



**Julian  
Hodge  
Bank**

**Julian Hodge Bank Limited**

Pillar 3 disclosures  
as at 31 October 2009

Approved by the Board on 25 March 2010

# Contents

	<b>Page</b>
1 Introduction	3
2 Scope	5
3 Risk management objectives and policies	6
4 Capital resources	13
5 Capital adequacy	14
6 Credit risk	17
7 Interest rate risk	23
8 Operational risk	24

## 1. Introduction

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

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

### 1.1. Overview of the Basel II framework

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

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

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

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

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

## 1.2 Adoption of the Basel II framework

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

## 1.3 Basis of disclosure

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

All numerical disclosures within this document have been prepared as at 31 October 2009, which is JHB's last financial year-end. Future disclosures will be issued on an annual basis, based on year end financial information, and will be made available within 6 months of the end of each financial year.

## 1.4 Verification of information

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

## 2. Scope of Pillar 3 disclosures

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

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

**Julian Hodge Bank Limited** – JHB's principal lending activities comprise equity release and commercial lending. Equity release, which is offered through the Hodge Lifetime brand, involves the provision of lifetime mortgages or home reversion plans to retired people in order that they can use their homes to raise money to fund their retirement. Commercial lending involves the provision of investment or development finance to clients operating within the property sector. JHB also invests in other financial instruments for investment purposes (for example corporate bonds) and as a means of managing its liquidity profile (for example gilts and bank deposits).

JHB's lending is funded using its own capital and customer deposits.

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

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

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

### 3. Risk management objectives and policies

#### 3.1 Risk management objectives

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

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

The principal methods used to manage risks identified by JHB include:

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

### 3.2 Risk governance structures

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

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

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

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

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

The Audit Committee meets at least four times per year.

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

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

The committee meets as required.

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

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

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

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

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

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

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

The next sections of this document discuss and comment on the principal risks faced by JHB.

### 3.3 Credit risk

Credit risk is defined as the risk that a customer or counterparty will fail to meet their financial obligations to the Bank as they become due. JHB is therefore exposed to credit risk within its commercial lending, equity release and treasury asset portfolios.

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

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

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

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

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

**Equity release** – Under the terms of an equity release loan, the borrower is not obliged to make any repayments during the life of the loan. The Bank is repaid at the end of the loan, which is the earlier of the date on which the borrower dies or vacates the property on a permanent basis as a result of moving into long-term care. The borrower also benefits from a “no negative equity” guarantee such that, at the end of the loan, the borrower is not obliged to repay more than the relevant value of the property.

Therefore, the primary driver of credit risk within the equity release portfolio of lifetime mortgages and reversion plans is a fall in house prices, which would result in losses if house prices have fallen in real terms over the period of the

---

loan. However, due to the long-term duration of these loans (of up to 25 years) a short term fall in house prices does not have a significant effect.

A credit policy has been agreed by the Board which sets out the types of residential property eligible for an equity release loan, together with the maximum amounts the Bank will lend to borrowers of various ages.

All applications are reviewed by a specialist underwriting team, and are supported by a survey and valuation report concerning the property, conducted by a qualified member of the Royal Institution of Chartered Surveyors.

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

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

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

### 3.4 Market risk

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

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

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

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

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

### 3.5 Liquidity risk

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

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

- A buffer of highly liquid assets (comprising high quality government bonds) which can be sold or repo'd to meet cash requirements;
- Liquidity insurance, in the form of committed funding lines from other banks.

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

### 3.6 Operational risk

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

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

On a quarterly basis, the Board receives a report of all of the losses or near-miss events that have taken place in the quarter.

### 3.7 Concentration risk

Concentration risk is defined as the risk of any single exposure or group of exposures with the potential to produce losses large enough to threaten an institution's health or ability to maintain its core operations. Credit risk concentrations, by their nature, are based on common or correlated risk factors,

---

which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration.

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

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

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

### 3.8 Pension obligation risk

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

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

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

## 4. Capital resources

As at 31 October 2009, and throughout the period to 31 October 2009, JHB maintained its capital resources at a level above the minimum Pillar 1 capital adequacy requirements as required by the FSA.

The following table shows the breakdown of the total available capital for the Bank as at 31 October 2009:

	<b>Notes</b>	<b>£'m</b>
Tier 1 capital		
Ordinary shares		100.0
Profit and loss reserve		22.1
		<u>122.1</u>
Deductions from Tier 1 capital		
Investments in subsidiaries	1	(16.0)
		<u>106.1</u>
Tier 2 capital		
Eligible general provisions	2	6.7
<b>Total capital resources</b>		<u><b>112.8</b></u>

### Note

- 1 This represents the investment in Hodge Life, which is excluded from the regulatory capital of the Bank.
- 2 The Bank is allowed to add-back a proportion of its general provisions to its capital resources. The amount of the add-back is determined by a formula set out in the FSA Handbook.

## 5. Capital adequacy

On 1 January 2008, JHB adopted the requirements of the Basel II Capital Requirements Directive, as set out within the BIPRU chapter of the FSA Handbook.

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

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

## 5.1 Pillar 1 capital requirement

The table below sets out the Pillar 1 capital requirements as at 31 October 2009 determined in accordance with the BIPRU chapter of the FSA Handbook.

<b>Exposure class</b>	<b>Description</b>	<b>Principal constituents</b>	<b>£'m</b>
1	Governments and central banks	• Gilts	0.0
4	Multilateral development banks	• Debt securities	0.0
6	Institutions	• Bonds issued by financial institutions	1.5
7	Corporates	• Hedging exposures • Commercial lending • Corporate bonds	18.3
9	Secured on real estate property	• Lifetime mortgages	14.0
14	Short term claims on institutions and corporates	• Cash deposits	1.5
16	Other items	• Reversionary interests in property • Fixed assets	7.5
Credit risk minimum capital requirement			42.8
Operational risk ( <i>basic indicator approach</i> )			2.3
<b>Pillar 1 capital requirement</b>			<b>45.1</b>
Total capital resources			112.8
<b>Excess of capital resources over Pillar 1 capital requirement</b>			<b>67.7</b>

## 5.2 Capital management

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

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

The Bank's Pillar 2 capital requirements are reviewed formally on a six monthly basis, and additional reviews are undertaken in the intervening periods if management become aware of a material issue or deviation.

## 5.3 Internal Capital Adequacy Assessment Process

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

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

The ICAAP is presented to the Board for challenge and approval with the most recent review being completed in February 2010.

## 6. Credit risk

### 6.1 Summary of JHB's credit risk exposures

The gross exposures (before any bad debt provisions) are summarised as follows:

Exposure class	Description	Exposures at 31 October 2009 £'m	Average exposures to 31 October 2009 £'m
1	Governments and central banks	18.2	9.1
4	Multilateral development banks	2.3	1.2
6	Institutions	19.5	20.6
7	Corporates	232.8	241.7
9	Secured on real estate property	574.0	524.4
14	Short term claims on institutions and corporates	92.6	89.7
16	Other items	93.1	77.8
		<b>1,032.5</b>	<b>964.5</b>

The average balances represent the averages measured between 1 November 2008 and 31 October 2009.

The geographic distribution of these exposures as at 31 October 2009 is shown below.

Exposure class	Description	UK £'m	Europe £'m	USA £'m	Other £'m	Total £'m
1	Government and central banks	18.2	-	-	-	18.2
4	Multilateral development banks	-	2.3	-	-	2.3
6	Institutions	12.6	2.0	3.9	1.0	19.5
7	Corporates	229.9	2.1	0.5	0.3	232.8
9	Secured on real estate property	574.0	-	-	-	574.0
14	Short term claims on institutions and corporates	92.6	-	-	-	92.6
16	Other items	93.1	-	-	-	93.1
		<b>1,020.4</b>	<b>6.4</b>	<b>4.4</b>	<b>1.3</b>	<b>1,032.5</b>

The residual maturity of these exposures at 31 October 2009 is shown below.

<b>Exposure class</b>	<b>Description</b>	<b>Up to 1 year £'m</b>	<b>1-5 years £'m</b>	<b>More than 5 years £'m</b>	<b>Non-interest bearing £'m</b>	<b>Total £'m</b>
1	Governments and central banks	-	3.0	15.2	-	18.2
4	Multilateral development banks	-	0.5	1.8	-	2.3
6	Institutions	-	0.5	19.0	-	19.5
7	Corporates	129.5	85.1	18.2	-	232.8
9	Secured on real estate property	2.6	15.8	555.6	-	574.0
14	Short term claims on institutions and corporates	92.6	-	-	-	92.6
16	Other items	0.1	12.4	55.0	25.6	93.1
		<b>224.8</b>	<b>117.3</b>	<b>664.8</b>	<b>25.6</b>	<b>1,032.5</b>

Residual maturity has been defined as the contractual maturity of the loan. In the case of equity release loans, the contractual maturity is determined based on the life expectancy of the applicants.

## 6.2 Overview and terminology

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

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

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

Doubtful debts are defined as those accounts where the full recovery of the balance is not considered probable, either as a result of a client falling behind their repayment schedule, or more appropriately in the case of both commercial lending and equity release, the value of the security is impaired. Such

impairment would therefore result in a shortfall between the sale price of the security and the client's balance outstanding.

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

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

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

### 6.3 Commercial lending credit risk

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

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

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

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

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

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

#### 6.4 Equity release credit risk

Borrowers are not required to make any repayments on lifetime mortgage loans or reversion schemes, as the full amount of the debt is repaid either when the borrower dies or moves into long term care, at which point the property is sold.

Therefore, JHB's credit risk arises at the point of maturity, if the value of the property is lower than the value of the debt. By virtue of the 'no negative equity' guarantee offered to lifetime mortgage borrowers, JHB is not able to recover any shortfall from the client's estate.

Given this exposure, the maximum amount that JHB will lend to a client is age-related in order to minimise the extent to which JHB is exposed to credit risk.

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

#### 6.5 Treasury credit risk

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

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

JHB uses the ratings issued by the ratings agency Moody's, and the Bank's exposures at 31 October 2009, analysed by credit rating, are summarised in the table below.

Moody's rating	Credit quality step	Exposure class				
		1 £'m	4 £'m	6 £'m	7 £'m	14 £'m
Aaa to Aa3	1	18.2	2.3	1.7	0.2	49.5
A1 to A3	2	-	-	9.1	6.3	43.1
Baa1 to Baa3	3	-	-	4.1	4.3	-
Ba1 to Ba3	4	-	-	0.5	-	-
B1 to B3	5	-	-	4.1	-	-
<b>Total</b>		<b>18.2</b>	<b>2.3</b>	<b>19.5</b>	<b>10.8</b>	<b>92.6</b>

## 6.6 Bad debt provisions

The table below summarises the bad debt provisions held against each of JHB's portfolios at 31 October 2009.

	<b>Commercial lending £'m</b>	<b>Equity release £'m</b>	<b>Treasury assets £'m</b>	<b>Total £'m</b>
General provisions (1)	8.8	2.4	-	<b>11.2</b>
Specific provisions (2)	6.4	-	-	<b>6.4</b>
<b>Total provision</b>	<b>15.2</b>	<b>2.4</b>	<b>-</b>	<b>17.6</b>
Charge for the period				
General provisions	1.6	(2.3)	-	<b>(0.7)</b>
Specific provisions	4.9	-	-	<b>4.9</b>
<b>Charge for the period</b>	<b>6.5</b>	<b>(2.3)</b>	<b>-</b>	<b>4.2</b>

(1) General provisions cover the entire portfolio of performing loans which are not in arrears or default.

(2) Specific provisions are made against relevant bad and doubtful debts reported on the Bank's default list, to the extent that the balance is considered to be irrecoverable.

The table below summarises the movements in provisions during the year ended 31 October 2009.

	<b>General provisions</b>	<b>Specific provisions</b>	<b>Total £'m</b>
Balance at 1 November 2008	11.9	4.0	15.9
Charge for the period	(0.7)	4.9	4.2
Recoveries	-	-	-
Write-offs	-	(2.5)	(2.5)
<b>Balance at 31 October 2009</b>	<b>11.2</b>	<b>6.4</b>	<b>17.6</b>

### 6.7 Credit risk mitigation

For both commercial lending and equity release, JHB takes security in the form of legal charges over the property to be financed. This is the primary method used by the Bank to mitigate credit risk.

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

Properties subject to an equity release plan are also valued at inception of the loan by a RICS-qualified surveyor. Further inspections take place at regular intervals to ensure that the Bank's security is maintained in an adequate state of repair.

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

---

## 7. Interest rate risk

Interest rate risk is described in section 3.4 of this document. Interest rate arises within the Bank's lending portfolios as follows:

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

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

At 31 October 2009, JHB's interest rate gap sensitivity, being the impact on the Bank's reported profit before tax over the next 12 months, resulting from a +/- 100bps parallel shift in the yield curve was £840,000 and -£840,000 respectively.

## **8. Operational risk**

Operational risk is described in section 3.6 of this document.

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