USB BANK PLC

Pillar 3 disclosures for the year ended 31 December 2011

December 2012

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1. Introduction

The principal activity of USB BANK PLC (the ‘Bank’) is the provision of banking and financial services in Cyprus through the operation of 16 branches. The activities of the Bank are mainly focused on three large business areas: Retail Banking, Corporate Banking and International Banking.

This report has been prepared pursuant to paragraph 70(1) of Chapter 5 of Unit A (the “Disclosures”) of the Directives to banks for the calculation of the capital requirements and large exposures of banks of 2006 to 2011 (‘the Directives’) issued by the CBC. The Directives implement the European Union’s Capital Requirements Directive (‘CRD’).

The Directive describes the Basel II framework which is based on three pillars:

- Pillar 1 has to do with the standards that set out the minimum regulatory capital requirements that are required for credit, market and operational risk
- Pillar 2 covers the Supervisory Review Process which assesses the internal capital adequacy processes. Banks and Supervisors have to evaluate and assess whether a bank should hold additional capital against risks not covered in Pillar 1
- Pillar 3 (Market discipline) covers transparency and the obligation of banks to disclose meaningful information to the market related to their risks, capital and generally risk management.

The Bank’s Disclosures below have been prepared using 31 December 2011 data in accordance with the Directive.

The Bank as part of its operations, exceptionally acquires property from very problematic customers in settlement of their debts. The properties are acquired by companies which are controlled directly or indirectly by the Bank and whose sole business is the management of these properties. The properties are recognized in the Financial Statements of the Bank as Investment properties and are consolidated for accounting purposes, reflecting the substance of these transactions.

2. Risk Management Objectives and Policies

Risk taking constitutes a major characteristic of the business of the Bank, and the development of a robust risk management framework is considered of high importance. The Bank believes and supports the functioning of this framework in the promotion of a risk management culture within the Bank to enable the detection of developments in the internal and external environment which may endanger the institution, as early as possible, in order to facilitate activation of mitigating actions. The identification and classification of risks begins from the definition of the vision and business objectives, which clearly provide guidance and direction, defining the approach that the Bank adopts in order to successfully confront and respond to different risks inherent in its operations and functions.

2.1 Risk Management Framework

The Bank's Board of Directors (BoD), which has the ultimate responsibility for the risk management framework, has delegated the responsibility for the implementation of the approved risk strategy and objectives in a uniform manner throughout the Bank. The responsibility of the day-to-day management of risk is delegated to the different executive managers of the Bank depending on the risk type.

The Risk Management Unit (RMU) reports to the Deputy Managing Director and the BoD through the Risk Management Committee (RMC). It is subject to audit control by the Internal Audit Unit (IAU) in relation to the adequacy and efficiency of risk management procedures. The RMU is made up of six persons, other than the Risk Manager. There are four employees allocated to the Credit Risk Management Unit, one employee to the Operational Risk Management Unit and one employee to the Legal Services Department.

The main task of the RMC is to assist the BoD in establishing a policy for handling risks and managing funds that reflect the business goals of the Bank. The RMC comprises of seven members of whom five are non-independent non-executive directors, one executive director and one independent non-executive director.

The Bank's credit risk framework has been finalized and approved by the RMC in 2010. The operational and market risk frameworks have been finalized and approved by the BoD in November 2011, following consultation with the Bank's parent company BLC Bank S.A.L. These frameworks are based on a set of principles, developed in cooperation with external advisors. These principles are dynamically evolving and reviewed to be compliant and consistent with the changing internal and external environment of the Bank. The set of basic principles that govern the Bank's risk management are:

A. BoD and Senior Management Responsibility: Overall risk management policies and tolerances are set on a comprehensive basis by senior management, reviewed and finally approved by the BoD. Policies and tolerances addressing risk identification, measurement, monitoring and control are communicated to all relevant bank officers.

B. Framework for managing risk: An overall framework for the management of each of credit, market and operational risks will be developed and approved by the BoD. As mentioned above, the Bank's credit risk framework has been finalized and approved by the RMC in 2010. The operational and market risk frameworks have been finalized and approved by the BoD in November 2011, following consultation with the Bank's parent company BLC Bank S.A.L.

C. Integration of risk management: Risks are evaluated both in isolation and in aggregate. The required analysis for the aggregation of risks is carried out on an entity-wide basis.

D. Business Line Accountability: Business line managers and staff are accountable for managing the risks associated with their activities and establish tolerances for taking these risks. The accountability exists notwithstanding the presence of any support functions dedicated to risk management activities.

E. Risk evaluation/measurement: All risks are qualitatively evaluated and wherever practical, the evaluation includes quantitative analysis. Risk assessment considers both the effects of likely and unlikely events.

F. Independent review: Risk evaluations are validated by the RMU and the IAU that have the necessary expertise to assess the risks, test the effectiveness of risk management activities and make recommendations for remedy.

2.2 Risk Management Process

Risk appetite is the amount of risk that the Bank is prepared to accept, tolerate, or be exposed to at any point in time and is set by the BoD and implemented and monitored by the Senior Executive Management. The Bank sets its risk appetite specifically for each risk type through policies, controls and procedures that are established and communicated throughout the organization. These procedures suggest the level of risk that each manager is allowed to take, which in turn gives guidance on the risks that the Bank can assume in order to maximize its performance always considering the following:

- The risk strategy and policy of the Bank.
- The risks that are the product of the implementation of the business plan of the Bank.
- The level of the minimum required regulatory capital.

2.3 Credit Risk Management

Credit Risk in USB Bank is defined as the risk that a Bank will incur losses arising from the default of a borrower or a counter-party because his/her financial position has deteriorated to a point that the value of an asset including off balance sheet assets is reduced or extinguished. The definition includes the following: Residual Value Risk, Concentration Risk, Counterparty Risk, Country Risk, Documentation Risk, Cyclicality and Economic Risks, Risk associated with inadequate credit policies and procedures, Credit grading system and Risk arising from USB's associates.

Credit Risk Management Framework

The BoD is responsible to set the strategy for credit risk management. It is responsible to give a clear definition of credit risk and its management framework. The BoD approves and reviews the overall credit risk management on a regular basis and makes changes whenever necessary.

Senior management has the responsibility for setting and implementing the overall credit risk management policies and tolerances, which are reviewed and approved by the BoD. The framework is consistently implemented throughout the organization, and the set policies and procedures are communicated to all staff.

Four members of staff are employed in the Credit Risk Management Division. Their responsibilities include:

- Calculation of credit risk capital requirements for Pillar I and COREP submission.
- Identification and assessment of credit risk under Pillar II.
- Assessment of customer credit application above a certain limit.
- Preparation of circulars and guidance to credit officers.
- Set up of limits in lending and write-offs.
- Assesses the entrance to new markets and products.
- Assist in the preparation of the information required for Pillar III reporting.
- Recommend changes and additions to the Credit Policies manual and Credit Risk Management Framework
- Reporting to the CBC and senior management.
- Make suggestions for the improvement of the Bank's MIS. Involved in the stages of providing specification, testing system results and issuance of circulars to staff.

IAU has the responsibility of assessing the robustness of the credit risk framework. The Bank has a simple client rating system, based on the clients' performance, according to which the clients are allocated to one of the five risk grade categories:

1. "1" (Outstanding facilities): Client facilities that do not exhibit any negative indicators.
2. "2" (Satisfactory facilities): Client facilities that even though are not yet problematic, they are in need of monitoring for avoiding possible future problems.
3. "3" (Attention required): Client facilities that are problematic but at the current stage there are no doubts raised as to their collection by the Bank. As a result there is possibility for improvement and repayment of the debt after close handling and monitoring from the Bank.
4. "4" (Problematic facilities): Client facilities with long term difficulties and problems having as a result the possibility of default. The attempts from the Bank for settlement or coverage of the irregularity by the customer have not yet resulted in the desired outcome but no legal measures have been taken.
5. "5" (Doubtful loan repayment): Clients for which legal action has already been initiated by the Bank. For such clients, provisions have been made by the Bank.

The approval and monitoring stages are carried out following the guidelines set by senior management. Segregation of duties exists between credit origination, approval and implementation/monitoring. In addition, individuals responsible for credit administration such as custody of documents, wiring of funds and entering limits in the IT systems, is independent from the credit origination function.

Credit Risk Mitigation

The Bank has a strict credit risk mitigation framework. In accordance with this framework, the Bank in order to assume credit risk needs to obtain adequate collateral. The following assets have been approved to be accepted by the Bank as collateral:

- Cash pledged within the Bank
- Land and Buildings
- Shares either listed or non-listed in a recognized stock exchange
- Bonds/Development Stock either listed or non-listed in a recognized stock exchange
- Assignment of life insurance
- Import Letters of Credit
- Fixed and floating charges on assets
- Guarantees (personal, bank, corporate, sovereign)
- Pledge of insurance policies (fire and earthquake)
- Pledge of life insurance policies
- Goods in bonded warehouses

The Bank requires collateral at a value that is initially adequate to provide sufficient cushion against decline in collateral value. Periodic reviews are performed to assess whether the Loan to Value ratio remains at acceptable levels. The Bank has also designed a system for early remedial action on deteriorating credits, managing problematic credits and similar workout situations. A reduction in credit quality should be recognized at an early stage when there may be more options available for improving the credit. The main steps that are followed to monitor amounts in arrears and excesses are the following:

- Regular checking and monitoring of customers' arrears and excesses.
- Contacting the client i.e. telephone conversations.
- Meeting with clients.
- Keeping records of agreements with clients for follow up purposes.
- Sending notification letters to the client and to its guarantors.
- Restructuring and obtaining additional collateral.
- Send the client to the Recoveries department if no improvement is made, to initiate legal action.

Credit Risk Limits

The BoD has set-up prudent lending approval limits for credit facilities.

The Bank follows the CBC's directives and limits regarding loans to customers.

The Bank also has controls in place relating to Treasury instruments and counterparties. These controls are clearly defined and documented and relate to:

- The external credit rating of the obligor
- The currency and settlement of the transaction
- The origin of the counterparty

Monitoring and Measurement of Credit Risk

Monitoring of credit risk is done through the following:

- Regular credit reviews are performed by the IAU.
- Assignment of credit ratings.
- Daily monitoring of counterparty's account movement and repayment.
- Revaluation of collaterals received and especially real estate property (approximately every 2 – 3 years).
- A detailed provision review is carried out on a quarterly basis.
- Credit risk capital requirement is calculated on a quarterly basis using the Standardised approach to satisfy Pillar I of Basel II regulations.
- Additional capital is kept aside based on stress tests performed on a yearly basis to satisfy Pillar II of Basel II regulations. The results are reviewed by senior management and appropriate action is taken when necessary.

The concentration risk of the Bank is regularly monitored and more specifically the concentration to specific economic sectors and the collateral risk i.e. pledge of shares. These economic sectors are internally defined and they relate to industries. These sectors are trade and manufacturing, tourism, financial services, governments and local authorities, property and construction, personal and professional and other.

Almost all of the Bank's loans are granted to customers located in Cyprus, therefore the geographic concentration of credit risk relates to Cyprus only.

2.4 Legal Services Department

The Legal Department is currently staffed with one lawyer, who reports to the Risk Manager. In addition, the Bank has a retainer agreement with two external law offices which support the duties of the internal lawyer of the Bank.

The main responsibilities of the Legal Department are the following:

- Give legal advice which coincides with all applicable laws on various matters referred to by all Units/branches/departments of the Bank;
- Draw up and submit or review contracts, agreements and other legal documents;
- Act as a liaison between the Bank and its external legal advisors and between the Bank and the Cyprus Bank Association.

2.5 Operational Risk

The Bank defines operational risk as the risk of direct or indirect loss resulting from a wide range of factors relating to procedures and policies of the Bank, the staff, the information technology, the premises infrastructure, the health and safety as well as external factors, such as those resulting from compliance with Laws and Regulations including outsourcing to third parties. The definition adopted by the Bank includes legal, compliance and reputation risk but excludes strategic risk, which is line with the Basel definition.

The Three Lines of Defence – roles, responsibilities, obligations

The first line of defence is the responsibility of Business Line Management / Senior Managers, those who take risks in the day to day operations of the Bank. This includes daily risk management at the operational level, based on and considering processes, controls, agreed risk policies and risk appetite.

The second line of defence is those who have responsibility for oversight of risks and who give guidance on risk management. Support Departments such as Risk Management & Legal Services, Compliance, Information Technology, Information Security, O&M, Human Resources, Health & Safety.

The third line of defence is the independent review and validation to the Board and Business Lines / Senior Managers, of the effectiveness of the operational risk management framework. This is the responsibility of the Internal Auditors of the Bank.

All three lines of defence refer to the Board of Directors, so in a sense, the Board is acting as a fourth line of defence.

Operational Risk Management Framework

The Operational Risk Framework Manual was approved by the BoD on November of 2011 and is one of the three Risk Strategy Frameworks that each Bank has to have in place to manage its risks. The other two are the Credit Risk Management Framework and the Market Risk Framework Manuals.

The Operational Risk Framework Manual includes the following:

- A description of the responsibilities of the Board, the Senior Management and the Operational Risk Management Unit.
- The definition of operational risk, the risk objectives and some of the operational risk management tools such as the Risk Control Self Assessment process (RCSA), the collection of Operational Risk Data Losses and the formulation and follow up of Key Risk Indicators (KRI's).
- A description of risk mitigating techniques and guidelines with regards to the reporting process.

The BoD is aware of the major aspects of the Bank's operational risks as a distinct risk category that should be managed. The BoD assigns to the RMC of the Bank the responsibility of overseeing the operational risk profile of the Bank. Senior management has the responsibility for implementing the operational risk management framework and developing policies, processes and procedures and for managing operational risk in all of the Bank's material products, activities, processes and systems. Also the responsibility for the identification and monitoring of the specific operational risks falls on all the departments and units of the Bank.

The Operational Risk Management Unit (ORMU) is responsible to monitor the operational risk within the Bank. The ORMU acts as a liaison to business lines and provides the means of monitoring aggregations or risks in the business lines. Furthermore, the ORMU is responsible to ensure that corrective action is being taken by the appropriate departments to minimize the possibility of loss recurring. Also the ORMU has the responsibility to assist management to understand and effectively manage operational risk according to the operational risk framework. The ORMU assess the robustness of the operational risk framework through the evaluation of reports from the Internal Audit function and through the collection of data losses.

Operational risk mitigation

The Bank has established various techniques which are used for the mitigation of operational risk. These techniques include the following:

- Risk avoidance strategies (e.g. cease the problematic activity, sale of the business activity, outsourcing)
- Risk reduction strategies – to reduce either the severity or the probability of occurrence (e.g. improvements of internal controls, training of employees, disaster recovery planning, implementation of automatic controls)
- Risk prevention strategies (e.g. development of new procedures or improvement of existing procedures and training of staff to ensure the process is correctly executed)
- Risk transfer strategies (e.g. insurance)

Each Business Unit is responsible to choose the preferred mitigation technique which will be reviewed and agreed with the RMU.

The Bank reviews these mitigation techniques on an ongoing basis in order to ensure that they reflect the changing operational environment.

2.6 Market Risk

The Bank defines Market Risk as the risk of loss arising from adverse movements in interest rates, exchange rates, equity shares and other security prices.

Interest rate risk arises when there is a mismatch between positions, which are subject to interest rate adjustments within a specified period.

Foreign exchange risk arises when there are adverse exchange rate movements in the main currencies used by the Bank causing a decrease in its profitability.

Price risk is the risk of loss from unfavourable changes in the price of financial instruments held by the Bank.

During 2011, the Bank did not maintain a trading book so the market risk of the Bank is confined only in the Banking Book.

Management Framework

Organizational Structure:

The BoD is aware of the major aspects of the Bank's market risk as a distinct risk category that should be managed. The BoD approves and periodically reviews the Bank's market risk management framework. The BoD is responsible for the following:

- The existence of appropriate policies for the management of market risks, through the settings of maximum acceptable risk limits.
- The creation of an appropriate internal environment within the Bank for ensuring that every member of the staff at all hierarchical levels understands the nature of every risk associated with the discharge of his operational or supervisory duties and the need for managing these risks and that he appreciates the importance of control functions and facilitates their implementation.
- The provision of all necessary resources to the bank's senior executive management and operational units which will enable them to discharge their functions properly.
- To ensure that senior management and individuals responsible for the management of market risk possess sound knowledge and expertise.

For the above targets, the BoD assigns to the Risk Committee the following responsibilities:

- The development of a market risk framework, which corresponds to the corporate objectives of the Bank both at an individual level and at a group level.
- The approval of the ALCO composition and the terms of reference
- Receiving adequate reassurance that the senior executive management fully comprehends and applies the acceptable risk taking levels as these have been defined by the Board of Directors, and that excessive risk taking is not encouraged.
- The assessment of the adequacy and effectiveness of the Risk Management policy and the appropriateness of the risk limits the adequacy of provisions and the overall capital adequacy of own funds in relation to the size and nature of the risks undertaken.
- The submission to the Board of proposals and recommendations for corrective action whenever weaknesses are identified in implementing the Risk Management strategy.

The Risk Committee meets whenever required and its chairman is responsible for briefing the BoD. Senior management has the responsibility of providing information to the ALCO/ Risk Committee regarding the levels of the above risks, for monitoring compliance with predefined and CBC limits and guidelines on an ongoing basis and for escalating any breaches to the Deputy Managing Director. Members of the Senior Management (such as the Treasurer and the Risk Manager) participate in the meetings held at the Risk Committee level when invited. Furthermore, the Internal Audit department is responsible for auditing both the Treasury and the RMU for identifying any weaknesses, internal controls, and recommending corrective action when necessary.

The Assets and Liabilities Committee (ALCO) is responsible for the following:

- Monitor and review market, liquidity and credit (involving treasury operations) risks
- Adoption of policy on market, liquidity and credit (involving treasury operations) risks positions and limits
- Monitor the implementation of the policy for minimizing the market, liquidity and credit (involving treasury operations) risk
- Monitor the implementation of the supervisors' requirements regarding the market, liquidity and credit (involving treasury operations) risks
- Pricing policy setting (interest rate and margins guidelines setting) regarding the deposits, loans and overdrafts
- Pricing approval of new products
- Charges and Commissions approval for services offered by the Bank
- Investments approval
- Regular monitoring and discussion of the capital adequacy ratio
- Approval of stress testing scenarios regarding the market and liquidity risks and
- Monitoring developments in supervisory requirements

Interest Rate Risk

Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates. It arises as a result of timing differences on the re-pricing of assets and liabilities.

The Bank assesses two perspectives with relation to IRRBB:

- The earnings perspective: the focus of the analysis is on the impact of fluctuation in interest rates on reported earnings.
- Economic value perspective: it reflects the impact of fluctuation in interest rates on the economic value of the Bank. The economic value of the Bank is defined as the present value of the future cash flows.

The Bank uses re-pricing gap schedules to measure its IRRBB as per the CBC's guidelines.

The Bank measures the impact of the gap analysis on the following:

- Net interest income: the Bank calculates the impact on profitability of a 200 basis points change in the yield curve.
- Economic value: this is accomplished by applying sensitivity weights to each time band. Such weights are based on estimates of the duration of assets and liabilities in each time band, where duration is a measure of the % change in the economic value of a position that will occur given a change in the interest rates.

The analysis is prepared for all currencies that constitute more than 5% of the own funds of the Bank on a monthly basis by the Treasury. This analysis is reviewed by ALCO (where decisions of minimizing the risk according to the market conditions prevailing are taken). The above analysis/reports mentioned are also sent on a quarterly basis to the CBC.

Foreign Exchange Risk

Foreign exchange risk is the risk that arises from adverse exchange rate movements in the foreign exchange open positions (either overbought or oversold, in a foreign currency, creating an exposure to a change in the relevant exchange rate) that the Bank holds.

The Bank uses foreign exchange swaps for hedging foreign exchange risk. The Bank does not apply hedge accounting because there are no open positions in any currency, and consequently the impact on net profit and equity of reasonably possible changes in the exchange rates is not expected to be significant.

The Treasury Department minimizes the above risk on an ongoing daily basis and complies with CBC directives. More specifically:

- The closing open position held (summed for all currencies) does not exceed the 1% of the capital base of the bank (as per Basel II requirements).
- The closing open position held for each currency individually does not exceed the 0,25% of the capital base of the bank.
- The daily intraday open position is monitored on an on-going basis and actions to close (cover) any open position takes place accordingly. The maximum intraday open position should not exceed the 6% (summed for all currencies) and the 2% (for each currency) of the capital base of the bank
- Any deviations from the above limits are reported to the Deputy Managing Director and to the Manager of Risk and Legal Services.
- An FX open position report is prepared on a daily basis by the Treasury Department and is reviewed by the Treasurer and the Risk Manager.

In cases of breach of limits, the Deputy Managing Director and the CBC are notified timely.

Price risk

The risk of the price of equity shares arises when there is an unfavorable change in the price of investments inequity securities held by the Bank. The Bank is not subject to significant risk from such changes.

The Bank's Senior Management has taken the decision that it will not assume any risk arising from gold or commodities as it is the Bank's policy not to sell or hold any such instruments.

With regards to price risk from debt securities, arise from adverse price movements in these securities. The Bank has formulated an Investment policy outlining the specific criteria that investments should fulfil if the Bank is to invest in them. Specifically:

- All investments purchased (as at the date of purchase) should be considered as liquid (as per the CBC's guidelines). Furthermore, investments in corporate bonds should be limited to financial institutions only (including investment banks/companies)
- All investments should meet the IFRS criteria for classification under "Held to Maturity unless otherwise specified by the ALCO
- The maximum amount to be invested in Sovereign Bonds and Cyprus Government Treasury Bills should not exceed 50% of the total deposits of USB Bank
- The maximum amount to be invested in Sovereign Bonds and Treasury Bills to each Government, in their local currency (provided that the government is in G10 or Australia, Switzerland and any EU country and has a minimum rating of A3) should not exceed 10% of the total assets of USB Bank;
- Investments in financial institutions capital securities or in subordinated debt should be approved by the Risk Management Committee.
- The maximum amount to be invested in Sovereign Bonds and Treasury Bills to each Government in foreign currency should not exceed 10% of the total assets of USB Bank (for governments with a minimum rating of Aa3) and 5% of the Bank's capital base (for governments with rating A1 – A3);
- The maximum amount invested (in senior debt) in Cypriot Banks and the Parent Bank issues (provided that they are classified to investment grade) should not exceed 10% of the Bank's capital base;
- The maximum amount invested (in senior debt) in each counterparty provided they have a minimum rating of A3 (face value of the investment), should not exceed 25% of the Bank's capital base;

With regards to the monitoring of price risk, the Treasury Department forwards on a weekly basis to the ALCO, the Bank's summarized Investment portfolio for review, in order to take any corrective actions needed for mitigating market price risk.

2.7 Liquidity Risk

Liquidity risk is the risk that the Bank, although solvent, either does not have available sufficient financial resources to meet its obligations as they fall due, or can only do so at excessive cost. The BoD has approved and periodically reviews the Bank's liquidity risk management framework. The framework provides a firm-wide definition of liquidity risk and lays down the principles of how liquidity risk is to be identified, assessed, monitored, and controlled/mitigated.

The BoD is responsible for the following:

- To define the Bank's strategic direction and tolerance level for liquidity risk.
- To continuously monitor the Bank's performance and overall liquidity risk profile.
- To ensure that liquidity risk is identified, measured, monitored and controlled.
- To review the contingency plans of the Bank for handling disruptions to its ability to fund some or all of its activities in a timely manner.

The BoD has delegated the responsibility for overseeing the liquidity risk profile of the Bank to the RMC. Senior management has the responsibility for implementing the liquidity risk management framework approved by the BoD. The Treasury is responsible for the day-to-day management and of the liquidity risk management framework.

IAU has the responsibility of assessing the robustness of the liquidity risk framework.

For the effective management/minimization of liquidity risk, the Bank is following the guidelines set by the Central Bank of Cyprus by setting the following limits:

- The liquidity ratio of the bank (as defined by the CBC circulars) in local currency should never fall below 20%.
- The liquidity ratio of the bank (as defined by the CBC circulars) in foreign currency should never fall below 70%. In case where this ratio falls below the level of 70%, then liquidity may be transferred from the local currency to cover the shortfall.
- The protective liquidity ratio of the bank (as defined by the CBC circulars) should always be less than the –10% for the 0-7 days maturities band.
- The protective liquidity ratio of the bank (as defined by the CBC circulars) should always be less than –25% for the 8-30 days maturities band.

Customer deposits are monitored daily and interest rates are adjusted based on market forces to avoid deposit outflows.

The liquidity ratio was as follows:

	2011	2010
	%	%
As at 31 December	25,41	34,97
Average Ratio	33,28	36,71
Maximum Ratio	38,56	37,80
Minimum Ratio	25,41	34,97

3. Own Funds

The own funds of the Bank as at 31/12/2011 were €36.181 thousand as shown below:

	€000
Original Own Funds (Tier 1)	
Share Capital	34.584
Share Premium	24.667
Reserves	(35.367)
Investment Revaluation Reserve	(1.066)
Intangible Assets	(297)
Core Tier 1	**22.521**
Subordinated Loan Stock	974
Total Tier 1	**23.495**
Additional Own Funds (Tier 2)	
Property Revaluation Reserve	3.477
Subordinated Loan Capital	9.209
Total Tier 2	**12.686**
Total Own Funds	**36.181**

3.1 Original Own Funds

Share Capital

As at 31/12/2011 the share capital of the Bank comprised of 60.674.171 shares with a nominal value of €0,57 each.

During the year, the issued share capital of the Bank increased by €8.646.069 through a capital increase from the parent company BLC Bank SAL. More specifically, following a resolution of the Board of Directors dated 31 March 2011 which was approved by the Extraordinary General Meeting (EGM) on 4 May 2011, the Bank proceeded with the issue to BLC Bank SAL of 15.168.543 new shares of nominal value €0,57 each at the price of €0,80 each, at a ratio of 1 new share for every 3 existing shares in the issued share capital of 45.505.628 shares.

Subordinated Loan Stock

The subordinated loan stock consists of capital securities which were offered to professional investors and to a specific number of non-professional investors in Cyprus and which were issued on 30 December 2005 and have no maturity date. However, they may be redeemed in whole at the option of the Bank subject to the prior consent of the CBC, at their nominal amount together with any outstanding interest payments, five years after their issue date or on any interest payment date thereafter, and provided that they will be replaced with capital of equivalent or more senior ranking unless the CBC concludes that the Bank's capital is at a satisfactory level.

The Capital Securities bear floating interest rate, which is revised at the beginning of each period interest is charged and will be valid for that specific period. Interest rate is equal to the base rate of the Bank at the beginning of each period interest is charged plus 1,60% annually. According to the terms of issue, if the Bank does not proceed with the repurchase of Capital Securities within ten years from their issuance date (i.e. up to 31 December 2015), then from 1 January 2016, the Capital Securities will be bearing floating interest rate that will be revised at the beginning of each period in which interest will be charged and will be equal to the base rate ruling at the beginning of each period interest is charged plus 2,25% annually.

3.2 Additional Own Funds

Subordinated Loan Capital

On 30 December 2009 the Bank issued bonds amounting to €8.000.000 with a maturity date of 31 December 2019. The bonds constitute direct, unsecured, subordinated securities of the Bank and bear a fixed interest rate of 7,50% on the nominal value for the period from the issue date to 31 December 2014. From 31 December 2014 to their maturity, the bonds will bear a fixed annual interest rate of 9% on the nominal value. Excluding the first interest rate period commencing on (and including) 22 December 2009 and maturing on 30 June 2010 (not included), all subsequent interest periods will cover six months.

The Bank has the right to redeem wholly the bonds at any time before their maturity date, in cash at their nominal value, along with any accrued interest relating to the current interest rate period, on 30 June 2015, or on any following interest payment date, upon approval from the CBC.

On 14 June 2010 the Bank issued €1.209.060 convertible bonds maturing on 30 June 2020. The convertible bonds are direct, unsecured and subordinated obligations of the Bank and carry a fixed rate 7,25% on the nominal value for the period from the date of issue until 30 June 2015. From 1 July 2015 until their maturity the convertible bonds will carry fixed interest rate 8,75% on the nominal value. Except the first interest period commencing on (included) 26 May 2010 and matures on 30 June 2010 (not included), each interest period will be 6 months.

The convertible bonds may, at the option of the holder, be converted into ordinary shares of the Bank in the year 2012 until 2014 as follows:

- 15-30 March and 15-30 September for 2012
- 15-30 March and 15-30 September for 2013
- 15-30 March and 15-30 September for 2014

The conversion price is set at the average closing price of the share of the Bank on the CSE for a period of 30 days prior to the beginning of each conversion period. For the conversion periods of the years 2013 and 2014, the conversion prices is as described above, less 5% and 15% respectively.

The Bank has a right of early redemption of convertible bonds in whole, but not part of cash at par plus accrued interest of the current interest period on 30 June 2015 or any interest payment date, after approval from the Central Bank.

4. Minimum Required Own Funds for Credit, Market and Operational Risk

The different methods used to assess the adequacy of the capital for the different categories of risks are described below.

4.1 Credit Risk - Standardised Approach

The Bank has adopted the Standardised Approach for the calculation of the minimum capital against credit risk. Under this approach, exposures are classified in specified classes and are weighed using specific weights, depending on the class the exposures belong to and their credit rating. Also, Basel II suggests two methods for the recognition of collateral, the Simple Approach and the Comprehensive Approach. The Bank has applied the Comprehensive Approach, as this enables the fairer recognition and more accurate estimation of the Bank's collateral.

The following table shows 8% of the risk-weighted exposure amounts as at 31/12/2011 for each of the exposure classes specified in paragraph 23 of Unit A of the Directive.

Exposure class	**€000**
Central governments or central banks	0
Administrative bodies and non-commercial undertakings	14
Institutions	1.586
Corporates	14.580
Retail	3.496
Secured by real estate property	2.310
Past due items	8.621
Other items	654
Total	**31.261**

4.2 Market Risk

Regarding market risk, the Bank has adopted the Standardized Approach, according to which the minimum capital requirement is estimated by adding together the interest rate, equity and debt securities position, foreign exchange and price risk on derivatives using predefined models.

The Bank does not have a trading book and the overall net foreign exchange position does not exceed 2% of its total own funds.

The Market Risk Capital requirement as at 31st December 2011, in relation to Equity Position Risk was €40k (RWA of €500 thousand at 8%).

4.3 Operational Risk - Basic Indicator Approach

The Bank uses the Basic Indicator Approach for the calculation of the capital requirements for operational risk, based on which the operational risk capital requirement is estimated using a specific percentage on the average sum of gross income on a three year basis. According to the Directive for the calculation of Capital Requirements and Large Exposures, the relevant indicator is the average over three years of the sum of net interest income and net non-interest income of the last three Financial Years.
The same figure of Operational Risk Capital requirements as at 31st December 2011, will also be reported on the next three quarterly returns upon preparation of the COREP (31/3/12, 30/6/12 and 30/9/12) i.e will be the same figure as at 31st December 2011.

Table below shows the calculation of capital requirement for operational risk under the Basic Indicator Approach.

Gross Income (€000)			**Average**	**Capital Requirement (Average * 15%)**
2009	**2010**	**2011**		
15.553	15.501	19.654	16.903	**2.535**

4.4 Capital Adequacy Ratio

The Bank closely monitors its capital adequacy both for compliance with the requirements of the supervisory authority as well as to maintain a base to support and develop its activities and safeguard the interests of its shareholders.

In July 2011 the Central Bank of Cyprus has amended the Directive for the Calculation of Capital Requirements and Large Exposures, introducing a new index which refers to the Core Tier 1 Capital with effect on 31 December 2011. Core Tier 1 capital includes the share capital, share premium reserve and revenue reserve. The carrying amount of intangible assets and other regulatory adjustments are deducted in arriving at Core Tier 1 capital. The minimum rate of the new index is set at 8% plus surcharge calculated on the percentage of the assets of the Bank compared to the gross domestic product of the Republic of Cyprus. The Directive provides a transitional period until 2014 for the purposes of calculating the surcharge. Until 30 December 2012 the surcharge on the minimum rate has been set at zero, which will gradually increase with the full implementation on 31 December 2014.

The minimum increment for purposes of determining the Core Tier 1 capital ratio on the Core Tier 1 equity index is set at 150 basis points, i.e. for 2011 the minimum ratio stands at 9,5%.

The minimum increment for purposes of determining the overall capital ratio on the Core Tier 1 equity index is set at 200 basis points i.e. for 2011 the minimum ratio stands at 11,5%.

All the above ratios of supervisory capital of the Bank are below the minimum required by the Central Bank of Cyprus. The Bank is already examining a recapitalization plan which will strengthen its capital adequacy in order to exceed all required minimum capital adequacy ratios.

The main shareholder of the Bank has committed to take appropriate measures to ensure that the Bank maintains its capital adequacy ratios to the levels required by the Central Bank of Cyprus

The table below presents the position of the Bank's regulatory capital, in accordance with the principles of Basel II, at 31 December:

	2011	**2010**
	€ '000	**€ '000**
Regulatory Capital		
Core Tier 1	22.521	20.574
Original own funds	23.495	21.548
Additional own funds	12.686	12.539
Total own funds	**36.181**	**34.087**
Risk weighted assets – credit risk	390.751	334.935
Risk weighted assets – operational risk	31.688	28.513
Risk weighted assets – market risk	500	-
Total Risk weighted assets	**422.939**	**363.448**
Core Tier 1 ratio	5,3%	5,6%
Original own funds ratio	5,6%	5,9%
Additional own funds ratio	3%	3,5%
Capital Adequacy ratio	**8,6%**	**9,4%**

Recent Developments

It is noted that the Bank has already issued additional share capital of €22m in 2012 in order to increase its capital base.

Specifically, the Bank issued €17m of share capital in October 2012 and €5m in December 2012.

Following the above increases of the Bank's share capital, the minimum capital adequacy ratios as per the Directive, as at 31st December 2012 were met.

5. Counterparty Credit Risk

As at 31 December 2011, the Bank did not have any outstanding securities or commodities lending or borrowing transactions, long settlement transactions, margin lending transactions or derivative instruments transactions.

6. Exposure to Credit Risk and Impairment

Loan Impairment

Past due loans and advances are defined as all loans and advances where the counterparty has failed to make a payment when it is contractually due. Loans and advances are considered past due from the first day of the delay of the payment due.
The Bank reviews its loan portfolio for evidence that it will not be able to collect all amounts due from an individual loan or a portfolio of homogeneous loans. Evidence includes the customer's payment record, his overall financial position and the realisable value of any collateral. If such evidence exists, the recoverable amount is estimated and a provision is made for loan impairment and is charged to the income statement.

The methodology and assumptions used for estimating the provision are reviewed regularly to reduce any differences between estimated and actual losses. In addition to the provisions on an individual basis, the Bank also makes provision for impairment of loans on a collective basis. The percentages of losses are based on estimates, historical data and management experience of the Bank.

Impairment of Available for Sale Equity Investments and Investments Held to Maturity

Available for sale equity investments are impaired when there has been a significant or prolonged decline in the fair value below its cost. The determination of what is significant or prolonged requires judgment from the Bank. Factors taken into consideration in making this judgment include the expected volatility in share price. In addition, impairment may be appropriate when there is evidence that significant changes with an adverse effect have taken place in the technological, market, economic or legal environment in which the investee operates.
Bonds held to maturity are impaired when there is objective evidence of impairment in one or more events that occurred after initial recognition of the investment and the loss event (or events) affects the expected future cash flows of investment. The assessment takes into account a number of factors such as the economic situation of the issuer, a breach of the terms of the contract, the likelihood of the issuer to declare bankruptcy or make a financial reorganisation, and therefore requires significant judgments.

6.1 Total Amounts of Original Exposures

The table below presents the total amount of original exposures with the off-balance sheet amounts being presented before the application of credit conversion factors and before credit risk mitigation techniques. Additionally, the table presents the average amount of exposures over the year, broken down by different types of exposure classes.

Exposure class	**Original Exposure amounts 31/12/2011**	**Average exposure amount for 2011**
	€000	**€000**
Central governments or central banks	200.561	143.483
Administrative bodies and non-commercial undertakings	343	354
Institutions	94.428	100.487
Corporates	213.576	190.481
Retail	88.315	83.690
Secured by real estate property	72.203	73.089
Past due items	148.366	136.845
Other items	16.130	16.252
Total	**833.922**	**744.681**

6.2 Distribution of the Exposures by Industry or Counterparty Types

The table below presents the total amount of exposures broken down by major industries and material exposure class.

	Retail Customers	Corporate Customers	Financial Institutions	Governments and Local Authorities	Other	Total
	€000	€000	€000	€000	€000	€000
Trade and manufacturing	21.252	68.971	-	-	-	**90.223**
Tourism	10.689	30.526	-	-	-	**41.215**
Financial services	-	-	94.428	-	-	**94.428**
Governments and Local Authorities	-	-	-	200.561	-	**200.561**
Property and construction	13.985	110.491	-	-	-	**124.476**
Personal and professional	108.298	111.569	-	-	-	**219.867**
Other sectors	6.174	40.848	-	-	16.130	**63.152**
Total	**160.398**	**362.405**	**94.428**	**200.561**	**16.130**	**833.922**

6.3 Geographic Distribution of the Exposures

The table below presents the total amount of exposures broken down by significant geographical area, based on the country of residence, and material exposure class.

	Retail Customers	Corporate Customers	Financial Institutions	Governments and Local Authorities	Other	Total
	€000	€000	€000	€000	€000	€000
Cyprus	154.662	355.698	2.887	194.441	16.130	**723.818**
Greece	306	304	14	6.120	-	**6.744**
Other EU countries	3.918	989	15.688	-	-	**20.595**
Non-EU countries	1.512	5.414	75.839	-	-	**82.765**
Total	**160.398**	**362.405**	**94.428**	**200.561**	**16.130**	**833.922**

6.4 Residual Contractual Maturity Breakdown of all the Exposures

The table below presents the total amount of exposures broken down by residual contractual maturity and material exposure class.

Credit exposure by residual contractual maturity as at 31 December 2011					
	Less than 1 year	**1 to 5 years**	**5-10 years**	**More than 10 years**	**Total**
	€000	**€000**	**€000**	**€000**	**€000**
Central governments or central banks	112.595	56.929	31.037	-	**200.561**
Administrative bodies and non-commercial undertakings	-	-	-	343	**343**
Institutions	62.392	31.953	83	-	**94.428**
Corporates	97.577	40.802	36.833	38.364	**213.576**
Retail	29.505	20.627	11.657	26.526	**88.315**
Secured by real estate property	14.842	7.217	11.841	38.303	**72.203**
Past due items	87.691	16.178	28.966	15.531	**148.366**
Other items	16.130	-	-	-	**16.130**
Total	**420.732**	**173.706**	**120.417**	**119.067**	**833.922**

6.5 Impaired Exposures and Past Due Exposures

The table below provides an analysis of impaired exposures, past due exposures, value adjustments and provisions, and charges for value adjustments and provisions during the year 2011.

Impaired and past due loans and advances as at 31 December 2011				
	Neither past due nor impaired	**Past due but not impaired**	**Impaired**	**Total**
	€000	**€000**	**€000**	**€000**
Total	**258.477**	**96.503**	**94.441**	**449.421**

Provisions for impairment of loans and advances	
	€000
1 January 2011	**55.714**
Collections/reversals	**(4.435)**
Charge for the year	**7.323**
Net charge for the year	**2.888**
Restriction of interest on impaired loans	**6.040**
Write-offs	**(328)**
Total	**8.600**
31 December 2011	**64.314**

7. The Standardised Approach

7.1 Exposure Classes for Which External Credit Assessment Institutions ('ECAI') or Export Credit Agencies ('ECA') are used

For the purposes of applying the Standardised Approach, the nominated External Credit Assessment Institutions (ECAI) which are recognised by the CBC are Fitch Ratings, Standard and Poor's Rating Services, and Moody's Investor Service.

The Bank uses external ratings from Moody's. These ratings are used for all relevant exposure classes, which are the following:

- Claims or contingent claims on central government or central banks
- Claims or contingent claims on institutions

In the case of financial institutions the credit quality step is determined according to the rating of the country under whose supervision they operate. Exposures with financial institutions with original maturity of three months or less are risk weighted 20% unless the risk weight assigned to its country is higher.

7.2 Description of the Process Used to Transfer Issuer and Issuer Credit Assessments Into Items Not Included in the Trading Book

For the following exposure classes the external rating of the sovereign in which the counterparty is incorporated is applied:

- Claims or contingent claims on central government or central banks
- Claims or contingent claims on institutions

7.3 Association of External Rating of Each Nominated ECAI or ECA with Credit Quality Steps

The Bank complies with the standard association published by the CBC, regarding the association of the external rating of each nominated ECAI or ECA with the credit quality steps prescribed in Annex VI of the Directive. The table below presents the association of each credit quality step with the external rating of Moody's.

Credit quality step	Moody's rating of central government	Institutions Risk Weight	Sovereigns* Risk Weight
1	Aaa to Aa3	20%	0%
2	A1 to A3	50%	20%
3	Baa1 to Baa3	100%	50%
4	Ba1 to Ba3	100%	100%
5	B1 to B3	100%	100%
6	equal or lower than Caa1	150%	150%

* The above association also applies for central government, central banks and institutions unless they are specifically stated in the CBC rules to be zero risk weighted.

7.4 Exposure Before and After Credit Risk Mitigation

The exposure before and after credit risk mitigation associated with each credit quality step mostly for financial institutions and governments, as at the year-end was as follows:

	Total Exposures before	**Total exposure after**
	€000	**€000**
Credit quality bands		
0%	200.561	200.561
20%	98.949	98.949
100%	15	15
150%	14	14

8. Exposure in Equities not included in the Trading Book

Non-trading equity risk is defined as the potential variation in the Bank's non-trading income and reserves arising from changes in equity prices. The risk may crystallise during the course of normal business activities or in stressed market conditions.

During 2011 and as at 31 December 2011 the Bank held shares in two companies which are listed in the Cyprus Stock Exchange. The fair value of investments quoted in an active market is based on quoted bid prices. The balance sheet value of the Bank's equity exposures not included in the trading book as at 31 December 2011 was €248.180.

The total unrealised loss resulting from the revaluation of these equities during 2011 amounts to €56.256 and is recognised in the Bank's financial statements within the statement of comprehensive income.

9. Exposure to Interest Rate Risk on Positions not included in the Trading Book

9.1 Impact on Net Interest Income

Information in relation to interest rate risk can be found in Section 2.5. The table below indicates the effect on the Bank's net interest income and profit before tax, over a one-year period, from a reasonable parallel shift in the interest rate of the main currencies:

Change in interest rates	**Euro**	**US Dollars**	**British Pounds**	**Other currencies**	**Total**
	€	**€**	**€**	**€**	**€**
+0,5% for all currencies	429.408	105.017	27.001	3.409	**564.835**
-0,25% for USD and -0,5% for all other currencies	(423.792)	(52.509)	(27.001)	(3.409)	**(506.711)**

9.2 Impact on the Economic Value

The table below indicates the effect on the Bank's economic value over a one-year period, from a reasonable parallel shift in the interest rate of the main currencies:

Change in interest rates	Euro €	US Dollars €	British Pounds €	Other currencies €	Total €
+0,5% for all currencies	1.258.299	11.727	391	(345)	**1.270.072**
-0,25% for USD and -0,5% for all other currencies	(1.258.299)	(5.864)	(391)	345	**(1.264.209)**

10. Remuneration policy and practices

The Bank applies the provisions regarding the Remuneration of the Directors that are included in the Cyprus Stock Exchange Corporate Governance Code as well as the High-level Guidelines for Remuneration Policies issued by the Central Bank of Cyprus.

The Remuneration Committee proposes to the Board of Directors, the Remuneration policy that is prepared in accordance with the above. The Directors' Remuneration Report is submitted for approval at the Annual General Meeting of the shareholders.

Composition and service of the members of the Committee during 2011.

Current composition	Since	
Chairman: George Galatariotis	21/3/2011	Non Executive, Independent
Members:		
Philippos Philis	21/10/2010	Non Executive, Independent
Maurice Sehnaoui	21/3/2011	Non Executive, Non Independent

Also, on 21 March 2011 Messrs Tania Moussallem and George Stylianou resigned as members of the Committee following the reorganisation of all Committee memberships as a result of resignations and new appointments in the Board of Directors. All the members of the Remuneration Committee have sufficient knowledge and experience in the remuneration policy sector.

During the year 2011, the Committee has met once.

The remuneration of the members of the Board of Directors is analysed between remuneration as members of the Board of Directors and remuneration for their executive services.

Remuneration of Executive Members of the Board

The salaries and other short-term benefits of the Executive Members of the Board totalling €245K (2010: €389K) concern €126K (2010: €121K) for Mr. Andreas Theodorides and €119K (2010: €108K) for Mrs. Despo Polycarpou and also €160K (2010) for Mr. Kyriacos Kyriakides who retired from the Board of Directors on 1 July 2010.

The employment and remuneration of the Executive Directors are governed by the collective agreements as applied to all other staff members of the Bank.

The Executive members of the Board of Directors are also entitled to any other benefits that are offered to the management and personnel of the Bank as part of its overall employment policy and collective agreements.

As far as the remuneration of the Executive Directors is concerned, no Remuneration Policy is provided, under which variable remuneration components are included, nor were any schemes adopted under which share options are granted.

All Executive Members of the Board of Directors are participating in the Staff Retirement Benefits Scheme with the same terms applicable to the personnel of the Bank. The main characteristics of the Scheme are described in Note 6 of the audited financial statements for the year ended 31 December 2011.

Remuneration of Non- Executive Directors

The Remuneration of the Non Executive members of the Board includes fees for their participation as members in the Board of Directors of the Bank and also as members in the Committees of the Board of Directors.

Based on the existing policy of the Bank, the remuneration of the Non Executive Directors is based on their responsibilities, time spent on meetings and their participation to the various Committees of the Board of Directors. The remuneration of the Non Executive Directors has last time been revised at the Extraordinary General Meeting of the Bank's shareholders at 21 January 2009, taking into account the above and also the respective remuneration of Directors in other comparable organisations.

Also, as per the Bank's Articles of Association, the members of the Board of Directors can claim the travelling expenses incurred for attendance in meetings.

The revision of the remuneration of the Non Executive Directors is authorised by the shareholders at the General Meeting of the Bank.

Appendix 1 – Glossary of Terms

CBC	Central Bank of Cyprus
IRRBB	Interest Rate Risk Banking Book
IT	Information Technology
BoD	Board of Directors
ALCO	Assets and Liabilities Committee
RMU	Risk Management Unit
RMC	Risk Management Committee
MIS	Management Information System
IAU	Internal Audit Unit

Senior Management:

- Deputy Managing Director
- Internal Audit Manager
- Assistant General Manager/Retail Banking, Products Development and Marketing Manager
- Assistant General Manager/Compliance and Projects Manager
- Risk and Legal Services Manager
- Corporate Banking Manager
- Treasury and Correspondent Banking Manager
- Finance Manager
- Debt Recovery Manager
- International Business Division Manager