's response to those risks.
- Risk Committee ("**RC**"). The committee reviews the credit risks to which the Group is exposed. It ensures that these are within the policies laid down by the Board, and identifies developments or trends within individual customers to whom the group is exposed, or to groups of such customers in order to identify required or desirable changes in policy for recommendation to the Board. The committee also reviews the processes by which credit applications are considered to ensure that they remain robust.
- Internal Credit Committee. ("**ICC**"). Credit applications which fall within the limit approved from time to time by the Board may be dealt with as follows:-
    - The Chief Executive, and certain other executives carry personal authorisation limits which permit them to approve applications on their sole authorities.
    - For applications above those limits (but below the limits requiring referral to the ECC), an ICC will meet to discuss the application and, if unanimously agreed, to approve it.

Appendix 1 to this report shows the outline governance structures within the Group. The individuals who served on the Board during 2010, together with the details of the committees on which they served, and those who served as executive managers, are shown in the Group's 2010 Annual Report and Financial Statements.

Decisions on matters of strategic significance or high importance can only be taken by the Board. For the avoidance of doubt, the SHA includes a Schedule of Reserved Matters listing specified matters which must always be referred to them for review and approval. Matters agreed by the Board include all policies that dictate the Group's risk appetite.

A key mechanism for determining risk appetite is the Group's planning process. Executive management prepare regular strategic and annual business plans involving detailed reviews of the Group's various business lines. As a part of that process the Executive Management will review the Group's current risk appetite, and will propose possible amendment to the Board.

In the light of these strategic and annual operating plans, the Group's risks are also reviewed annually through the Internal Capital Adequacy Assessment Process ("**ICAAP**") and, for liquidity risk, the Internal Liquidity Adequacy Assessment ("**ILAA**"). The output of these processes are formal reports ("the ICAAP and ILAA reports") which are submitted to the Group's Board for review and approval. The ICAAP identifies all the risks which may bear on the Group's solvency and either evaluates what level of capital should be held against each, or else considers the appropriate remediation policies. The ILAA determines the group's appetite for liquidity risk, and sets out the methodologies for managing and limiting that risk. These processes are informed by stress and scenario tests, including tests whose starting point is the failure of the Group (the Reverse Stress Tests).

2.3. Risk management process

Risk is inherent to the Bank's business and the ability to identify, control, monitor and mitigate each type of risk to which the bank is exposed is vital to ensure financial stability and future success. Principal risks to which the bank is exposed include credit, operational, market, liquidity, business, compliance and reputational. These risks are documented within a Risk Register and an overview of the controls in place to mitigate them is contained in a high level statement of the systems and controls in place to identify, measure and manage risk described as the Control Objectives Statement.

Maintenance and review of the Group's risk management policies and Group-wide procedures is the responsibility of RMD. Policies that define and implement the Group's risk appetite, including those dealing with liquidity, concentration risk, sectoral lending and market risk are reviewed annually by RMD, considered in ALCO or RC and submitted to the ARC for review and subsequently to the Board for approval.

Risk management policies are documented in the Group's General Instructions Manual ("**GINs**"), a high level manual, maintenance of which also falls within the responsibility of RMD. GINs are subject to annual formal review by management and adherence is mandatory for all employees. Amendments to this manual require the approval of Executive Management and RMD. Compliance with the policies and procedures set out in GINs is monitored by the Group's Internal Audit department.

Operational processes are documented, where necessary in departmental desk manuals that are also subject to annual review and senior management approval. This ensures that primary responsibility for the identification of risk lies with operational areas with oversight and governance being provided by RMD.

At the operational level, the policies and procedures contained in GINs and desk manuals ensure compliance with the Group’s legal and regulatory obligations as well as ensuring the confidentiality and security of information, the safeguarding of items of value and the maintenance of appropriate segregation of duties through physical and logical system controls.

The Group’s ALCO and RC play an important role in the identification, monitoring and management of risk and through the review of risk management policies.

Internal Audit also has a significant role in the bank's risk management process by providing independent and objective assurance on the adequacy and effectiveness of the bank’s risk management, control and governance processes, as designed and represented by management. It carries out an annual risk-based programme of work, which has been approved by the bank's ARC, designed to evaluate and improve the bank's risk management and control environment. The result of Internal Audit's work, including management's progress in addressing identified issues, is formally reported to the ARC on a quarterly basis.

3. CAPITAL RESOURCES

3.1. Total available capital

At 31 December 2010 and throughout the year the Group complied with the capital requirements that were in force as set out by the FSA.

The Group's regulatory capital base and capital adequacy ratio at 31 December were as follows[2]:

	2010 £'000s	*2009 £'000s*
Tier 1 Capital	182,942	*167,702*
Tier 2 Capital	62,610	*59,792*
Total eligible capital at 31 December	245,552	*227,494*
Risk Weighted Assets	1,150,216	*1,266,237*
Tier 1 Ratio	15.9%	*13.2%*
Capital Adequacy Ratio	21.3%	*18.0%*

The amounts of regulatory capital shown above differ from the balances shown in the Group's balance sheet in light of adjustments in respect of certain reserves, which arise on the application of IFRS. They also differ from the amounts reported to the FSA as at 31 December as the total above includes the retained profits for the year which cannot be included in the amounts reported to the FSA until such time as the financial statements for the subject year are approved.

There have been no changes to the amount of capital available to the Group as a result of the events described in 1.5 above.

3.2. Tier 1 Capital

Tier 1 capital comprises ordinary share capital plus reserves. Adjustments are made in respect of certain revaluation reserves in accordance with the FSA regulatory rules.

	2010 £'000s	*2009 £'000s*
Ordinary Share Capital	79,453	*79,453*
Reserves	103,592	*89,820*
Total Capital	183,045	*169,273*
Less: Dividend payable	0	*0*
Other regulatory adjustments	(103)	*(1,571)*
Tier 1 Capital	182,942	*167,702*

[2] In this table Risk Weighted Assets is the total value of the Group's on and off balance sheet exposures, weighted in accordance with the rules set out in the standardized approach to credit risk.

3.3. Tier 2 Capital

Tier 2 capital comprises perpetual subordinated debt (upper Tier 2) and term subordinated debt due 2018 (lower Tier 2), each issued in US Dollars and on terms which qualify for inclusion in capital resources. Tier 2 capital was made up as follows:-

	2010	***2009***
	£'000s	***£'000s***
Permanent issued subordinated debt	0	*27,544*
Other adjustments	1,676	*1,283*
Total Upper Tier 2	1,676	*28,827*
Term issued subordinated debt	60,934	*30,965*
Total Tier 2 capital	62,610	*59,792*

4. CAPITAL MANAGEMENT

4.1. Overview

The Bank has adopted the Standardised approach to credit risk, the Basic Indicator approach to operational risk and the standard FSA regulatory rules to market risk since 1 January 2008 in order to calculate the Basel II Pillar 1 minimum capital requirement.

In the opinion of the Group's Board, the amount of capital required by the Group is the same as the amount required by the Bank.

As part of the ICAAP process (as described below), the Board have identified a number of other risks faced by the Group which do not attract capital under the Pillar 1 rules. The Group has allocated additional capital requirement for these additional Pillar 2 risks ("the Pillar 2 capital requirement"). The total capital requirement of the Group is determined as the sum of the Pillar 1 and the Pillar 2 capital requirements.

The policy of the Group is to maintain a degree of headroom above the total required capital level. A minimum margin of 10% will be maintained at all times and the headroom of £93,899,000 at 31 December 2010 *(2009: £73,313,000)* leaves some scope to accommodate growth in risk weighted assets ("**RWAs**") as part of the Group's overall growth strategy and also provides a buffer against adverse exchange rate developments.

The FSA has imposed an Interim Capital Guidance ("**ICG**") requirement on the Group pending its review of the Group's own assessments. The ICG requirement is somewhat higher than the assessment set out above, and the Group is managing its capital in accordance with this latter requirement pending completion of the FSA review process.

4.2. Internal Capital Adequacy Assessment Process

The Group undertakes an Internal Capital Adequacy Assessment Process which is an internal assessment of its capital needs.

As noted above, the ICAAP process takes account of both Pillar 1 capital requirements, making use of the various standardised approaches set out in the FSA's BIPRU rules, but also considers the amounts of capital which are required to support other risks faced by the Group (the Pillar 2 risks).

The outcome of the ICAAP is presented in an ICAAP Report detailing all material risks to determine the capital requirement over a three-year horizon, and includes stressed scenarios to satisfy the regulatory requirements. Where capital is deemed as not being able to mitigate a particular risk, alternative management actions are identified and described within the ICAAP Report.

The ICAAP report is reviewed annually by the Group's ALCO before being presented to the Board (with whom ultimate responsibility lies) for challenge and approval.

4.3. Minimum capital requirement: Pillar 1

BACB's overall minimum capital resource requirement under Pillar 1 is calculated by adding the credit risk charge to that required for operational risk and market risk.

The following table shows both the Group's overall minimum capital requirement and capital adequacy position under Pillar 1 at 31 December:

	2010 £'000	*2009* *£'000*
Credit Risk	90,717	*101,299*
Market Risk		
Interest Rate PRR	888	*113*
Foreign Exchange PRR	63	*58*
	951	*171*
Counterparty risk capital component	941	*1,530*
Operational Risk	6,622	*5,910*
Total Pillar 1 capital requirement	99,231	*108,910*
Capital in place	245,552	*227,494*
Excess of capital in place over minimum requirement under Pillar 1	146,321	*118,584*

PRR – Position Risk Requirement

4.4. Credit risk component

The following table shows BACB's overall minimum capital requirement for credit risk under the standardised approach (expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes) at 31 December:

	Capital Requirement	Exposure Value	
	At 31 December 2010		Average during 2010
	£'000	£'000	£'000
Central governments or central banks	4,615	444,725	570,632
Institutions	49,146	2,791,613	2,870,792
Corporates	34,610	560,403	575,681
Secured on real estate property	33	421	502
Other items	2,313	29,295	30,098
Total	**90,717**	**3,826,457**	**4,047,705**

	Capital Requirement	*Exposure Value*	
	At 31 December 2009		*Average during 2009*
	£'000	*£'000*	*£'000*
Central governments or central banks	*3,876*	*215,259*	*372,646*
Institutions	*54,302*	*2,870,933*	*2,889,635*
Corporates	*40,782*	*642,730*	*704,375*
Secured on real estate property	*47*	*582*	*582*
Other items	*2,292*	*29,027*	*30,202*
Total	***101,299***	***3,758,531***	***3,997,440***

Note: The amount of the exposure value in the table above does not agree to the Maximum Credit Exposure totals in section 3.1 as the totals above have been adjusted by way of credit conversion factors in accordance with the FSA regulatory rules. The average exposure value is calculated using the four returns submitted to the FSA during the year.

Under the Standardised approach BACB uses Standard and Poor's, Moody's and Fitch Ratings as External Credit Assessment Institutions (ECAIs) across all its portfolios. Credit ratings are mapped to credit quality steps using the standard table as follows:-

Credit quality Step	S&P Rating	Moody's rating	2010 Exposure value [1] £'000	2010 Exposure values after mitigation [2] £'000	*2009 Exposure value [1] £'000*	*2009 Exposure values after mitigation [2] £'000*
Central Governments or Central Banks						
1	*AAA to AA-*	Aaa to Aa3	351,821	351,821	*134,718*	*134,718*
2	*A+ to A-*	A1 to A3	0	0	*0*	*0*
3	*BBB+ to BBB-*	Baa1 to Baa3	35,477	17,820	*39,850*	*19,925*
4	*BB+ to BB-*	Ba1 to Ba3	8,405	0	*0*	*0*
5	*B+ to B-*	B1 to B3	6,101	0	*5,858*	*0*
Unrated			42,921	17,396	*34,833*	*12,161*
			444,725	387,037	*215,259*	*166,804*
Institutions						
1	*AAA to AA-*	Aaa to Aa3	1,835,563	1,466,317	*1,997,192*	*1,596,006*
2	*A+ to A-*	A1 to A3	418,493	329,151	*451,851*	*347,262*
3	*BBB+ to BBB-*	Baa1 to Baa3	184,122	148,138	*108,867*	*84,066*
4	*BB+ to BB-*	Ba1 to Ba3	23,022	10,949	*28,339*	*5,699*
5	*B+ to B-*	B1 to B3	1,062	142	*2,732*	*10*
Unrated			329,351	220,025	*281,952*	*157,318*
			2,791,613	2,174,722	*2,870,933*	*2,190,361*
Corporates						
1	*AAA to AA-*	Aaa to Aa3	1,630	476	*756*	*592*
2	*A+ to A-*	A1 to A3	9,326	4,663	*15,226*	*7,613*
3	*BBB+ to BBB-*	Baa1 to Baa3	20,218	4,152	*25,327*	*3,973*
4	*BB+ to BB-*	Ba1 to Ba3	15,359	0	*12,717*	*0*
5	*B+ to B-*	B1 to B3	0	0	*0*	*0*
Unrated			513,870	113,664	*588,704*	*115,631*
			560,403	122,955	*642,730*	*127,809*
Secured on real estate			421	105	*582*	*145*
Other items			29,295	7,829	*29,027*	*29,027*
			3,826,457	**2,692,648**	***3,758,531***	***2,514,146***

[1] Exposure value is the amount after applying credit conversion factors to off balance sheet exposures in accordance with the FSA regulatory rules.

[2] Mitigation comprises eligible financial collateral

4.5. Capital Requirement: Pillar 2

In addition to the capital required in respect of Pillar 1 risks, the Group uses an internal model to allocate additional capital in respect of other risks not addressed under Pillar 1 minimum capital requirements. These include the following:-

- Concentration Risk. The standardized approach to credit risk does not take account of geographic or sectoral concentrations of credit exposure. Stress tests undertaken by the Group indicate that an additional capital add on should be allocated to address these specific concentration risks.
- Pension fund risk. There is a risk that the liabilities associated with the pension arrangements made by the Group for its staff may increase.
- Interest rate risk. Large changes in interest rates could give rise to losses for which capital should be allocated.
- Liquidity Risk. In the event of liquidity stress the Group may be required to sell assets at a discount to carrying book value.
- Market risk. The Pillar 1 allocation for market risk is based on actual positions and exposures at reporting dates. At present, the Group has limits in place for market risk which are higher than the average amount of risk actually taken

At 31 December 2010 the Group has allocated £42,004,000 *(2009: £45,271,000)* of capital to cover these additional risks.

4.6. Post balance sheet position

The capital requirements of the Group have fallen since 31 December 2010 in light of reductions in the credit risk component.

5. SOURCES OF RISK

5.1. Credit Risk

The Group is exposed to credit risk in its on and off-balance sheet activities, and in its daily settlements. The Group manages credit risk by establishing country and individual counterparty limits, and limits for closely related counterparties, within the terms of the Group's credit policies, based upon analyses undertaken by the Group's Institutional & Corporate Banking ("**ICB**") department of relevant political, economic and financial information.

The Group is also a third-party member of the Continuous Linked Settlement ("**CLS**") system, which eliminates counterparty settlement risk on eligible trades.

Such assessments are the subject of independent review and challenge by the Group's RMD.

Based on the initial review of ICB, and with the support of RMD, applications for new credit facilities, and for changes in credit limits, whether for individual counterparties, or for groups of counterparties, are submitted for approval.

Credit limits are established for all transactions which give rise to credit risk. In the case of loans and advances, the amount at risk is the maximum book value. For guarantees, letters of credit and other commitments not appearing on the Group's balance sheet, the amount at risk is the gross amount of the commitment or potential commitment given. For derivatives, the amount at risk is the current mark-to-market value of the contract (if positive) plus an add-on the size of which is determined by the type of contract, and the time to maturity. For certain derivatives, it may also be appropriate to have in place separate settlement limits in recognition that the credit exposure on the day of settlement may equate to the underlying notional amount of the contract involved.

Approvals are granted in accordance with a documented hierarchy. Credit approval authority has been delegated by the Board to the ICC and to the Chief Executive, who may delegate up to a maximum of 80% of that authority to each of a small number of senior executives, subject to notification of delegation to the Board. Requests for credit facilities which exceed the CEO's approval limit must be submitted to the ECC.

A schedule of all credit approvals granted, whether by Executive Management or by the Credit Committee, is submitted to BExCo for their review.

Once approved, all credit limits are subject to annual review by ICB and RMD and are submitted for re-approval under delegated internal credit authorities.

The Group employs a credit grading system to facilitate monitoring of the quality of the overall portfolio and individual segments thereof, including movements in the portfolio over time. The results of this analysis are reviewed by the RC. The results of credit grading are also taken into account as part of the credit approval process, as are the prospective and historic returns on risk adjusted capital ("**RoRAC**") arising from the relationship, and the proposed transaction.

At 31 December credit risks (net of eligible collateral and provisions) assessed in accordance with that methodology were as follows:-

	2010 Maximum exposure to credit risk £'000	*2009 Maximum exposure to credit risk £'000*
Low	2,593,717	*2,615,416*
Satisfactory	987,383	*1,015,623*
Fair	576,362	*602,621*
Watchlist	47,779	*21,538*
Substandard	25,259	*0*
Doubtful	3,288	*3,174*
Loss	0	*0*
Total credit exposures	4,233,788	*4,258,372*

Credit risk mitigation

The Group seeks to mitigate credit risk in a number of ways. In each case the gross potential exposure is included in the assessment of the maximum exposure to credit risk, but the existence of the collateral will be taken into account in determining the size of the limits which the Group is prepared to entertain.

The existence of collateral will also be taken into account for capital requirement purposes where the type of collateral, and the manner in which it is managed, fulfil the minimum requirements in the capital adequacy regulations. These regulations restrict the types of collateral which may be recognised for this purpose, and also require procedures for the monitoring and management of the collateral, and for legal certainty.

Principal types of credit risk mitigation

The following risk mitigation techniques are taken into account in determining capital requirements:-

- Cash. A number of the credit facilities extended by the group require that full or partial cash collateral be placed with the Group by way of security. The Group ensures that documentation for such facilities is robust and has obtained opinions from external counsel that such documentation is legally enforceable in all relevant jurisdictions. At 31 December 2010 the value of cash collateral held by the Group on terms under which set off can be applied in the event of default by the counterparty was £300,418,000 *(2009: £239,380,000)*.
- Reverse Repo transactions. A part of the Group's surplus funds are placed with other institutions by way of reverse repurchase transactions executed in accordance with market standard terms. Such transactions involve the lending of money secured by AAA rated EEA or equivalent government securities. At 31 December 2010 the value of loans undertaken on this basis was £38,466,000 (*2009: £nil)*. Such facilities are entered into for short periods, and the requirement to make adjustments to the balances as a result of valuation changes (margining) does not normally arise.
- Eligible guarantees. The Group also participates in lending activities under EEA and equivalent government sponsored guarantee schemes. In such cases the Group regards

its credit risk as being to these guarantee providers rather than to the underlying borrower.

Collateral may also be taken in the form of personal guarantees given by individuals associated with the obligor counterparty, or covenants such as financial ratios or other performance obligations embedded into loan documentation. These type of guarantees or mitigation are not recognised for regulatory capital purposes.

Cash collateral is held on terms which ensure that the cash cannot be paid away before the maturity of the secured exposure. Both logical systems, and operational controls are in place to prevent the inadvertent payment away of such collateral funds, and clear management information is in place both in real time and at end of day to monitor the balances of collateral in relation to the varying amount of the exposure, and to prevent the granting of new exposures which exceed the amount of collateral held.

The Group has not used on and off balance sheet netting.

Credit risk exposures

The Group provides facilities to 432 counterparties encompassing exposure to 60 countries and territories *(2009: 461 counterparties in 63 countries).*

The following tables summarise the various concentrations of credit risk assumed by the Group.

Regional concentrations of credit risk arising from operations were as follows:

	United Kingdom	Other European Union	Middle East and Africa	Other Countries	Impairments	Total
31 December 2010	**£'000s**	**£'000s**	**£'000s**	**£'000s**	**£'000s**	**£'000s**
Central Governments or Central Banks	151,528	67,332	82,723	65,169	0	366,752
Multilateral Development Banks	0	0	12,951	0	0	12,951
Institutions	1,150,885	1,080,730	660,097	257,161	(32,740)	3,116,133
Corporates	38,601	79,816	581,958	45,735	(8,579)	737,531
Secured on real estate mortgages	421	0	0	0	0	421
Impairments	0	0	(41,319)	0	0	
Total	1,341,435	1,227,878	1,296,410	368,065	(41,319)	4,233,788

31 December 2009	*United Kingdom* *£'000s*	*Other European Union* *£'000s*	*Middle East and Africa* *£'000s*	*Other Countries* *£'000s*	*Impairments* *£'000s*	*Total* *£'000s*
Central Governments or Central Banks	*82,847*	*32,288*	*128,173*	*3,967*	*(1,944)*	*245,331*
Multilateral Development Banks	*0*	*0*	*10,381*	*0*	*0*	*10,381*
Institutions	*1,393,942*	*968,311*	*740,726*	*229,720*	*(26,298)*	*3,306,401*
Corporates	*47,779*	*108,815*	*496,463*	*49,479*	*(6,859)*	*695,677*
Secured on real estate mortgages	*582*	*0*	*0*	*0*	*0*	*582*
Impairments	*0*	*0*	*(35,101)*	*0*	*0*	
Total	*1,525,150*	*1,109,414*	*1,340,642*	*283,166*	*(35,101)*	*4,258,372*

By industry, concentrations of credit risk were as follows:

31 December 2010	**Gross exposure** **£'000**	**Impairments** **£'000**	**Net exposure** **£'000**
Central Governments or Central Banks			
Central Governments	283,241	0	283,241
Central Banks	51,740	0	51,740
Public administration	31,771	0	31,771
Multilateral Development Banks	12,951	0	12,951
Institutions			
Banks	2,971,217	(15,229)	2,955,988
UK Building Societies	129,568	0	129,568
Other financial intermediaries	48,088	(17,511)	30,577
Corporates			
Commodities	8,908	0	8,908
Construction and engineering	55,291	0	55,291
Energy	349,535	0	349,535
Non-bank credit grantors	65,179	0	65,179
Transport and storage	80,765	0	80,765
Other	186,432	(8,579)	177,853
Secured on real estate mortgages	421	0	421
Total	4,275,107	(41,319)	4,233,788

31 December 2009	Gross exposure £'000	Impairments £'000	Net exposure £'000
Central Governments or Central Banks			
Central Governments	*67,716*	*0*	*67,716*
Central Banks	*83,095*	*0*	*83,095*
Public administration	*96,464*	*(1,944)*	*94,520*
Multilateral Development Banks	*10,381*	*0*	*10,381*
Institutions			
Banks	*3,145,055*	*(12,562)*	*3,132,493*
UK Building Societies	*138,662*	*0*	*138,662*
Other financial intermediaries	*48,982*	*(13,736)*	*35,246*
Corporates			
Commodities	*8,022*	*0*	*8,022*
Construction and engineering	*85,967*	*0*	*85,967*
Energy	*275,041*	*0*	*275,041*
Non-bank credit grantors	*73,444*	*0*	*73,444*
Transport and storage	*86,083*	*0*	*86,083*
Other	*173,979*	*(6,859)*	*167,120*
Secured on real estate mortgages	*582*	*0*	*582*
Total	*4,293,473*	*(35,101)*	*4,258,372*

The residual maturity of the Group's exposures were as follows

31 December 2010	Up to 1 month £'000	1-3 months £'000	3-12 months £'000	1-5 years £'000	Over 5 years £'000	Total £'000
Central Governments or Central Banks	70,524	117,226	101,115	77,887	0	366,752
Multilateral Development Banks	12,934	17	0	0	0	12,951
Institutions	2,180,931	451,311	382,553	99,649	1,689	3,116,133
Corporates	69,944	134,387	174,321	163,697	195,182	737,531
Secured on real estate mortgages	0	0	0	421	0	421
Total	2,334,333	702,941	657,989	341,654	196,871	4,233,788

31 December 2009	Up to 1 month £'000	1-3 months £'000	3-12 months £'000	1-5 years £'000	Over 5 years £'000	Total £'000
Central Governments or Central Banks	19,457	35,348	47,722	113,340	29,464	245,331
Multilateral Development Banks	10,381	0	0	0	0	10,381
Institutions	1,989,966	602,681	444,419	205,552	63,783	3,306,401
Corporates	139,993	59,469	98,277	202,623	195,315	695,677
Secured on real estate mortgages	582	0	0	0	0	582
Total	2,160,379	697,498	590,418	521,515	288,562	4,258,372

At 31 December 2010 the Group had no exposures to asset classes such as US sub-prime mortgages that became impaired as a result of the credit problems that emerged in the market during 2007, and which continued through 2010 *(2009: £nil).*

Counterparty Credit Risk

Counterparty Credit Risk ("**CCR**") in the context of this disclosure is the risk that the counterparty to a derivative transaction could default before the settlement of the transaction's cash flows. The duration of the derivative and the credit quality of the counterparty are both factored into the internal capital and credit limits for counterparty credit exposures. No netting of derivative transactions is undertaken.

The Group measures exposure value on counterparty credit exposure under the CCR mark to market method. This exposure value is derived by adding the gross positive fair value of the contract (replacement cost) to the contracts potential credit exposure, which is derived by applying a multiple based on the contracts residual maturity to the notional value of the contract.

The Group's exposures to CCR arise in respect of forward foreign exchange contracts, foreign exchange and interest rate options, and interest rate swaps.

Derivatives are used both to hedge existing or anticipated positions in the Group's balance sheet, but also as part of the Group's trading activities. All such contracts have been entered into in accordance with standard market terms.

No collateral has been either received or provided in respect of derivative contracts. No collateral would need to be provided in the event of a downgrade in the Group's credit rating. The Group does not employ netting arrangements in respect of derivative contracts.

	Gross positive fair values of contracts £'000	Potential credit exposure £'000	Total derivative credit exposure £'000
31 December 2010			
Foreign Exchange contracts	2,646	8,120	8,120
Interest rate swaps	817	2,760	2,760
Interest rate floors	949	725	725
Foreign Exchange options	710	155	155
Total	**5,122**	**11,760**	**11,760**
31 December 2009			
Foreign Exchange contracts	*9,436*	*16,671*	*16,671*
Interest rate swaps	*1,850*	*2,449*	*2,449*
Interest rate floors	*118*	*645*	*645*
Foreign Exchange options	*1,161*	*0*	*0*
Total	***12,565***	***19,765***	***19,765***

5.2. Market risks

Banking and trading

As part of its banking activities, and for the purpose of providing efficient services to its customers, the Group holds and issues financial instruments including derivative contracts. The Group's objectives in holding such instruments, or entering into such contracts, may either be characterised as being in pursuance of its principal banking activities, or as a trading activity carried on as an adjunct to its banking activities.

The Group's trading activities are accounted for on a mark-to-market basis, and financial assets, financial liabilities and derivatives which form part of such activities are accounted for at fair value through the profit and loss account. In identifying activities to be accounted for on this basis, the Group takes into consideration the following factors:

- The Group's motive for trading that instrument, and in particular where the purpose is to sell or repurchase in the short term, or
- where the instruments formed part of a portfolio for which there is evidence of a recent actual pattern of short term profit-taking, or
- where it is a derivative other than a financial guarantee contract, or a designated and effective hedging instrument.

The Group's trading activities are limited to transactions in financial instruments, mainly comprising the trading of foreign exchange and debt securities. Market risk relates primarily to exchange and interest rate risks. Exposures to those markets, together with a description of the risk management policies arising from both banking and trading activities are set out below. Market risk exposures are measured and monitored daily and are formally reviewed monthly by the Group’s ALCO.

Exchange rate risk

The Group makes loans, and takes deposits, in a number of currencies. Payments made on behalf of customers in one currency may be met from balances held in another currency. Further, the Group is active in the international foreign exchange markets, both for own account trading, and for the management of Group assets and liabilities.

The Group manages its exposures to foreign exchange risk by way of limits on the size of permitted positions, both intra-day and overnight. Overnight positions are protected by stop-loss orders placed with reputable correspondent banks. The size of the position limits is consistent with the amount of profit that the Group is prepared to place at risk in the foreign exchange markets.

All of the Group's exposure to exchange rate risk is managed by the Group's Treasury department on a continuous basis. Subject to such positions as the traders in the Treasury may wish to assume from day to day within their delegated limits, it is the policy of the group not to have any structural positions in any currency other than the functional currency, Sterling.

The Group allocates capital to its foreign exchange positions in accordance with the FSA Foreign Currency Position Risk Requirement ("**PRR**") rules.

Interest rate risk

The Group is exposed to changes in interest rates in various currencies arising from gaps in the future dates of repricing of assets, liabilities and derivative instruments. The Group manages that risk by calculating sensitivity of changes in the present value of committed future cash flows to a 0.01% change in interest rates using a methodology called the Present Value of a Basis Point ("**PVBP"**). Limits are placed on the overall amount of calculated PVBP, and the size of those limits is consistent with the amount of profit that the Group is prepared to place at risk in the interest rate market. The Group considers the impact of changes in future interest rates on its future income streams by reference to these interest rate gaps.

Interest rate risk arises in both the banking book and in the trading book. The PVBP methodology is used to monitor and manage the level of interest rate risk from both these sources.

As with exchange rate risk, it is the policy of the Group to centralise the management of interest rate risk within the Group's Treasury department. The traders within that department manage the gaps between repricings of receivables and payables on a continuous basis either by seeking to influence or control maturity dates of loans and deposits, or else by using derivative contracts.

A structural position does exist in the interest rate book as the group holds more interest bearing financial assets than interest bearing financial liabilities. This surplus arises as a part of the funding for the assets is derived from the Group's capital funds. This structural position gives rise to interest income which is not matched by interest expense, and this stream of income is designated as being income from shareholders' funds.

Certain structural funding costs including the margins on longer term borrowings and issued subordinated debt, and on the maintenance of liquidity resources are also deducted from this stream of income.

A notional pool of assets is identified as being the source of this income, and these notional assets are excluded from the PVBP calculations. Responsibility for managing this notional pool rests with the Group's ALCO who lend the funds to the Treasury department. The Treasury may or may not match-fund those placements depending on their own appetite at the time.

Interest rate risk in the banking book does not give rise to a capital charge under the Pillar 1 capital calculations, though the Group does make an allocation for this risk in its Pillar 2 assessment (See paragraph 4.5 above). Interest rate risk in the trading books gives rise to specific and general interest rate PRR which is determined using the standard PRR rules.

Sensitivity to interest rate risk

A simultaneous change in interest rates of 0.5% in all currencies, and in all maturities on 1 January would increase or (reduce) the present value of the gaps in the banking book as follows:-

	Change in fair value	
	Increase 0.5%	**Decrease 0.5%**
31 December 2010	**£**	**£**
US Dollar book	-30,776	31,661
Sterling book	-68,850	68,710
Euro Book	-38,497	39,262
Other books	-12,105	12,124
Total	-150,228	151,757
31 December 2009		
US Dollar book	*-257,431*	*258,646*
Sterling book	*-819*	*814*
Euro Book	*-145,395*	*147,037*
Other books	*-17,475*	*17,507*
Total	*-421,120*	*424,004*

However, income from shareholders' funds from the notional pool of financial assets associated with non-interest bearing liabilities not included in the gaps above, and from the change in costs arising from the funding of interest rate floor provisions embedded in the Group's issued subordinated debt would also change during 2010 as a result of such changes in rates. Such earnings would change as follows:-

Change in income	**2010**		***2009***	
	Increase in rates	**Reduction in rates**	***Increase in rates***	***Reduction in rates***
	£	**£**	***£***	***£***
Sterling	666,000	-666,000	*635,000*	*-635,000*
Total	666,000	-666,000	*635,000*	*-635,000*

5.3. Other risks

Liquidity risk

During 2009 the FSA introduced new requirements for banks for the management of liquidity. These requirements were set out in a new chapter of the regulatory handbook: BIPRU 12.

The FSA recognises that financial institutions require time to bring their business models into alignment with the new requirements. During 2010, an extensive project was undertaken by the Group to start to bring it into compliance with these requirements and by the year end substantial changes in the structure of the balance sheet had been made such that the directors are confident that current practices accord with regulatory expectations. The net liquidity gaps of the Group (being the difference in contractual cash inflows from maturing assets, and outflows from maturing liabilities) was as follows:-

Net liquidity gap (Outflow)/inflow	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Undated
	£'000	£'000	£'000	£'000	£'000	£'000
31-Dec-10	(237,061)	1,344	72,148	195,950	129,769	(162,150)
31-Dec-09	*(466,345)*	*(24,786)*	*200,991*	*251,725*	*210,236*	*(171,821)*

The new requirements encompass four principal concepts (as they affect the Group):

- Self-sufficiency. Entities are required to maintain all their liquidity resources within designated liquidity groups defined around management, legal entity and geographic boundaries. The Group operates as a single entity in the UK and manages its liquidity requirements without dependency on other parties.
- Systems and Controls framework. BIPRU 12 sets out the FSA's comprehensive expectations regarding the systems and controls which institutions are expected to have in place for the management of liquidity resources. These requirements detail requirements under a number of headings including involvement of the governing body (board of directors), stress testing and contingency funding plans. The Group's directors have satisfied themselves that such controls are in place having regard to the scale and complexity of the Group's operations.
- Quantitative requirements. Banks will be expected to make changes to balance sheet structures including the establishment of portfolios of high quality liquid assets (termed the Liquid Asset Buffer: LAB), and the determination of maturity transformation in the light of liquidity risk tolerance, itself informed by the results of the stress tests. The Group has started to increase the level of holdings of assets which qualify for LAB treatment. This balance is expected to grow over the coming few years.
- Reporting requirements. New and more demanding reporting regulatory requirements were introduced in 2010. The Group has complied with those requirements from their inception.

The new quantitative requirements are significantly more restrictive on the Group's ability to undertake maturity transformation activities in its balance sheet, and as a result the extent of such activities is being reduced both by seeking out increases in the term of liabilities, and also by reducing the term of assets. The Group has introduced comprehensive new management information to support the staff responsible for managing the bank's liquidity operations, and

undertakes regular liquidity stress tests to ensure that liquidity resources are sufficient to survive an extended period of idiosyncratic and market-wide stress.

During 2010, the Group's approach to the management of liquidity was documented in a comprehensive ILAA document, drawn up in accordance with regulatory requirements. This document describes the Group's liquidity risk tolerance, including the methodologies for ensuring that risk is restricted within that tolerance. It analyses the sources of liquidity risk, and describes the assumptions and approach taken to stress testing in light of those risks. It also incorporates the Group's liquidity contingency plans, and identifies those risks which have the potential to cause the Group to fail (reverse stress tests), as demanded by regulatory requirements.

At 31 December 2010, the board of directors was satisfied that the Group's liquidity resources were sufficient to survive the stresses identified in the ILAA document.

Events since 31 December have a bearing on the Group's liquidity position. On 26th February 2011 the Group held deposits from Libyan institutions which are subject to the Sanctions introduced over that weekend totalling £1,496,779,000 (at the exchange rates ruling on 26th February 2011) which cannot be paid away or otherwise depleted other than in accordance with the procedures described in 1.5 above. The Group holds further deposits from other affected Libyan institutions which, although not specifically listed in the Regulation, are also encumbered by these procedures, and are therefore largely blocked with the Group.

Sanctions therefore mean that the effective maturity of these deposits will be extended beyond their contractual terms. Accordingly the Group does not, for the time being, need to raise additional deposits in order to meet its obligations.

Operational risk

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

The operational risks facing the Group have been carefully analysed and risk management policies, procedures and controls are in place to minimise their impact. These procedures and controls are documented in formal procedure manuals, accessible by all staff and are regularly updated. Overall management of operational risk falls within the responsibility of the Bank's Risk Management department.

Key elements of the control environment are the strict segregation of duties, clearly defined authority levels and expenditure controls and strict safeguards over the integrity of and access to all types of confidential data. Secure offsite storage arrangements for key magnetic data and paper records are in place.

Underpinning the Group's operational controls is the existence of an independent Internal Audit function together with contingency planning and disaster recovery arrangements that include the availability of a "warm" site where replicated systems and office facilities are available. These arrangements are the subject of regular testing in accordance with documented procedures.

Semi-annual reviews of potential areas of operational risk are undertaken by departmental managers and following analysis of the results, issues arising are reported to the Group's Audit & Risk Committee. In addition, a reporting system is in place to capture and analyse instances

of operational loss “near misses” which are similarly reported to Audit & Risk Committee. Where control weaknesses are identified as a result, changes to procedures are made.

To assist with the identification of operational risk in specific transactions, a predictive model has been developed that is currently undergoing live testing.

Operational losses are closely monitored and reported to the Group’s Asset and Liability Committee (“ALCO”).

Operational losses in 2010 amounted to £23,000 *(2009: £32,000).*

Compliance with financial sanctions

Section 1.5 of this document sets out details of the various sanctions regimes introduced over the weekend of 26th and 27th February in connection with certain Libyan persons, and the institutions over which they might be able to exercise control or influence.

One consequence of these sanctions is that financial institutions are required to undertake significant additional due diligence in respect of payments for or on behalf of a wide range of Libyan persons and institutions. In common with other financial institutions the Group has implemented additional procedures and controls, but in light of the high level of such transactions undertaken by the group, and in agreement with, and under the supervision of the Financial Services Authority, additional controls have been put in place. These additional controls include the introduction of an independent third party (Grant Thornton UK LLP) into the Group’s approval processes to verify that no payments are made by the Group other than in full compliance with the new requirements.

Reputational risk

Reputational risk is recognised as a key risk area and policies are in place to minimise the potential impact. These include comprehensive Know Your Customer (KYC) requirements, environmental, defence and sectoral lending policies and a risk based due diligence programme. Electronic transaction screening and a behavioural monitoring system are also in place to prevent inadvertent involvement in money laundering, terrorist financing or fraud.

Other risks

The Group is exposed to a range of other operational risks. In each case various risk mitigation techniques are adopted to control the risk. These risks include the following:

- Legal risks. The Group enters into contracts both in the course of its ordinary business, but also as part of its banking activities. Specialist staff are employed to review and negotiate contract documents, and external legal counsel is also sought where appropriate.
- Settlement and confirmation risk. The Group seeks to employ, retain and train its staff to ensure that they are competent to carry out such procedures. Suitable computer systems to support such operations are maintained, and operational procedures are documented, and subject to regular audit.

- Litigation risks. Disputes arise from time to time in the course of the Group's business. Such disputes are subject to early identification, and escalation to senior executives qualified to manage their resolution. External counsel's opinions and assistance is sought as required.
- Pension Fund Risk. The Group offers defined benefit pension arrangements to some of its staff. There are risks that the liabilities associated with these arrangements may be higher than expected, or that the assets may not grow as expected. The Group recognises that these are long term obligations, and seeks to manage the risks through the use of assumptions and investment strategies designed to reduce the various risks.

6. NON TRADING BOOK EXPOSURES IN EQUITIES

The Group has exposure to equities by way of a small number of long term investments. These comprise two strategic investments in unquoted financial companies in the North African region, and two investments in venture capital equity investment funds managed by specialist fund managers whose objective is to invest in growing companies in that same region.

The two direct investments are as follows:-

Company	Holding	
Banque d'Affaires de Tunisie:	2,474 ordinary shares of Tunisian Dinars 100	6.67%
International Company for Leasing SAE:	1,727,999 ordinary shares of Egyptian Pounds 10	8.64%

The Group's objective in holding these investments is to seek long term investment growth. The Group also participates in the Board's of each of these companies, and seeks to gain access to intelligence regarding developments in the relevant local markets thereby.

The objective of the investment in the venture capital funds is to achieve long term capital growth by way of participation in growing companies in that region.

The investments are held in the Groups' balance sheet as Available for Sale assets. In the case of the direct investments the Group has estimated fair value based on the audited net assets of the companies involved. In the case of the investment funds the valuation is based on reports provided by the fund managers.

At 31 December 2010 the carrying value of those investments in the Group's balance sheet (which is the same as estimated fair value) was as follows:-

	2010 Fair value of investments £'000	***2009 Fair value of investments £'000***
Equity shares	2,625	*2,369*
Equity investment funds	4,683	*4,653*
	7,308	*7,022*

There were no sales or liquidations of investments during the year. At 31 December 2010 £1,676,000 *(2009: £1,285,000)* was included in Tier 2 capital by way of unrealised fair value gains on these investments.

7. IMPAIRMENT PROVISIONS

7.1. Summary of accounting policy

The Group's accounting policy for the determination of impairments is set out in Note 3k of the Annual Report and Financial Statements. A summary of the main provisions of the policy is set out below.

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or portfolio of financial assets is impaired. A financial asset or a portfolio of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or portfolio of financial assets that can be reliably estimated. Objective evidence that a financial asset or portfolio of assets is impaired includes observable data that comes to the attention of the Group.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a portfolio of financial assets with similar credit risk characteristics and collectively assesses them for impairment.

Once a financial asset or portfolio of similar assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the loss.

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics (i.e. on the basis of the Group's grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). There were no collective impairments as at 31 December 2010 *(2009: £nil).*

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

If in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed to the extent it is now excessive by reducing the loan impairment allowance account. The amount of any reversal is recognised in the income statement.

In the case of available-for-sale assets, the Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a portfolio of financial assets is impaired. If any such evidence exists for available-for-sale financial assets, the cumulative loss, measured

as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss, is removed from equity and recognised in the income statement.

7.2. Past due amounts

The Group's normal policy is to assume that payments which are due to be paid on a particular date will be settled, and adjusts its books accordingly. However, the Group closely monitors and actively manages receivables which are not paid on their due date (past due amounts), and expects to identify such amounts either on the day it was due for large sum amounts (using real time settlement enquiry systems), or else on the morning of the following day following completion of correspondent account reconciliations (nostro reconciliation).

There are many reasons why an amount may not be settled on the due date, the most common of which being delays in the settlement process which arise in the normal course of business. In such cases settlement normally takes place within a very short period of the contractual date, and interest or "good value" claims will arise to ensure that the Group is held harmless.

Delays may also be indicative of other difficulties being experienced by the payment obligor. In such cases the Group's policy is to re-book the amount as an overdue balance and to immediately contact the counterparty with a view to establishing the reason for the delay.

Overdue amounts are reported to appropriate levels of management to ensure that necessary actions are being taken. If the reasons for the delay are indicative of difficulty being experienced by the counterparty, then all of the balances due from that counterparty will be classified as being on "watchlist", resulting in increased management scrutiny and action.

7.3. Summary of position at 31 December 2010

The Group is active primarily in the wholesale markets. Accordingly, its portfolio of financial assets comprises a relatively small number of individually significant claims, rather than a large number of individually insignificant claims as would be the case for similar financial institutions acting in retail markets. This means that each claim due to the Group is subject to individual impairment review at the reporting date taking account of the factors described above.

At 31 December 2010 eleven facilities comprising amounts due to the Group from counterparties in the Middle East and African region of £68,828,000 were determined to be impaired *(2009: seven facilities comprising £38,275,000 due to the group)*. No collateral was held in respect of these facilities, but £2,900,000 *(2009: £2,900,000)* was covered by personal guarantees issued by the owners of both of the borrowing companies.

At 31 December 2010, £4,814,000 was past due which was in respect of unimpaired financial assets *(31 December 2009: £18,000)*.

The movement in impairments during the year was as follows:

£'000	2010 Individual	2010 Collective	2010 Total	*2009 Individual*	*2009 Collective*	*2009 Total*
Balance at 1 January	35,101	0	35,101	*3,456*	*2,293*	*5,749*
Exchange translation and other movements	1,699	0	1,699	*237*	*(222)*	*15*
Effect of discounting	(64)	0	(64)	*(119)*	*0*	*(119)*
Provisions written off	0	0	0	*0*	*0*	*0*
Profit and loss account						
New allowances	4,617	0	4,617	*31,767*	*0*	*31,767*
Reversal of allowances no longer required	(34)	0	(34)	*(240)*	*(2,071)*	*(2,311)*
Recoveries of amounts written off in previous periods	0	0	0	*0*	*0*	*0*
	4,583	0	4,583	*31,527*	*(2,071)*	*29,456*
Balance at 31 December	41,319	0	41,319	*35,101*	*0*	*35,101*

It is noted that, at the time this document is approved, the imposition of Sanctions, and the other post balance sheet events described in 1.5 above have not given rise to new material actual or contingent losses.

8. REMUNERATION CODE

There has been extensive public debate and regulatory focus during 2010 on staff remuneration within the banking sector. In December 2010, the FSA issued its Policy Statement PS10/20 "Revising the Remuneration Code" ("**the Code**") which set out the FSA's requirements in this regard.

The Group's Compensation Committee is responsible for the implementation of the Code and the annual review of the Group's adherence to it.

This statement sets out the disclosures required under the Code as they apply to the Group.

The Group employed 147 members of staff at 31 December 2010 (2009: 143 staff). The staff costs of the Group were as follows:-

	2010	2009
	£'000	£'000
Staff costs:		
Salaries and other emoluments	7,796	7,693
Social security costs	1,202	864
Other pension costs:		
- Defined benefit scheme	789	454
- Defined contribution scheme	414	333
Total fixed staff employment costs	**10,201**	**9,344**
Variable staff costs: Performance awards	3,331	687
Total staff employment costs	**13,532**	**10,031**
Reorganisation costs	17	609
Other employment related costs	510	312
Total staff costs	**14,059**	**10,952**

The Group qualifies as a Tier 2 firm under the Code. It is required to disclose certain qualitative items and quantitative remuneration items.

Governance of all matters related to remuneration within the Group lies with the Compensation Committee, comprising three non-Executive Directors. The Group's executive head of Human Resources is a member of the committee acting as secretary, but carries no vote in decision making. The Committee is composed of the Chairman, and two other non-executive directors. These three directors are regarded as being independent of the Group and also to possess the necessary skills to exercise the appropriate judgement.

The Compensation Committee has recently reviewed the Group's remuneration policies to ensure compliance with the Code. Additionally, it has confirmed the rules for use within the Group for the identification of Code Staff as required under principle 12 of the Code (see also below).

The Group has in place performance award schemes for the benefit of its employees. The schemes were revised in 2009, with awards being closely linked to risk adjusted shareholder return, but with non-financial performance metrics (such as risk management and assessed individual performance) taken into account. Performance awards under the schemes qualify as "variable remuneration" as defined in the Code.

Individual performance awards are split between amounts payable in March following the year to which the reward relates, and amounts deferred for three years. Deferred amounts are

increased (or decreased) during the period of deferral by the Group's return on equity achieved during each of those following years.

At 31 December 2010 the total amount payable in future years under the deferred award scheme (excluding associated National Insurance) was £1,394,000 payment of which will take place in March 2012, 2013 and 2014. Deferred awards outstanding at 1 January 2010 were augmented by £77,000 in light of the return on equity achieved by the Group during 2010. Payments made in the year in respect of deferred awards made in earlier years amounted to £21,000.

The calculation of performance awards for individuals is undertaken annually and is linked to five factors:

- Individual role level.
- The Group's risk adjusted return on equity.
- Assessed individual performance.
- Assessed compliance with the Group's documented core standards of behaviour.
- The Group's performance against the business plan prepared before the start of the year to which it relates.

The Code requires that banks identify relevant senior executives and designate them as "Code Staff". Additional restrictions apply to the remuneration of such staff. 11 senior executives of the Group have been identified as Code Staff including all those who serve on the Executive Management Committee and three individuals who are FSA Approved Persons. Within this group no individual has either variable or total remuneration in excess of £500,000. Where their variable remuneration exceeded 33% of total remuneration, at least 40% of the variable remuneration is deferred for at least 3 years.

The Group had 145 employees at 31 December 2010 who are expected to be eligible for performance awards in respect of their service during 2010. The cost of performance awards payable in respect of 2010 (excluding associated National Insurance) was £3,331,000 of which £1,303,000 was allocated to the 11 Code staff. Of the total performance award £695,000 was deferred as described above, of which £320,000 was in respect of Code Staff. Total staff employment costs (including variable remuneration) in 2010 were £13,532,000 and of which the employment costs of the Code staff were £3,398,000.

Guaranteed bonuses are not offered as part of the Group's current performance award arrangements and the Group did not offer any "sign-on" inducements. No severance payments were made during the year.

Organisation Chart