



Habib Bank Zurich Plc – Pillar 3 Disclosures

31 December 2019

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1. Overview

1.1 Company information

Habib Bank AG Zurich (HBZ or Parent bank) established its branch in UK in the year 1974. In 2014, Habib Bank Zurich plc (“the Bank”) HBZ was established as a 100% owned subsidiary of HBZ. The Bank acquired the operations of the UK branch of the Parent on 01 April 2016, subsequent to authorisation from the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) and successfully transferred business of UK Branch of Habib Bank AG Zurich, Switzerland to the Bank, vide business transfer scheme (“Scheme”) under Part VII of the Financial Services and Markets Act 2000 (“FSMA”).

1.2 Purpose

The Disclosures in this document are set out in accordance with Pillar 3 disclosure requirements issued by Basel Committee of Banking Supervision (BCBS) in January 2015, which were updated by BCBS in December 2018.

The December 2018 BCBS Pillar 3 disclosure document requires the institutions to disclose composition of capital, credit risk, operational risk, leverage ratio and credit valuation adjustment (CVA), the Net Stable Funding Ratio (NSFR), the countercyclical capital buffer, interest rate risk in the banking book and remuneration, which has been updated in relevant sections of this document.

The information in this document is based on data as at 31 December 2019, which also information extracted from Audited Financial Statements for the year 31 December 2019.

Audited Financial Statements can be found on website www.habibbank.com

The framework requires the institutions to maintain and ensure the following:

1.1.1 Total Capital Requirements which is a sum of:

- Pillar 1 Minimum Capital Requirements with defined rules for the calculation of credit risk, counterparty credit risk, market and operational risk; and
- Pillar 2A that frames the requirements for the institution to hold additional capital against risks that are not fully captured under Pillar 1. The institution’s internal models and assessments support this process. The details of the assessment are contained in the Bank’s “Internal Capital Adequacy Assessment Process” (“ICAAP”), elements of which are disclosed within this document.

1.1.2 The Bank maintains TCR through at least 75% of Common Equity Tier1 capital (CET1) and 25% from Tier 2.

1.1.3 Bank requires maintaining specific CRD Buffers. One is Capital Conservation Buffer (CCB) that is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred and the other is Countercyclical Buffer (CCyB) that aims to ensure that banking sector capital requirements take account of the macro-financial environment in which bank operates.

1.1.4 PRA also sets a buffer called ‘PRA Buffer’ which is in addition to TCR and CRD buffers.

1.1.5 Pillar 3 – External communication of risk and capital information, which complements the TCR that allows market participants to assess the institution’s capital adequacy.

1.1.6 Leverage ratio disclosure requirements as per BCBS, Basel III leverage ratio framework and disclosure requirements, January 2014.

1.1.7 The BCBS committee issued disclosure requirements for the LCR and NSFR in January 2014 and June 2015 respectively.

1.3 Basis and frequency of disclosure

The Bank applied the provisions of CRR and Prudential Source Book to cover the qualitative and quantitative disclosure requirements of Pillar 3 based on data as at 31 December 2019. Pillar 3 requires firms to publish a set of disclosures, which allow market participants to assess key pieces of information on that firm's risk assessment process, risk exposure and capital.

This report is updated and published annually. The aim is to provide additional information to complement the Financial Statements, and should be read in conjunction with that information, in particular the section on risk, liquidity, leverage ratio, and capital management and corporate governance, as well as the Notes to the Financial Statements.

1.4 Principal activities

The Bank offers two main services; real estate finance and commercial banking services. The Bank also offers regular cash management, trade finance and retail banking in line with the customer needs. The Bank's product and service offering is comprised of buy to let finance, commercial loans, working capital finance, trade finance, current accounts, savings accounts, notice accounts, fixed term deposits, Internet deposits, cash management and treasury services. Our latest offerings are a range of Islamic personal and business banking products under the brand name "Sirat".

The Bank combines modern and efficient banking services with a personal approach through a network of eight branches across the UK. We offer commercial and retail banking services to Small and Medium Sized (SME) enterprise focusing on their evolving business needs.

The Bank's target market in the UK is frequently geared towards property investments, trading activities, services and small-scale manufacturing. The customer needs are catered by the conventional and Sirat suite of products.

Services are mainly delivered through the branch managers, specialist lending relationship managers and personal bankers for deposit mobilisation. The customer takes comfort in continuity with a relationship manager and quick turnaround on their requests as well as continued access to the decision makers at the Bank.

The Bank has introduced an Islamic Banking Window branded as 'Sirat' aligned to the Bank's customer-centric approach and vision. 'Sirat' offers selected Shariah-compliant banking products to existing and new clients. Sirat offers Islamic personal and commercial banking products, managed by a dedicated Sirat team, which has a UK-wide mandate.

The Bank is a participant of the Royal Bank of Scotland's (RBS) Business Banking Switch scheme, which is another customer acquisition channel for lending and deposits. The Bank is seeing growing interest from potential customers particularly in the area of commercial lending.

Intermediaries continue to offer their clients our lending products and services, while we continue to maintain full control of client relationships. This enables products to be offered through intermediaries comprising of commercial lending, residential and commercial buy-to-let and mixed use buy-to-let mortgages and are designed to be flexible and collaborative so that the Bank can adopt the most appropriate strategy for intermediaries and their clients.

The Bank became a participant in CASS which provides easy ways for clients to switch their current account from one provider to another. Backed by the Current Account Switch Guarantee, it is aimed to increase competition in the high street and supports banks in the current account marketplace.

We feel proud in creating long-term value for our customers, employees, suppliers, communities we serve and our shareholders.

The Bank is covered by the Financial Services Compensation Scheme (FSCS).

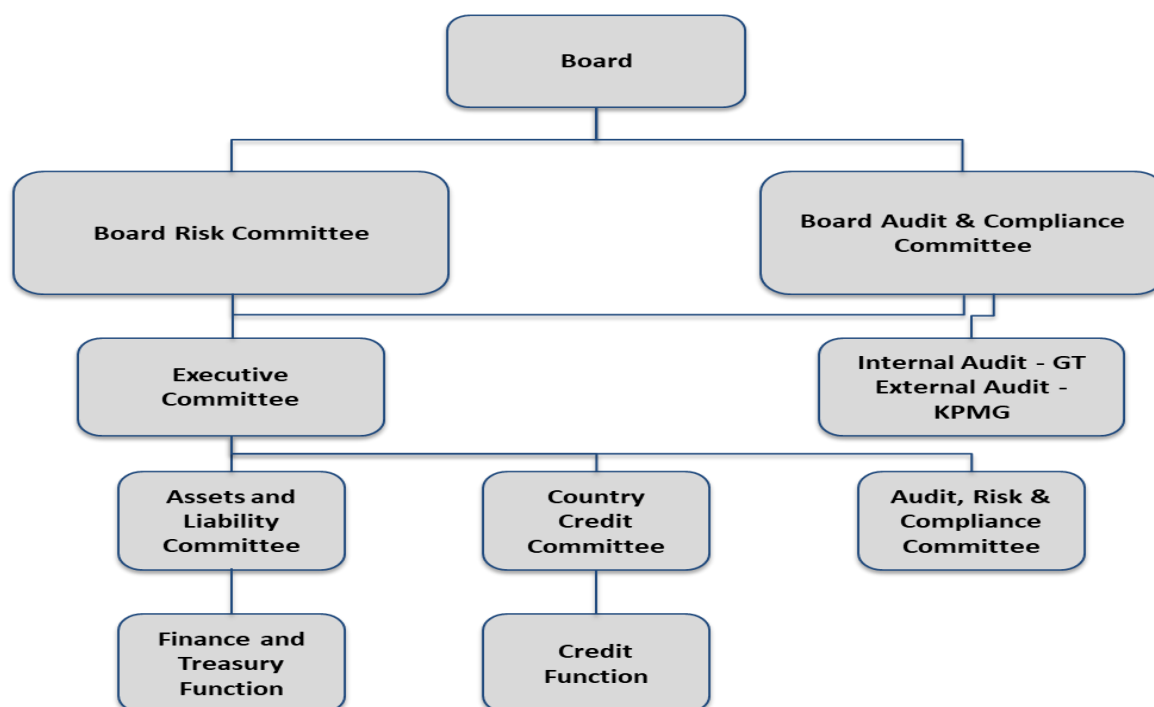
2. Governance Framework

The Governance and Control framework of the Bank is managed through a Board Structure and a Management Committee Structure. The Board structure comprises of a Board of Directors, which acts as the highest governance authority in the organisation and two Board sub-committees namely, a Board Risk Committee and a Board Audit and Compliance Committee.

The Board of Directors is responsible for the establishment of overall strategic direction and oversight by setting up the overall governance and risk management framework of the Bank. The Bank's risk appetite is set by the Board of Directors and takes into account the Bank's Strategic Intent. To implement an effective governance process, the Board has established a Board Risk Committee (BRC) and Board Audit and Compliance Committee (BACC).

The sub-committees keep an oversight on the key risks such as credit, liquidity, compliance, conduct and operational risk. Members of the sub-committees maintain close interaction with senior management and receive regular information from management committees. The BRC oversees and challenges the risk management function to ensure that governance arrangements, risk framework and systems and controls are evaluated and managed properly. The independent internal audit function reports into BACC and conduct reviews of all key risk areas including the risk management framework. Reports are presented to BACC and the Board.

The governance model, roles and responsibilities and reporting are shown below:



2.1.1 Board Responsibilities:

The Board monitors and periodically assesses the effectiveness of governance arrangements and takes appropriate steps to address any deficiencies. The Board evaluates the principal risks to the Bank's business model and the achievement of its strategic objectives, including risks that could have material impact its capital or liquidity. The Board reviews risk management process and internal control systems and satisfy itself that they are functioning effectively and corrective action is being taken where necessary. The Board ensures

that an appropriate risk culture is instilled in the Bank. It also ensures adequate succession planning for the senior management so as to maintain an appropriate balance of skills and experience within the Bank.

The Board’s responsibilities specific to risk include:

- Review and determine the risk appetite of the Bank
- Identify and evaluate the principal risks to the Bank’s Business model and the achievement of its strategic objectives, including risks that could threaten its capital or liquidity.
- Review of the risk management and internal control systems and satisfy itself that they are functioning effectively and corrective action is being taken where necessary
- Ensure that an appropriate risk culture is embedded in the Bank.
- Review and approval of the Enterprise Risk Management Framework.
- Approval of the Bank’s ICAAP, ILAAP, Recovery and Resolution Plan

2.1.2 Board Risk Committee

The Board Risk Committee assists the Board in the review and oversight of Risk Management Framework, ICAAP, ILAAP and other governance documents. Board Risk Committee (BRC) is designed to raise awareness of the whole risk landscape and has responsibility of its oversight. BRC ensures that a wider management membership is engaged in the capital and liquidity management process cycle. This includes involvement in the formulation of stress tests, the reasonableness of assumptions and likely outcomes given current and prospective market conditions. BRC periodically review the risk framework to evaluate its adequacy and appropriateness under the prevailing business environment and in light of major changes in internal or external factors. It provides assurance on the Bank-wide risk framework and monitors the overall risk profile of bank through effective control processes. BRC annually review the Risk Appetite Statement and consider the adequacy of risk limits and returns.

2.1.3 Board Audit and Compliance Committee

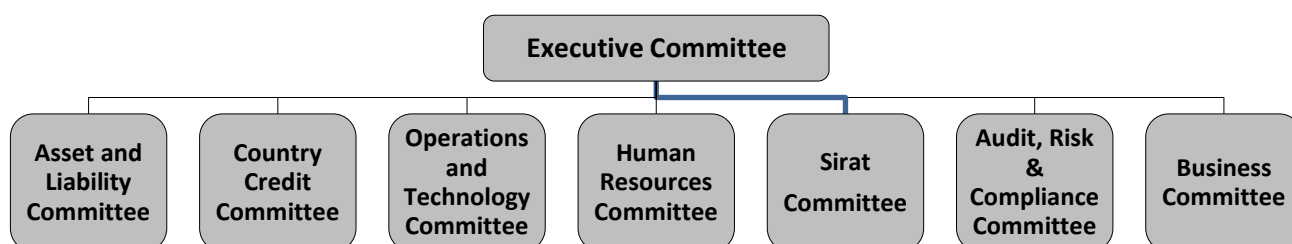
Board Audit and Compliance Committee (BACC) oversees and challenges the internal audit, external audit functions and Compliance function to ensure that governance arrangements, and system and internal controls are evaluated and managed properly. BACC reviews and approve key financial risks, assess effectiveness of system of financial reporting. The Committee also approve accounting policies and changes therein to comply with the requirements of International Financial Reporting Standards.

2.1.4 Management Responsibilities

The Management committee structure comprises of the Executive Committee (“EXCO) and six sub-committees. The EXCO presides over the committees and is responsible for implementing Bank’s strategic objectives and managing the business with adequate controls within the risk appetite of the Bank.

The ALCO is the responsible committee to review and recommend to the EXCO the capital calculations, capital structure and the ICAAP. The EXCO reviews and further recommends the same to the Board through the BRC for its consideration, review and approval.

The implementation of an effective Governance and Control framework is managed through a management committee structure:



The management of the Bank through committee structure allows for Enterprise Wide Risk Management through the consideration of different aspects and challenge at decision-making levels. This structure ensures that management of the Bank's operations, strategic decision-making and risk management is undertaken on a consultative basis at committee level by experienced functional and business personnel.

The management committees as above have specific Risk Management responsibilities.

2.1.5 Executive Committee (EXCO)

Capital is fundamental to the effective management of a bank and requires the full engagement of the Executive Management and the support functions. The Executive Committee assess the availability of adequate capital under normal going concern as well as under stressed scenarios and crisis conditions for the purpose of advance planning for remedial management.

The EXCO through the CEO assists the Board in drawing up strategies and policies for management of capital risks. It also supports the Board in determining the appropriateness of capital risk tolerance, keeping in view the Bank's business strategy, financial condition and funding capacity.

2.1.6 Asset & Liability Committee (ALCO)

ALCO ensures that Board approved capital and balance sheet strategies and policies are appropriately executed. ALCO oversee the development and implementation of appropriate risk measurement strategies, risk tolerance, policy and stress testing as approved by the Board.

The ALCO ensures that capital risk management limits are established and communicated in a manner that allows all levels of management to clearly understand the Bank's approach to managing the capital risk. This is carried out by ALCO through implementation of appropriate procedures and systems and controls.

The ALCO is responsible for determining the structure, responsibilities and controls for managing capital risk and report to the EXCO on capital risk profile. ALCO is also responsible for the supervision of the capital and liquidity risk exposures; risk limits adherence, early warning indicators as well as the review of capital planning and liquidity adequacy to support future business growth and stress and scenario testing to assess capital and liquidity adequacy with changing internal and external factors. Members include representatives from all functions that have duties to perform adherence of this process.

Members of ALCO monthly review the capital position of the Bank. In addition, changes in the assets book is monitored by the EXCO on a daily basis. As part of Enterprise Risk Monitoring, the Audit Risk & Compliance Committee monitors capital related compliance and thresholds/breaches.

2.1.7 Country Credit Committee (CCC)

The primary purpose of the CCC is to ensure the effective management of credit risk in the Bank.

CCC maintains an effective working relationship with the EXCO, other management committees, the Bank's Board and other committees as required ensuring effective functioning of the credit risk function.

CCC review Credit Line Proposals (CLP) along with the Risk report, position summary and any other relevant documents for credit decision-making purposes. Other sub committees such as Credit Policy Committee, Provisioning Committee and Active Credit Portfolio Monitoring also support CCC in performing its responsibilities.

2.1.8 Audit, Risk and Compliance Committee

The ARCC is responsible for providing independent assurance on the bank-wide risk management framework and monitoring the overall risk profile of Bank through effective control processes. ARCC ensure that risks are identified, accepted, measured, controlled, monitored and reported independent from the business. This is performed through a fully embedded risk event reporting process, which allows employees to report risk events to the independent Risk Assurance function. All risks reported are assessed and addressed with escalation at an appropriate level. Risk Assurance function also carries out root cause analysis of reported risks and makes appropriate recommendation for changes in systems and controls to the relevant function and committee.

3. Key Metrics

The table below provides an overview of Bank's prudential regulatory metrics:

£ 000	2019	2018	2017
Share capital	60,000	60,000	60,000
Retained earnings	11,226	9,683	7,109
Common Equity Tier 1 Capital: instruments and reserves	71,226	69,683	67,109
Additional Tier 1 Capital	-	-	-
Total Capital (CET 1 + Tier 1)	71,226	69,683	67,109
Tier 2 Capital – Subordinated liabilities	20,426	20,349	20,000
Total Own Funds (CET 1 + Tier 1 + tier 2)	91,652	90,032	87,109
Total Risk-Weighted Assets	442,493	387,179	359,941
Risk-based capital ratios as percentage of RWA			
CET 1 ratio (%)	16.10%	18.00%	18.64%
Tier 1 (%)	16.10%	18.00%	18.64%
Total capital ratio (%)	16.10%	18.00%	18.64%
Capital Adequacy Ratio	20.71%	23.25%	24.20%
Additional CET1 buffer requirements as a percentage of RWA			
Capital conservation buffer requirement	2.50%	1.875%	1.250%
Countercyclical capital buffer (CCyB)* requirement	1.00%	1.00%	0.500%
Total of bank CET 1 specific buffer Requirement	3.50%	2.875%	1.750%
Basel III leverage ratio			
Total Basel III leverage ratio exposure measure	714,163	659,570	635,317
Basel III leverage ratio (%)	10.03%	10.62%	9.92%
Liquidity coverage ratio (LCR)			
Total high-quality liquid assets (HQLA)	91,624	122,555	141,876
Total net cash outflow	57,333	61,884	60,163
LCR ratio (%)	159.81%	198.04%	235.82%
Net stable funding ratio (NSFR)			
Total available stable funding	575,074	530,877	506,952
Total required stable funding	423,583	388,363	362,939
NSFR ratio	135.76%	136.70%	139.68%

* BOE reduced the rate of CCyB to 0% in its FPC meeting held on 11 March 2020.

4. Risk Management Framework

4.1 Overview

The Bank's approach to risk management is built upon risk identification and risk response in order to minimise crystallisation of risk and have a cost-effective way of dealing with it if it does occur.

The approach is driven by the principle of low to medium risk appetite and Investment return horizon which is medium to long term. In order to achieve this, the Bank's business strategy is built upon:

- a clearly defined target market (selected customer and industry segments);
- conventional products & service offering;
- robust governance and control framework.

4.2 The Bank's Risk Management Strategy

The Bank's risk management strategy is founded on the principles of Enterprise Risk Management with key emphasis on:

- Understanding Firm-wide Risk Profile
- Articulated Risk Appetite
- Proactive approach to risk management
- Ownership of risk across the organisation
- Multiplier effect of risk to account for combined stress scenarios
- Oversight of key risks at Management and Board level

The key elements of the Bank's risk management framework are as follows:

- Governance at the Board and Management level
- Risk Oversight
- Risk management controls

The Bank's risk management strategy and risk appetite are aligned with its motto 'Service with Security', Core Values and strategic intent of delivering sustainable growth.

4.3 Risk Management Process

4.3.1 Risk Management Cycle

Effective Risk Management is the combination of identification, assessment, and prioritisation of risk followed by coordinated and economical application of resources to minimise, monitor, and control the probability and /or impact of risk events.



Risk Management cycle can be broken down in two broad sections with first focusing on the identification, categorisation and prioritisation of risk. The second section focuses on the mitigation and monitoring of the risks. The diagram below represents the main activities undertaken in the two broad sections:



Identification of individual Risks within the broad risk types allows the Bank to focus on the key threats. The risk identified is weighted based on the probability of occurrence and the impact it will have on the organisation. Low probability and impact are acceptable and preferred, however the controls and mitigation in place derive the final residual risk.

Residual risk forms a key indicator for the Bank to prioritise the various risks posed and focus on the areas identified to mitigate the risk by enhancing controls and prioritising independent reviews through audits to establish the effectiveness of risk mitigation.

4.4 Covid-19 Impact

The COVID-19 crisis has surpassed the existing challenges of Brexit related uncertainty and the ongoing low BoE base rate environment. Against this backdrop, our focus has been on being able to serve our customers, supporting government initiatives to prevent spread of Coronavirus and put in place preventive measures to safeguard our colleagues and customers.

Coronavirus has seriously impacted the global economy. Like other governments, the UK government also took significant steps that include strict lockdown across the country covering hospitality sector, schools, non-essential shops, shopping centres and services. All these had a serious impact on business across the country which resulted in one of largest ever reduction in the GDP.

The UK government implemented various unprecedented relief measures for individuals and businesses who are impacted by COVID-19. These include direct cash relief for small and medium size businesses, payment of salary for employees in private sector, low cost funding for businesses and protection for tenants of private landlord. These measures have been taken to keep the economy alive till such time the impact of COVID-19 is subsided.

The UK government is now taking measures to control second spread of COVID-19 with opening up economy in particular hospitality sector and schools. Any further increase in infection rate may lead to further lockdown, which will have serious consequences for the economy.

The Bank is continuously monitoring the impact of COVID-19. It has formed a crises management team comprising of senior management staff to monitor and address various challenges, which have been broadly categorised in the areas of:

- Human resources to ensure their well-being and address any of their concerns

- Prevention measures by informing employees and customers for taking steps to protect themselves by following Government advice
- Contingency measures for operational continuity by invoking business continuity plans and making additional arrangements to ensure minimum service disruption
- Business and financial impact of COVID-19 on Bank's overall performance
- Regular meetings being held to discuss these areas of concern posed by the pandemic and measures to put in place to mitigate impact to the extent possible.

The Bank has also been following Government advice by implementing measures such as work from home for its employees, providing Covid secure working place, sending communications to customers keeping them informed of measure taken by the Bank. To ensure Bank has the ability of meeting any stress on its liquidity additional funds are being kept in Reserve Account with Bank of England and with the clearing bank.

The Bank is also taking steps to play its role by having continuous discussions with customers who are affected by the impact of COVID19 due to supply chain issues, rental income from tenants, or loss of business. Such measures will also take into account relief measures provided by the Government for SME sector such Term Lending for SME scheme (TFSME) or mortgage holiday period for borrowers.

Throughout the outbreak, the Bank remained open and maintained its critical services running to ensure continuous and uninterrupted service to customers. The Bank also implemented phased return to work whereby most of the Bank's employees have gradually return to work in the office or branches. The Bank has taken all the necessary safety measures to ensure a safe working environment for all its employees as well as its customers when they visit our branches.

The Bank is committed to remain as a fighting unit, work for the best outcome of the SMEs within the risk appetite and have the right resources to meet the ever-changing requirements of a rapidly evolving new normal.

The Directors have considered and continue to actively monitor the financial implications of the risks associated with Covid-19, including the expected effect of Management actions taken in response to mitigate the impacts.

4.5 Overall Risk Appetite

The Bank's risk appetite is set by the Board of Directors and takes into account the Bank's Strategic Intent. The executive management of the Bank is responsible for implementation of the risk appetite throughout the Bank's operations and business. The Board Risk Committee maintains oversight of the business performance against the risk appetite. Management review is conducted by the relevant management committee and monitoring by Audit, Risk & Compliance Committee (ARCC).

The bank's risk appetite articulates the type and quantum of risk that the bank is able and willing to accept in pursuit of its strategy. Risk appetite is based on qualitative statements, which articulate the risk-taking intent of the Bank, and is supported by quantitative limits and controls. The primary objective of the risk appetite is to protect the Bank from an unacceptable level of financial performance volatility, conduct and compliance failures and adverse reputational impact.

The Board of Directors (BOD) approves the Bank's risk appetite statement, and the BRC maintains oversight of the Business Performance against the Risk Appetite (RA). Management review is conducted by the Country Credit Committee (CCC) and monitoring by the Audit Risk & Compliance Committee (RCC).

The Overall Risk Appetite of the Bank is set out below:

Capital

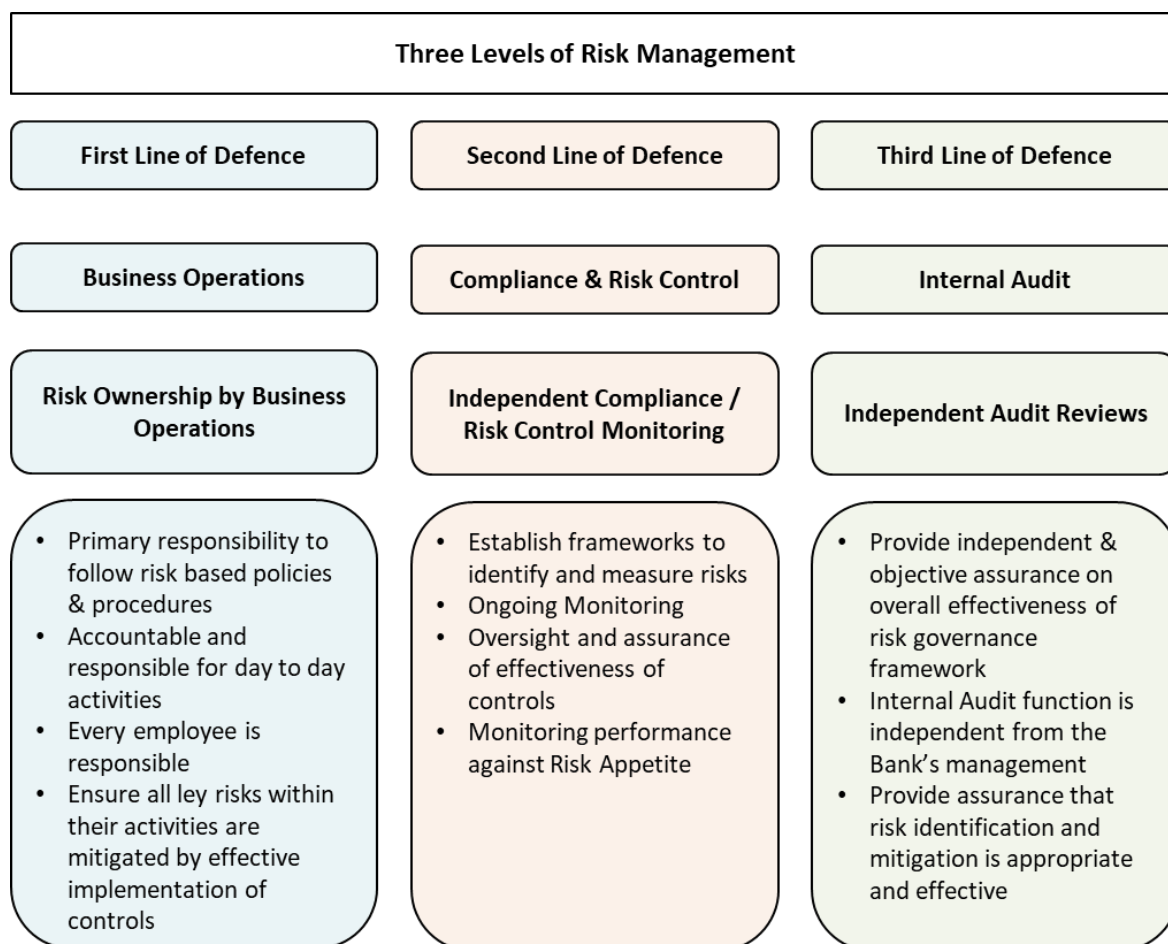
- Maintain capital of 2% over and above the minimum regulatory capital requirement.

Liquidity

- Minimum survival period of 90 days under firm own stress test
- Minimum LCR of 110%
- AD ratio not to exceed 100%

4.6 3 Lines of Defence

For smooth running and effective risk / threat identification and mitigation, the Bank operates on the 3 lines of defence model.



The Bank regularly review, monitor and update the 3LOD model to ensure it remains current as part of overall review of Risk Management Framework.

4.6.1 Risk Governance - roles and responsibilities

First Line of Defence

As the first line of defence, the business functions, as the owners of the risk manage exposures arising in the Bank on a day-to-day basis. These business functions may be the front office, the back office or support functions.

The business functions identify, assess, control, and mitigate risks. As the first line of defence, they are also responsible for implementing corrective actions to address any process and control deficiencies. They also develop and implement internal policies and procedures ensuring that activities are consistent with goals and objectives of the Bank. The relationship managers also review and escalate any credit issues related to lending customers to the Country Credit Committee (CCC) to ensure timely action. This process has been re-emphasized during the implementation process of IFRS9 to avoid erratic movement between Stage 1 and Stage 2.

Second Line of Defence

The Bank has established a second line of defence to help build and/or monitor the first line of defence controls and provide appropriate challenge to assumptions and assertions made by the business. At the Bank typically Risk, Compliance and Finance act as the second line of defence, however if these departments are the owner of a business process and act as first line of defence, then other departments become the second line of defence.

These functions facilitate and oversee the implementation of effective risk management and assist risk owners in defining the target risk exposure and reporting adequate risk-related information to the Bank, the Parent Bank and to the Regulators.

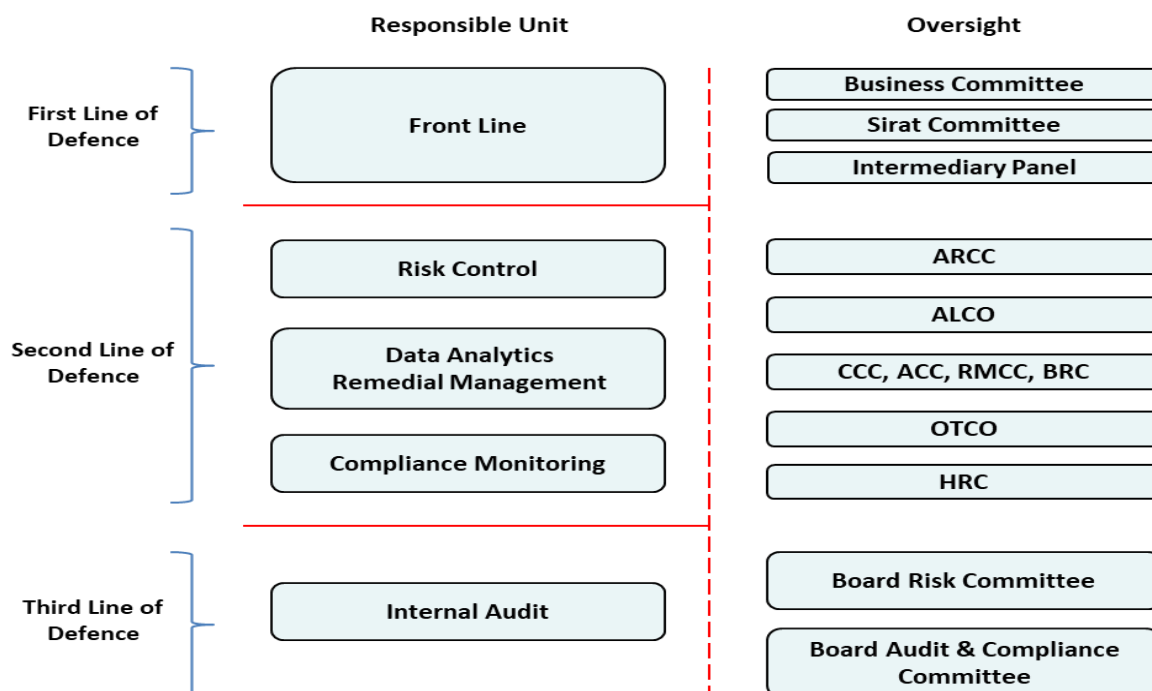
The senior management and committees such as ALCO, EXCO and ARCC are also part of overall second line of defence providing an oversight, challenge and monitoring of the adequacy and implementation of effective internal control and risk management practices.

With the implementation of IFRS9 the second Analytics function working under Head of Credit closely monitors overdue accounts and provides reminders to relationship managers for recovery and identification of problems loan at an initial stage. This process is reviewed at CCC and other sub committees such as Credit Policy and MI and Remedial Management committee.

Third Line of Defence

Audit, as the third line of defence provides independent assurance on the operations and the performance of the first two lines of defence. The Board Audit and Compliance Committee (BACC) has defined the internal audit program and outsourced the performance of the internal audit function to an independent audit firm in order to provide assurance on the efficiency and effectiveness of operations, safeguarding of assets, reliability and integrity of reporting processes and compliance with laws, regulations, policies, procedures, and contracts.

The BRC provides oversight to the overall effectiveness of enterprise risk management framework.



IFRS 9 Adoption, implementation and model validation

The Bank has adopted IFRS 9 “Financial Instruments” from 1st January 2018. The Bank has successfully updated its relevant credit processes and impairment requirements which relates to model and data governance, credit impairment and value adjustments. ICAAP document has been updated to incorporate these changes.

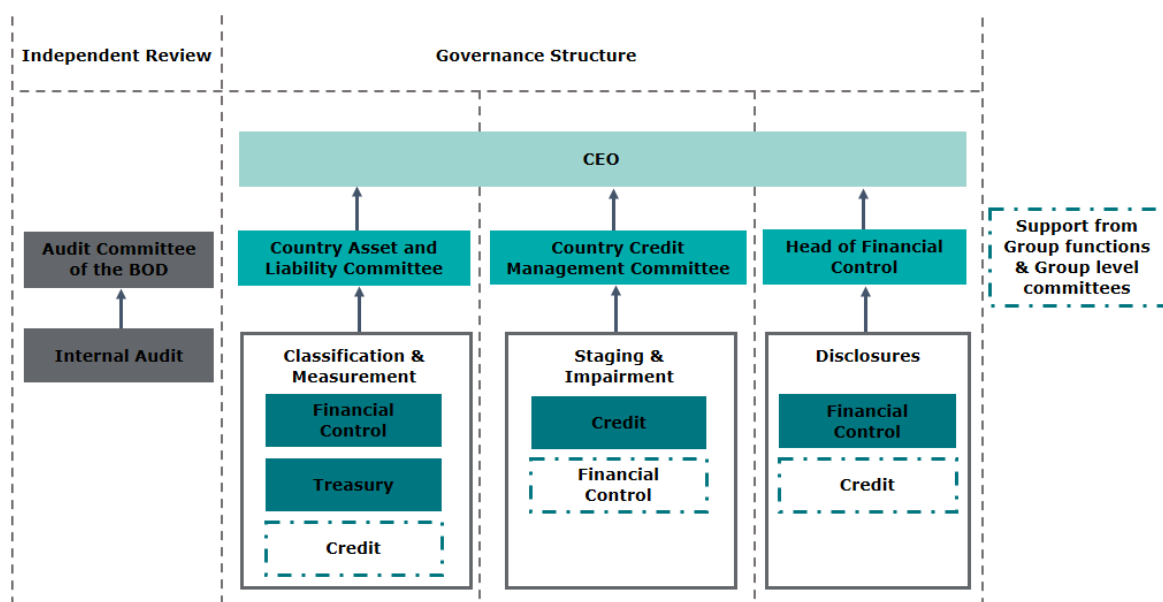
The Bank has followed a general approach in designing ECL methodologies, which are commensurate with its size, complexity, structure, economic significance and profile of exposure. The approach taken is considered proportionate in the context of the size of the Bank within the UK financial market, its relative lack of complexity as well as minimal volatility in its credit losses over the past five years.






IFRS 9 Impairment applies to financial instruments that are not measured at fair value through profit and loss (FVTPL). Financial assets falling within the scope of impairment are provided for by calculating their Expected Credit Loss (ECL). This requires considerable judgement regarding how changes in economic factors affect ECLs, which will be determined on a probability-weighted basis. ECL is an estimate of present value of cash shortfalls over the life of the financial instrument and is computed as a product of probability of default (PD), loss given default (LGD) and exposure at default (EAD). The present value of cash shortfalls is calculated by taking into account the time value of money and forward-looking information.

Post implementation of IFRS 9, the Bank established principles for ongoing IFRS 9 governance to ensure effective oversight of IFRS 9 processes. IFRS 9 governance structure incorporates Credit, Risk and Finance departments as central support functions for each component of IFRS 9, defines clear process owners and reviewing functions and utilises the three lines of defence to ensure an effective framework.

Governance Structure outlined below are the three lines of defence for the four key IFRS 9 processes, classification and measurement, staging, impairment and disclosures,

- The process owners i.e. Credit, Financial Control and Treasury form the first line of defence
- The reviewing/approving functions i.e. Chief Executive Officer, Head of Financial Control, Country Credit Management Committee and Country Asset and Liability Committee form the second line of defence
- The independent review functions i.e. Internal Audit and the Audit Committee of the BOD form the third line of defence



	Reporting and Oversight Authority
	Reviewing/Approving Authority
	Process Owners
	Supporting Functions
	Independent Reviewing Authority

The Bank has also put in place appropriate control to cover credit risk model governance risk. The objective was to set out the governance for the development, validation / review, deployment and maintenance of the credit risk related models. The implemented controls put in place framework for governance along the different stages of the model lifecycle.

The purpose of these controls is to set out in particular the principles and requirements for effective governance of the Bank's Expected Credit Loss (ECL) models and methodologies used for estimating the respective risk components. The main statistical models in scope of these controls include the following:

- credit risk rating model for rating of obligors belonging to the Corporate / SME portfolios
- probability of default ("PD") models (and /or methodologies)
- loss given default ("LGD") models (and /or methodologies)
- exposure at default ("EAD") models (and /or methodologies)
- credit conversion factor ("CCF") models (and /or methodologies), and
- macroeconomic models.

For the purpose calculating ECL Bank has developed models for types of financial assets

- Customer Lending – separate models for property lending and other lending
- Investments and Financial Institutions

4.7 Scenario Analysis and Stress Testing

A stress test is commonly described as the evaluation of a bank's financial position under a severe but plausible scenario to assist in a forward-looking decision making within the bank.

Stress testing is an important risk management tool that is used by the Bank and supplements other risk management approaches and measures. It plays a particularly important role in:

- providing forward-looking assessments of risk;
- feeding into capital and liquidity planning procedures;
- informing the setting of a Bank's risk appetite and thresholds; and
- facilitating the development of risk mitigation or contingency plans across stressed conditions.

The Board and senior management are involved in ensuring the appropriate use of stress testing in the Bank's risk governance and capital planning. This includes setting stress testing objectives, defining scenarios, discussing the results of stress tests, assessing potential actions and decision-making.

The Board has ultimate responsibility for the overall stress-testing programme, whereas senior management is accountable for the programme's implementation, management and oversight.

The Stress Testing scope covers the following key risk areas:

- Capital
- Liquidity
- Credit Risk & Provisions
- Earnings – P&L

The Stress testing scenarios cover Bank specific risks, market specific risks and a combined impact to arrive at the impact on the key measures of capital, liquidity, provisions and earnings. The frequency of review is once a year except for the property stress test, which is conducted twice a year.

The process for reverse stress testing involves defining the point of failure of the firm (in this case full capital erosion) and working backwards to identify the scenarios leading to that. The challenge in the exercise is to identify scenarios that are both sufficiently extreme and relevant to the Bank.

Details of stress testing, related financial impact and actions to deal with the stressed scenarios are covered in the ICAAP & ILAAP.

4.8 ECL Model Validation

The Parent Bank organised the groupwise exercise of ECL model validation conducted by the 3rd party consultant. The validation exercise was done during 2019 which covered all IFRS 9 models, data completeness, reliability and staging criteria. There was no significant finding raised by the external consultant. Bank has planned to update the existing ECL model with revised parameters in 2020 along with a group led project where all the recommendations of model validations will be addressed.

5. Significant Risks

The key risks as assessed by the Bank are as follows:

5.1 Credit Risk

Credit Risk is defined as of loss of principal or a loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation resulting in financial loss to the Bank. It is also measured in terms of credit losses or provisions charged to the profit and loss account. Qualitative information also used to assess issues related to the effectiveness of the risk appetite.

The Bank manages its credit risk through documented Credit Risk Management Framework ("CRMF"), which is part of the overall Risk management framework. CRMF serves as a collection of tools, processes and methodologies that support the Bank in identifying, assessing, monitoring and controlling the credit risk.

The CRMF also provides a sound basis for more informed risk-based decision-making across the business areas. The CRMF includes the credit risk appetite, which defines the bank's target customer segment, industries and products, risk acceptance. CRMF reflects regulatory requirements and guidelines in the UK while also referencing the overall credit risk framework and guidelines of the Group.

Through CRMF the Board ensure that the Bank has a clear and measurable statement of its credit risk appetite against which the strategy to achieve the credit related aspects of its business plan can be actively assessed. In order to measure its achievements against this goal, the Board and management of the Bank are provided with robust, well calibrated and sufficiently granular management information so that they can provide an effective challenge to management's actions.

5.1.1 Credit Risk – Impact of COVID-19

The Bank has provided loan moratorium to its customers in line with regulatory guidelines issued by PRA in March and June 2020. A comprehensive risk assessment process was followed by the Bank in evaluating the moratorium need of the customers, which included discussion with the customers, understanding their cashflow and liquidity needs and making available the support they needed to continue their businesses.

The Bank has implemented effective process to monitor business and financial position of the customers who availed moratorium to understand and assess recoverability of the loan and need of making any impairment provision in case the customer started showing sign of significant increase in credit risk despite support factors.

The Bank will continue to monitor the position also in light of support provided by government in the form of loans and furlough scheme, which is expected to end in October 2020.

5.1.2 Counterparty credit risk (CCR)

A Counterparty Credit Risk (CCR) Exposure is the risk of financial loss in derivative, foreign exchange trading or securities financing activities, due to a counterparty's failure to perform at any time from trade date to settlement date. It is the credit risk of the counterparty and is additionally subject to market risk. The exposure is calculated based on the regulatory requirement.

5.1.3 Credit value adjustment (CVA)

Credit Valuation Adjustment is an adjustment to the mid-market valuation accounting for the current market value of credit risk. Bank calculates a regulatory CVA capital charge. The purpose of this charge is to improve the resilience of banks to potential mark-to-market losses associated with deterioration in the creditworthiness of counterparties in non-cleared derivative trades.

5.1.4 Credit Quality Analysis

The following table set out information about the credit quality of financial assets measured at amortised cost and FVOCI debt investments. Unless specifically identified, for financial assets, the amounts in the table represent the gross carrying amounts.

	Amount in £000				
	2019				2018
	Stage 1	Stage 2	Stage 3	Total	Total
Cash in hand and with central bank	58,964	-	-	58,964	66,810
Due from banks	98,634	-	-	98,634	59,068
Loans and advances to customers	417,199	8,045	10,530	435,774	404,560
Financial investments - amortised cost	16,918	-	-	16,918	34,914
Financial investments - FVOCI debt instruments	67,669	-	-	67,669	68,473
	84,587	-	-	84,587	103,387
	659,384	8,045	10,530	677,959	633,825
Loss allowance	(1,570)	(193)	(3,612)	(5,375)	(5,722)
	657,814	7,852	6,918	672,584	628,103

The following table provide information about the credit quality of financial assets outstanding as at the balance sheet date in terms of regular, past due and impaired.

2019	Amount in £000					
	Cash and balances with central bank	Due from banks	Loans and advances to customers	Financial investments	Derivatives	Total
Current and past due up to 1 month	58,964	98,298	430,247	84,586	357	672,452
Past due 1 to 3 months	-	-	3,173	-	-	3,173
Past due over 3 months	-	-	2,354	-	-	2,354
Gross exposure	58,964	98,298	435,774	84,586	357	677,979
Less: impairment	-	-	(5,038)	-	-	(5,038)
Net exposure	58,964	98,298	430,736	84,586	357	672,941

5.1.5 Credit Risk Ratings

For the purpose of credit risk ratings, the Bank segregates its loans and advances portfolio into two categories namely, Property Sector lending and Other Lending (primarily comprising of commercial lending). Property sector lending covers major portion of the total lending portfolio. The Bank follows a program-based lending approach for property sector lending with clearly defined Risk Acceptance Criteria (RAC) for this segment rather than a credit risk rating methodology.

The Bank recognises loans and advances as past due when the customer does not meet its contractual payment obligations.

The Bank regards a loan and advance or a debt security as impaired if there is objective evidence that a loss event has an impact on future estimated cash flows from the asset. Financial assets split by external rating, where applicable:

Amount in £							
2019	Cash and balances with central bank	Due from banks	Loans and advances to customers	Financial investments	Derivatives	Contingent liabilities and commitments	Total
AAA to AA-	58,203	84	-	52,302	-	-	110,589
A+ to A-	-	11,576	-	32,284	4	2,711	46,575
BBB+ to B-	-	77,765	-	-	5	9,215	86,985
Unrated	761	8,873	430,736	-	348	39,067	479,785
	58,964	98,298	430,736	84,586	357	50,993	723,934

Bank uses the external credit agencies Fitch, S&P and Moody's to obtain ratings for its credit exposures relating to financial institutions, banks and sovereign agencies or entities.

5.1.6 Concentration of Risk

Concentration arises when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be affected by changes in economic, political or other conditions. The Country Credit Committee primarily manages concentration risk. The Bank Assets and Liabilities Committee also monitor credit concentration. All material exposures are reported to the Board Risk Committee, which escalates material concerns to Board of Directors.

Segmental concentration of financial assets and credit related contingent liabilities:

Amount in £000							
2019	Cash and balances with central bank	Due from banks	Loans and advances to customers	Financial investments	Derivatives	Contingent liabilities and commitments	Total
Super-nationals	58,203	-	-	33,828	-	-	92,031
Financial Institutions	-	98,298	-	46,910	9	18,334	163,551
Industrial & commercial	-	-	371,132	3,848	348	32,292	407,620
Individual	-	-	59,604	-	-	367	59,971
Other	761	-	-	-	-	-	761
	58,964	98,298	430,736	84,586	357	50,993	723,934

Super-nationals include investment made by the Bank in high rated bonds issued by sovereigns and multilateral development banks.

Geographical concentration of financial assets and credit related contingent liabilities:

Amount in £000							
2019	Cash and balances with central bank	Due from banks	Loans and advances to customers	Financial investments	Derivatives	Contingent liabilities and commitments	Total
United Kingdom	58,964	63,058	385,639	12,447	353	44,817	565,278
Europe excluding UK	-	442	10,428	42,852	4	3,037	56,763
Asia	-	16,376	4,713	14,099	-	21	35,209
North America	-	122	25,481	3,002	-	-	28,605
Africa	-	17,084	4,475	-	-	3,118	24,677
United States of America	-	1,145	-	6,936	-	-	8,081
Australia	-	71	-	5,250	-	-	5,321
	58,964	98,298	430,736	84,586	357	50,993	723,934

5.1.7 Collateral Management

Collateral Risk is mitigated through the use of readily marketable collateral, avoidance of collateral with high volatility and use of haircuts as per approved Bank's policy.

Collateral values are assessed by professional valuers. The Bank uses panel of valuers selected through a robust due diligence process. Residential or commercial collateral used by the Bank are on vacant possession, which provides fair degree of conservativeness to the values used for calculating LTV. The Bank generally performs valuation of properties every five years.

Key threat arising along with controls & mitigations in place are tabulated below:

Collateral Risk	Controls & Mitigation in Place
Risk Arising from reduction in collateral values	<ul style="list-style-type: none"> ▪ Generally acceptable collateral - Cash, Residential & Commercial Property, Bank Guarantees, Shares & Bonds & life insurance with surrender value. ▪ Lien is marked against cash taken as collateral ▪ Charge is recorded in Bank's name in land registry relating to residential and commercial properties taken as collateral. ▪ Other collateral like Bank Debenture, Stocks, Receivables, Personal Guarantees also available but discounted for lending and provision decisions. ▪ Well defined haircuts for all collateral with Property haircuts arrived at on the basis of type of property, location and market conditions ▪ Property Stress tests conducted every six months
Risk arising from inadequate perfection of Security for Customer Borrowing	<ul style="list-style-type: none"> ▪ Credit Administration unit centralised ▪ Standardisation of documents and processes for Risk mitigation ▪ Duly reviewed & approved panel of solicitors & valuation firms

The Bank accepts collateral subject to legal review and appropriate documentation in accordance with the Credit Risk Management Policy. The Credit Department keeps a comprehensive record of collateral received and is responsible for regular updates to the valuation of the underlying collateral. The documentation entered into with the obligor specifies the Bank's rights and ability to liquidate the collateral, if required. The Country Credit Committee is responsible for decisions regarding liquidation or appropriation of collateral based on recommendations from the Head of Credit and advice from the Legal Department. Further details of collateral can be found in the audited financial statements.

The carrying amount of financial assets recorded in the balance sheet, net of any allowances for losses, represents the Bank's maximum exposure to credit risk without taking account of any collateral obtained. The fair value of collateral and security enhancements held against loans or advances to customers is shown below:

Collateral Type	2019		2018	
	Collateral Value	Advances	Collateral Value	Advances
Commercial real estate	618,715	301,720	585,575	282,820
Residential real estate	227,686	109,949	217,984	98,448
Cash collateral	29,021	20,991	30,929	20,145
Other collateral	0	-	-	-
Guarantees	-	-	-	-
Unsecured	-	3,114	-	3,147
Total	875,422	435,774	834,488	404,560

5.1.8 Credit Risk Weighted Exposures

The Bank has adopted Standardized Approach as set out by CRR and approved by the PRA under which Credit risk weighted exposures are calculated on the basis of the rating regime as prescribed in Standardised Approach by PRA Supervisory Statement SS10/13.

Following table provides the breakdown of credit risk exposures post credit risk mitigation (CRM) and credit conversion factors (CCF) as at December 2018 segregated as per the sectors:

Exposures as per Sectors	Amount in £000			
	On Balance Sheet 2019	Off Balance Sheet 2019	Total 2019	Total 2018
Retail	28	-	28	33
Secured by mortgages on immovable properties	308,497	-	308,497	276,464
Exposures in default	9,854	-	9,854	16,205
Contingencies and commitments	-	17,015	17,015	10,650
Institutions	56,070	-	56,070	34,828
Counterparty credit risk	-	482	482	139
Other	15,513	-	15,513	15,074
	389,962	17,497	407,459	353,393

Following table provides the breakdown of credit risk exposures post credit risk mitigation (CRM) and credit conversion factors (CCF) as at December 2019 as per geographical breakdown:

Country wise Exposures	Amount in £000	
	2019	2018
United Kingdom	332,054	302,615
Europe excluding UK	14,487	10,326
Asia	11,048	10,131
North America	24,219	13,154
Africa	19,515	12,910
United States of America	4,846	3,349
Australia	1,290	908
	407,459	353,393

5.1.9 Credit Risk Mitigation (CRM)

Risk mitigation mechanisms are employed to minimize credit risk in the event of credit quality deterioration. This primarily includes cash and bank guarantees. The reported credit risk weighted assets in the above schedule are reflected after employing the risk mitigation techniques.

5.2 Interest Rate Risk in the Banking Book

Interest rate risk arises from changes in interest rates that could affect future profitability or the fair value of financial instruments. Interest rate risk at the Bank is managed and contained and the Bank has no significant long term or complex interest rate positions or products. The Bank seeks to minimise the negative impact on net interest income of adverse movement in interest rates. The Bank has assessed IRRBB in accordance with SOP 2018.

Duration Risk

The Bank's main lending product is a 5 years variable rate loan. For client asset pricing, the Bank uses its own base rate, which can be changed with notice to the customers. Deposits are typically of 6 months to 1-year duration. Therefore, any significant fluctuation in interest rate is contained to a 6-month window and unlikely to have a material impact on the Bank as it can re-price its lending and customer deposit books.

Basis Risk

The Bank uses its own base rate (HBZ Base Rate) to price up Client loans. For deposits it aligns closely to the overall cost of funds and does a peer analysis. Therefore, basis risk is very limited.

Optionality Risk

The Bank currently does not use Interest Rate derivatives, whether embedded in loan agreements or for hedging purposes. As asset and liability products offered by the Bank are simple in nature, which mitigates optionality risk.

Risk Identification and Quantification

The Bank is exposed to interest rate risk on part of its HQLA Bond portfolio (Fixed Coupon) maintained to meet the LCR requirement. The Bank also has an investment Bond portfolio of investment grade (or higher). These are Floating Rate Notes (FRN) no longer than 3-year maturity and benefit in an interest rate rising environment (USD and GBP) as the rates are linked to 3 months LIBOR. The Bank monitors the economic landscape closely for any change in the interest rate environment.

5.3 Operational Risk

Operational Risk is defined as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external parties. Specifically, this includes employees (e.g. fraud or key man dependencies), third party intermediaries, information technology (systems), and processes including failure to meet regulatory/legislative requirements or internal procedures.

The Bank's operational processes exist to support the servicing of customers and to maintain compliance with relevant regulation. These imperatives will be robustly protected. The Bank ensures that it remains compliant with the latter but its approaches to the former will vary according to priority and need. In terms of customer services, the Bank will actively employ flexible approaches to maintaining and protecting delivery and to this end will incur reasonable costs as required.

Operational Risk is the risk that the Bank triggers one or more of the below situations due to failed internal processes, people and systems – these can be internal or external to the Bank:

- Adversely impacts customers (customers are defined as customer of the Bank as well as internal "customers" such as colleagues with a dependency on particular output or service)
- Incurs losses e.g. operational losses (this includes temporary losses i.e. where recovery is made or is in progress of being made)
- Breaches in regulatory requirements or other policies and practices of the Bank

The Bank has adopted the Basic Indicator approach for calculating Operational Risk capital as set out in the CRR and consequently embarks on rigorous risk identification exercises to establish any Pillar 2 requirements for Operational Risk.

To mitigate occurrence of loss as a result of operational risk, the management has implemented systems and controls some of which includes introduction of operation risk register, risk event reporting process and centralisation of process.

5.4 Cyber Risk

In today's modern banking landscape banks are expected to provide multiple transactional gateways to their customer in order for the customers to access their bank account and conduct transactions round the clock. Banks are expected to provide these transactional capabilities to their customers ensuring they are authenticating the customers at various levels throughout the transactional journey. In opening up multiple transactional channels the banks are exposed to risk and threats, which exist today in the cyber space.

Habib Bank Zurich plc takes risks associated with Cyber Security extremely seriously and is constantly engaged in not only improving and strengthening its transactional gateways but also its internal operating environment. For the Bank it is equally important to ensure that its internal infrastructure on which employees are operating is secure and fit for purpose. The Bank has successfully completed various infrastructure-hardening projects some of which are mentioned below

- Deployment of Managed Switches: To ensure only authorised devices are allowed on Internal Network and to isolate any device within the network
- End Point Security: Deployment of centrally administered AV to ensure all user end points are protected
- Proxy Servers: Roll out of new proxy server operating on HBZ Group approved policies ensuring only permitted websites are accessible

- Thin Client: Planned roll out thin client systems using Citrix ensuring only permitted activities can be conducted and authorised applications are installed on end points
- Verified by Visa: HBZ UK successfully completed certification of VBV service to provide its customer secure online shopping experience

The Bank recognises risk associated with Cyber threats and is constantly taking proactive measures to strengthen its operating environment in order to provide secure banking experience to internal as well as external stakeholders.

5.5 Regulatory Compliance Risk

“Regulatory Compliance” means compliance with relevant UK and other regulatory rules and requirements. At its highest level this means the Bank’s “arrangements” to ensure that it comply with the regulator’s threshold conditions, Statements of Principle, rules, codes and guidance and any relevant directly applicable provisions of a European or group Directive or Regulation.

The Bank has an effective compliance function, which operates independently and, which has the following responsibilities:

- to monitor and, continually assess the adequacy and effectiveness of the measures and procedures put in place in accordance with SYSC 6.1.2 R, and the actions taken to address any deficiencies in the firm's compliance with its obligations; and
- to advise and assist the relevant persons responsible for carrying out regulated activities to comply with the Bank's obligations under the regulatory system.

The Compliance function measures and monitors regulatory compliance through the HBZ UK Compliance Monitoring Plan, and through its interactions with first line of defence.

6. Liquidity Risk

Liquidity risk is the risk that the Bank is unable to meet its obligations as they fall due and in the currency in which they are due. Typically, this arises from a mismatch in the cash flows arising from assets, liabilities and contingencies. To limit this risk, the Bank manages the maturities of its assets and liabilities and its cash flows on a daily basis.

The Bank has put in place strategies, policies, processes and systems that enable it to identify measure, manage and monitor liquidity risk over an appropriate set of time horizons, including intraday, so as to ensure that it maintains adequate levels of liquidity buffers. The Bank’s liquidity policy is based on maintaining sufficient liquid resources to ensure there is no significant risk that its liabilities cannot be met as they fall due.

The Board oversees liquidity risks. The risks identified in the Bank’s risk profiles are all at a level, which are in line with the current business operations and the Business Plan. The Bank has a clearly defined liquidity risk appetite approved by the Board. This forms the basis of its liquidity risk policy as well as systems and controls around the management of liquidity adequacy. The Bank continues to review and update its liquidity risk management framework based on developments in market and industry best practices.

The Bank has the following liquidity profile that analysis assets and liabilities into relevant maturity buckets based on the remaining period to contractual maturity. The maturity profile is the representative of its contractual undiscounted cash flows.

Amount in £000							
2019	Carrying amount	Gross nominal inflow/(outflow)	Within 1 month	1-3 months	3 months-1 year	1-5years	> 5 years
Financial asset by type							
<i>Non-derivative assets</i>							
Cash in hand & with central bank	58,964	59,001	59,001	-	-	-	-
Due from banks	98,298	98,469	40,152	28,283	30,034	-	-
Loans & advances to customers	430,736	502,816	31,188	9,579	20,586	70,901	370,562
Financial investments							
- fair value through other comprehensive income	67,669	67,951	2,505	6,124	13,628	45,694	-
- Amortised cost	16,917	17,120	-	-	-	17,120	-
	672,584	745,357	132,846	43,986	64,248	133,715	370,562
<i>Derivative assets</i>							
Risk management	357					-	-
Outflow		13,643	2,878	3,513	7,252	-	-
Inflow	-	(13,305)	(2,765)	(3,358)	(7,182)	-	-
	357	338	113	155	70	-	-
Financial liability by type							
<i>Non-derivative liabilities</i>							
Due to banks	6,722	(6,723)	(6,723)	-	-	-	-
Due to customers	577,013	(578,977)	(285,889)	(124,878)	(160,789)	(7,421)	-
Subordinated liabilities	20,098	(20,299)	-	-	-	(20,299)	-
Lease liability	2,796	(2,952)	(76)	(294)	(1,478)	(1,104)	-
	606,629	(608,951)	(292,688)	(125,172)	(162,267)	(28,824)	-
<i>Derivative liabilities</i>							
Risk management	312	0	-	-	-	-	-
Outflow	-	8,080	1,893	3,283	2,904	-	-
Inflow	-	(8,373)	(1,986)	(3,424)	(2,963)	-	-
	312	(293)	(93)	(141)	(59)	-	-

The Bank has disclosed a contractual maturity analysis for its financial instruments. This includes a maturity analysis for financial assets that it holds as part of its managing liquidity risk - e.g. financial assets that are expected to generate cash inflows to meet cash outflows on financial liabilities - because the Bank considers that such information is necessary to enable financial statement users to evaluate the nature and extent of its liquidity risk.

6.1 Liquidity risk management

The Bank has put in place strategies, policies, processes and systems that enable it to identify measure, manage and monitor liquidity risk over an appropriate set of time horizons, including intraday, so as to ensure that it maintains adequate levels of liquidity buffers. The Bank's liquidity policy is based on maintaining sufficient liquid resources to ensure there is no significant risk that its liabilities cannot be met as they fall due.

The liquidity and funding management and liquidity oversight ranges from high-level annual strategic plans and firm wide management engagement in stress-testing exercises, through to daily liquidity monitoring and management. The Bank has established and continues to develop a business strategy of balanced and manageable growth in light of known capital and funding resources and the prospective economic environment.

6.2 Liquidity and funding risk management governance

The Bank has a governance structure in place to ensure that its liquidity position is kept under close review, principally under the supervision of the ALCO. Treasury department is responsible for day-to-day management of liquidity and funding. Finance Department is responsible for daily monitoring and reporting on liquidity positions. Risk management as part of Enterprise Risk Management Framework keeps an oversight on the liquidity risk indicators. The ALCO and EXCO get the daily liquidity MI that includes regulatory thresholds as well as the assurance on the Bank's 90 days survivability.

The primary goal of liquidity risk governance is to establish operating parameters and hold people accountable for performance. The Bank has established a governance framework to ensure that all risks are covered adequately and monitoring is effective at all levels.

The model helps the Bank’s stakeholders in effective and efficient risk management as it provides a simple and effective way to enhance communications on risk management and control by clarifying essential roles and duties under the departmental level Functional Charters.

6.3 Qualitative Information (EU LIQ1)

6.3.1 Funding and liquidity sources

Bank has stable and diverse range of funding base including deposits from retail and non-retail customers with long length of relationship, deposits covered by Financial Service Compensated Scheme (FSCS) Tier1 and Tier2 Capital base and wholesale deposits.

6.3.2 Derivatives

The Bank transacts derivatives to manage and hedge its own risk and that of its customers. The Bank uses derivatives for hedging purposes for an economic perspective in the management of its own asset and liability portfolios. This enables the Bank to mitigate the market risk, which would otherwise arise from structural imbalances.

Forward foreign exchange currency contracts are Over the Counter agreements to deliver, or take delivery of, a specified amount of an asset or financial instrument based on a specific rate applied against the underlying asset or financial instrument, at a specific date.

Derivative transactions of the Bank are fully collateralised by the cash.

6.3.3 Liquid Assets

Bank held extremely high-quality liquid assets in the form of Bank of England Reserves and level 1 Securities. The LCR disclosure template with liquidity risk limits are provided hereunder:

Liquidity coverage ratio (LCR)	2019	2018
Total high-quality liquid assets (HQLA)	91,624	122,555
Total net cash outflow	57,333	61,884
LCR ratio (%)	160%	198%
Regulatory requirement (%)	100%	100%

7. Capital Management and Capital Adequacy

The primary objective of capital management is to maintain strong capital to support medium to long-term business growth. An effective capital management process provides resilience arising from both internal and external factors resulting in additional capital requirements. The Bank maintains strong capital ratios not only to support its business and maximise shareholders’ value but also to maintain depositors’ and market confidence. The Prudential Regulation Authority sets and monitors the capital requirement for the Bank.

The Bank’s capital has been invested by the Parent bank to support long-term business growth of the Bank, which includes capital resources to meet Pillar 1, Pillar 2, CRD Buffers and PRA Buffer. The Bank also maintains internal capital buffer over and above the minimum regulatory capital requirement. The Bank also takes into account changes in economic conditions; risk characteristics of its activities and regulatory requirement in managing its capital structure and make adjustments to it in the light of such changes.

Amount in £000

	2019	2018
Called up share capital	60,000	60,000
Retained earnings	11,226	9,683
Tier 1 capital before regulatory adjustments	71,226	69,683
Regulatory adjustments:		
- IFRS 9 (ECL) impact of regulatory capital (transitional adjustment)	426	349
Tier 1 capital after regulatory adjustments	71,652	70,032
Tier 2 capital (Subordinated liabilities)	20,000	20,000

7.1 Own Funds (Capital Resources)

Own funds or capital resources are the minimum amount of capital the institution must hold as per relevant regulatory rules and Total Capital requirement (TCR) received from the PRA. This is also called as regulatory capital. The Bank in accordance with CRDIV requirements must hold sufficient quantity and quality of own funds.

Bank's own funds comprises of Tier 1 and Tier 2 capital. Bank successfully complied with the capital requirements throughout the year 2018 and actively managed capital base to cover risks exposed to the Bank.

The table below summarizes the composition of regulatory capital for the Bank on a solo basis as at 31 December 2018.

Tier 1 Capital - Called up share capital includes 60 million of ordinary shares fully paid up.

Tier 2 Capital - Subordinated liabilities include the loan of £20m issued by Habib Bank AG Zurich, the parent Bank. The loan carries interest at a rate of 6-month Libor plus 125 bps per annum to be paid semi-annually. The initial term of the loan is five years. The term of loan can be extended for one additional year on each anniversary with the mutual consent of both lender and borrower after the expiry of the initial term.

7.2 Own Funds Requirements

Bank successfully maintained its regulatory capital substantially above what actually required.

The table below provides the detail of own funds or capital requirement for the bank:

Amount in £	2019	
	Risk Weighted Assets	Capital Requirement
Credit Risk	407,459	32,597
Operational Risk	34,540	2,763
Market Risk	494	39
Pillar 1 Total (8% of RWAs)	442,493	35,399
Pillar 2A (5.82% of RWAs)	442,493	25,753
Total Pillar 1 and Pillar 2A (13.82%) - TCR	442,493	61,153
Capital Conservation Buffer (2.5% of RWAs)	442,493	11,062
Countercyclical Buffer (1% of RWAs)	442,493	4,425
Total Capital Requirement - £ 000'	442,493	76,640
Total Capital Requirement - %		17.32%

Capital Adequacy Ratio of the Bank as at 31 December 2019 is as under:

- Risk Weighted Assets – Amount in £	442,493
- Regulatory Capital – Amount in £	91,652
- Capital Adequacy Ratio - %	20.71%

Amount in £	2018	
	Risk Weighted Assets	Capital Requirement
Credit Risk	353,393	28,271
Operational Risk	33,470	2,678
Market Risk	316	25
Pillar 1 Total (8% of RWAs)	387,179	30,974
Pillar 2A (5.82% of RWAs)	387,179	22,534
Total Pillar 1 and Pillar 2A (13.82%) - TCR	387,179	53,508
PRA Buffer (0.61% of RWAs)	387,179	2,362
Capital Conservation Buffer (1.875% of RWAs)	387,179	7,260
Countercyclical Buffer (1% of RWAs)	387,179	3,872
Total Capital Requirement - £ 000'	387,179	67,001
Total Capital Requirement - %		17.32%

Capital Adequacy Ratio of the Bank as at 31 December 2018 is as under:

- Risk Weighted Assets – Amount in £	387,179
- Regulatory Capital – Amount in £	90,032
- Capital Adequacy Ratio - %	23.25%

8. The Internal Capital Adequacy Assessment Process (ICAAP)

The Bank's capital adequacy assessment process demonstrates its sound and effective Risk Management Framework. The ICAAP has been structured to evidence the on-going processes established to ensure existing and new risks to the Bank's corporate objectives and operations are promptly identified and the impact assessed to ensure the Bank has sufficient capital to meet these risks.

The document quantifies the risks in the Business Plan and summarises the impact of those risks on capital. Having assessed the risks, the document sets out the management and mitigation of these risks.

The ICAAP is undertaken annually ensuring the Board governing process that includes reviews and approvals. ICAAP process includes the analysis of the Pillar 2 capital required in addition to the risks not covered under Pillar 1 requirements. Additionally, this process also accounts for various stress testing exercises and their potential impacts on Bank's capital and profitability.

The upfront and more than adequate capital demonstrate the commitment of the group to operate a sustainable and viable franchise in the UK. The ICAAP also demonstrates the adequacy of non-financial resources (in the form of people, systems, policies and procedures) to manage the adequacy of these financial resources on an on-going basis.

9. Leverage Ratio

The Basel III framework introduced a simple, transparent, non-risk-based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to:

- restrict the build-up of leverage in the banking sector to avoid destabilising deleveraging processes that can damage the broader financial system and the economy; and
- reinforce the risk-based requirements with a simple, non-risk based “backstop” measure.

The Basel III leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), with this ratio expressed as a percentage:

- Leverage ratio = Capital measure / Exposure measure

The PRA has proposed that the leverage ratio requirements will apply to all banks from 1 January 2018. This proposed requirement comprises of a minimum ratio of 3%. As at 31 December 2017 Bank has a leverage ratio of 10.65% (2017: 10.61%).

The tables below summarised the information as per the formats prescribed by the European Banking Authority (EBA). Rows with Nil balances are not deleted.

Summary comparison of accounting assets vs leverage ratio exposure measure (LR1)

	2019 £	2018 £
Total assets as per published financial statements	683,779	635,905
Adjustments for derivative financial instruments	23,187	19,994
Adjustment for off-balance sheet items (i.e. conversion to credit equivalent amounts of off-balance sheet exposures)	16,614	10,405
Other adjustments	(9,416)	(6,734)
Leverage ratio exposure measure	714,164	659,570

Leverage ratio common disclosure (LR2)

	2019 £	2018 £
On-balance sheet exposures (excluding derivatives and securities financing transactions (SFTs), but including collateral)	674,135	629,171
Deductions of cash variation margin provided in derivative transactions	-	(342)
Total On-balance sheet exposures (excluding derivatives and securities financing transactions (SFTs))	674,135	628,829
Replacement cost associated with all derivatives transactions (i.e. net of eligible cash variation margin)	23,187	20,136
Add-on amounts for PFE associated with all derivatives transactions (mark- to-market method)	288	200
Total derivatives exposures	23,415	20,335
Off-balance sheet exposures at gross notional amount	54,821	47,870
Adjustments for conversion to credit equivalent amounts	(38,207)	(37,465)
Total other off-balance sheet exposures	16,614	10,405
Capital and total exposure		
Tier 1 capital	71,652	70,032
Total exposure	714,164	659,570
Leverage ratio (%)	10.03%	10.62%

10. Impairment Provisions

The Bank has adopted IFRS 9 “Financial Instrument” with effect from 01 January 2018 which resulted in significant change in Impairment calculations as the whole process changed from incurred loss to expected loss model. Financial assets falling within the scope of impairment are provided for by calculating their Expected Credit Loss (ECL). This requires considerable judgement regarding how changes in economic factors affect ECLs, which will be determined on a probability-weighted basis. ECL is an estimate of present value of cash shortfalls over the life of the financial instrument and is computed as a product of probability of default (PD), loss given default (LGD) and exposure at default (EAD). The present value of cash shortfalls is calculated by taking into account the time value of money and forward-looking information.

10.1 Measurement of ECL

In determining ECLs, the Bank has considered two economic scenarios for selected macroeconomic variables, (i) government debt to GDP and (ii) unemployment rate and weighted these according to their likely occurrence. The scenarios include a baseline scenario, based on the current economic environment, an upturn scenario and a downturn scenario. Scenario forecasts were weighted by the scenario’s probability of occurrence in order to arrive at the probability-weighted macroeconomic impact over the 5-year forecast horizon.

The estimation and application of this forward-looking information will require significant judgement and be subject to appropriate internal governance and scrutiny.

Loss allowances for ECL are presented in the statement of financial position as follows:

- Financial assets measured at amortised cost: as a deduction from the gross carrying amount of the assets;
- Loan commitments, off balance sheet items and financial guarantees: generally, as a provision;

10.2 Significant increase in credit risk (SICR)

A critical element to the implementation of IFRS 9 for assessing Impairment is determining whether there has been a significant increase in risk of a credit exposure since origination to classify the assets into one of three stages as set out below.

The Bank considers 30 days past due (DPD), marking the status of a loan as non-performing, a rating downgrade, restructure tag, or cross product defaults as being strong indicators of a significant increase in credit risk of an account. Hence, staging rules have been determined based on these criteria, as explained below:

Impairment is measured as either 12 months ECL, or Lifetime ECL depending on the change in credit risk associated with the financial instrument. The approach allocates financial instruments into three stages:

10.3 Staging Criteria

Stage 1 - 12-month ECL

The Bank assesses ECLs on exposures where there has not been a significant increase in credit risk since initial recognition and that were not credit impaired upon origination.

Stage2 - Lifetime ECL

The Bank assesses ECLs on exposures where there has been a significant increase in credit risk since initial recognition but are not credit impaired. Bank recognizes a lifetime ECL (i.e. reflecting the remaining lifetime of the financial asset).

Stage3 - Lifetime ECL

The Bank identifies ECLs on those exposures that are assessed as credit impaired based on whether one or more events that have a negative impact on the estimated future cash flows of that asset have occurred. For exposures that have become credit impaired, a lifetime ECL is recognized as a specific provision, and interest revenue is calculated by applying the effective interest rate to the amortised cost (net of provision) rather than the gross carrying amount.

The following tables show reconciliations from the opening to the closing balances of the loss allowance by class of financial instrument.

Amount in £000

Due from banks at amortised cost	2019				2018
	Stage 1	Stage 2	Stage 3	TOTAL	TOTAL
Balances at the beginning of the year	137	-	-	137	83
New provisions	74	-	-	74	35
Increased provisions	163	-	-	163	19
Uncollectable recovered / settled	(38)	-	-	(38)	-
Net measurement of loss allowance	199	-	-	199	54
Transferred to 12 month's ECL Stage 1	-	-	-	-	-
Transferred to lifetime ECL stage 2 Credit not impaired	-	-	-	-	-
Transferred to lifetime ECL stage 3 Credit impaired	-	-	-	-	-
Balances at the closing of the year	336	-	-	336	137

Amount in £000

Loans and advances to customers at amortised cost	2019				2018
	Stage 1	Stage 2	Stage 3	TOTAL	TOTAL
Balances at the beginning of the year	1,057	458	4,068	5,583	13,738
New provisions	215	-	-	215	192
Increased provisions	3	86	694	783	1,246
Recovered / settled / reduced	(83)	(376)	(1,073)	(1,532)	(2,425)
Net measurement of loss allowance	135	(290)	(379)	(534)	(987)
Transferred to 12 month's ECL Stage 1	54	(52)	(2)	-	-
Transferred to lifetime ECL stage 2 Credit not impaired	(13)	83	(70)	-	-
Transferred to lifetime ECL stage 3 Credit impaired	-	(6)	6	-	-
Uncollectable written off	-	-	(11)	(11)	(7,168)
Balances at the closing of the year	1,233	193	3,612	5,038	5,583

Amount in £000

Financial investments	2019				2018
	Stage 1	Stage 2	Stage 3	TOTAL	TOTAL
Balances at the beginning of the year	2	-	-	2	8
New provisions	2	-	-	2	2
Increased provisions	31	-	-	31	5
Net measurement of loss allowance	33	-	-	33	7
Other movement	(4)	-	-	(4)	1
Impairment of FVOCI investment shown under OCI	(30)	-	-	(30)	(14)
Balances at the closing of the year	1	-	-	1	2

The following table provides reconciliation between:

- Amounts shown in above tables reconciling of opening and closing balances of loss allowance per class of financial instrument; and
- The impairment losses on financial instruments' line item in the statement of profit and loss.

	Amount in £000			
	Due from banks at amortised cost	Loans and advances to customers at amortised cost	Financial investments	Total
New provisions	75	215	2	292
Increased provisions	162	783	31	976
Uncollectable recovered / settled	(39)	(1,532)	-	(1,571)
Total - 2019	198	(534)	33	(303)
Total – 2018	54	(987)	7	(926)

IFRS 9 models are reviewed on a periodic basis with any material change being approved at the Board

11. Asset Encumbrance

Certain assets are pledged as collateral to secure liabilities under Credit Support Annex (“CSA”) for derivative liabilities and as security deposits relating to FX forward transactions. The holders of these securities do not have the right to sell or re-pledge the asset except where specifically disclosed. The aggregate amount of collateral pledged under CSAs is £150,000.

12. Employee Remuneration Policy

12.1 Remuneration governance and decision-making

The UK Human Resource Committee (the HRC) assists the Executive Committee in employees’ development strategies and plans, including their Continuous Professional Development. The HRC review and approve performance appraisal process. It ensures that the Bank has put in place required procedures to ensure effective implementation and continuous compliance with the requirements of all relevant UK employment rules and regulations including Senior Management and Certification Regime.

The Board is responsible for review and approval of Bank’s HR Policy including remuneration practices. The Board on the recommendation of Chief Executive Officer approves annual staff remuneration plan for the year along with total remuneration for senior executive staff including Material Risk Takers (MRTs).

12.2 Performance and reward

The Bank’s remuneration policy is in line with market practice and is weighted towards performance-based compensation plan. The Bank is fully cognisant of having a remuneration policy, which is aligned with its long-term objectives and can provide support in the successful implementation of its business strategy. The remuneration policy has been developed while keeping in view the core values of the Bank, which has trust as its core supported by integrity, team work, respect, responsibility and commitment. Values are upheld continuously and embedded at all levels of the organization.

The Bank recognises that robust performance assessment is essential for the sustained success and development of the Bank and its employees. The Bank’s performance assessment creates a shared vision of the purpose and aims of the Bank and ensures that each employee understands how he or she makes their contribution.

Performance is reviewed annually against pre-defined measures and efforts are recognized through a combination of monetary and non-monetary benefits. The performance management framework is managed through the Bank’s HR Committee and senior executive management.

The Bank’s objectives, organisation structure, and HR policies are integrated for best results. This works within an effective control framework and focus on the customer in order to implement the Bank’s business strategy.

The Bank's remunerations structure is not linked to any pre-defined business targets for front-end staff. Annual performance rewards are based on overall performance of the Bank and then of the employee based on overall achievement during the year. A key consideration given in evaluating the performance of employees is their overall conduct and compliance with relevant rules and competencies demonstrated during the year.

Annual performance is a self-assessment process where employees assess their own performance against their job profile, which is evaluated, agreed objectives with the line manager. Compliance function also provides their input in on adherence of certification regime staff with their required competencies

HBZ has been designated as a Level 3 firm by the FCA and as such is not required to have a deferral policy. There is no deferred portion of bonus applicable, and the bonus is paid in cash only). There are currently no Long-Term Incentive Plans or other executive incentive schemes in place and Bank has no plans to implement any in the future.

The Bank's Capital Adequacy Ratio will not be affected by the remuneration policy.

The Bank identified 37 employees as MRTs, whose professional activities were considered to have a material impact on the Bank's risk profile. The remuneration of the MRTs for 2019 was £2.5 million.

Appendix 1 Standardised approach - Credit risk exposure and CRM effects - CR4

Asset classes	Exposures before CCF and CRM		Exposures post-CCF and post-CRM		RWA and RWA density	
	On-balance sheet	Off-balance sheet	On-balance sheet	Off-balance sheet	RWA	RWA density
Sovereigns and their central banks	58,690		58,690		-	0%
Multilateral development banks	33,173		33,173		-	0%
Financial institutions	144,704	12,063	144,704	128	56,096	36%
Corporates	3,849		3,849		2,699	70%
Retail	37		37		28	75%
Exposures secured against real estate	395,433		389,900		308,497	78%
Exposures at default	6,569		6,569		9,854	150%
Other assets	31,680	66,529	12,815	17,472	30,287	31%
	674,135	78,593	649,737	17,600	407,459	54%

Appendix 2 Standardised approach – Exposure by asset class and risk weights– CR5
Total credit exposure amount (post-CCF and post-CRM)

Asst classes	0%	20%	50%	100%	150%	Other	Total
Sovereigns and their central banks	58,690	-	-	-	-	-	58,690
Multilateral development banks	33,173	-	-	-	-	-	33,173
Financial institutions	-	74,528	58,229	12,075	-	-	144,833
Corporates	-	-	2,300	1,549	-	-	3,849
Retail	-	-	-	37	-	-	37
Exposures secured against real estate	-	-	-	276,227	-	113,673	389,900
Exposures at default	-	-	-	-	6,569	-	6,569
Other assets	-	-	-	30,287	-	-	30,287
Total	91,863	74,528	60,529	320,175	6,569	113,673	667,337