

**ZURICH BANK GROUP**

**PILLAR 3**

**RISK MANAGEMENT DISCLOSURES**

**AS AT 31 DECEMBER 2010**

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# **1. Introduction and Scope of Application**

## **1.1 Background**

This document contains the Pillar 3 disclosures required for the Zurich Bank Group (the Group) for the year ending 31 December 2010, under the Capital Requirements Directives. These are in addition to the Basel II Accord Pillars 1 and 2 regulatory requirements. Pillar 1 sets out the minimum capital requirements for a credit institution's credit, operational and market risks. Under Pillar 2, banks undertake an Internal Capital Adequacy Assessment Process (ICAAP) to estimate their own internal capital requirements, which is then the subject of a supervisory review.

The Group became subject to the regulatory requirements of the Capital Requirements Directives on 1 January 2008.

The disclosures contained herein should be read in conjunction with the 2010 annual report and financial statements (the Annual Report) of the Group, where more detailed information is available. This risk management document has not been audited by the Zurich Bank's external auditors. This document will be made available on an annual basis and will be published shortly after the annual report and financial statements. Before publication this report is formally presented to the Board of Zurich Bank for review and approval.

This document will be available on Zurich Bank's website at [www.zurichbank.com](http://www.zurichbank.com).

## **1.2 Scope of Application**

This document sets out the risk management process for the Group, which incorporates Zurich Bank and its subsidiaries. Zurich Bank, the parent bank in the Group, is regulated by the Central Bank of Ireland and prepares its financial statements under International Financial Reporting Standards.

Zurich Bank has a 100% interest in the following operating subsidiaries:

- Dunbar Bank plc,
- Zurich Bank International Limited and
- Zurich Trust Limited.

These are fully consolidated for the purposes of the Annual Report and for prudential supervision, as is Zurich Fund Management Services Limited which ceased trading in October 2010. In addition, Zurich Bank has a 26.38% interest in Tactica Premium Finance Company Limited.

The Directors' Report, Note 36 (Shares in group undertakings) and Note 37 (Investments in associates) of the Annual Report contain more detailed information on each of the companies within the Group. There is no difference in the consolidation treatment of subsidiaries for accounting and regulatory purposes. The Group's investment in the associate company Tactica Premium Finance Company Limited was written down to nil during the year as it was deemed irrecoverable.

Dunbar Bank plc, Zurich Bank International Limited and Zurich Trust Limited are regulated entities and will thus have restrictions imposed on them by their local regulators on the transfer of funds or regulatory capital within the Group. Generally the repayment of capital from a regulated subsidiary to its parent will have to receive the prior approval of that entity's regulator.

## **2. Risk Governance Structure**

### **2.1 Overview**

Zurich Bank is an Irish regulated credit institution wholly owned by the Zurich Financial Services group. It has three direct operating subsidiaries:

- Dunbar Bank plc, a UK bank authorised and regulated by the Financial Services Authority,
- Zurich Bank International Limited, an Isle of Man bank regulated by the Financial Supervision Commission, and
- Zurich Trust Limited, a trust administration services company in Jersey, regulated by the Jersey Financial Services Commission. [NB Zurich Trust Limited has itself established a subsidiary, Zurich Fund Management Services Limited, to provide fund administration services. This activity is discontinued and the entity Zurich Fund Management Services Limited has been renamed. It will be liquidated by the end of 2011.]

Together these entities, and their subsidiaries, comprise the Zurich Bank Group (the Group), which is run as a single business unit.

The Group management structure is based around a series of Board and management committees operating under delegations from, and providing information to, the Board of Zurich Bank and to the wider Zurich Financial Services group.

The Zurich Bank Board (as Board of the parent company within the Group), will make recommendations to the wider Zurich Financial Services group on all aspects of the Group's business that requires approval, except to the extent delegated to it by Zurich Financial Services group. In those situations it will exercise its own authority or delegate to a Board sub-committee, a subsidiary board or the Group Executive Committee, as appropriate.

The Executive Committee, which reports to the Zurich Bank Board, comprises senior management from across Group. It operates under delegations from the Zurich Bank Board. It provides a forum for discussing and resolving issues.

All the Group operating entities have their own boards together with Audit Committees and Balance Sheet and Risk Committees (BSRC) with the exception of Zurich Trust Limited which has a Risk Committee. These bodies oversee the management of their legal entities and ensure compliance with the Group's policies and strategy.

Since the Group is managed as a single entity from a strategic, reporting, HR and IT perspective, additional committees are convened at the Group level to manage these aspects of the business. Various support functions, such as communications and internal audit are outsourced to Zurich Financial Services group. However local legal entities remain responsible for ensuring these deliver an appropriate level of service.

## 2.2 Board of Directors

The Board of each of Zurich Bank Group's operating companies formally approves that entity's financial plan. The Zurich Bank Board formally approves the strategy and financial plan for the consolidated Group, sets its risk appetite, allocates capital and approves new business lines, as well as determining remuneration for all the Group staff through a separate Zurich Bank Board Committee. Final approval of these elements will come from Zurich Financial Services group, in line with its usual practice.

The Zurich Bank Board determines policies on key areas such as accounting, staff remuneration, consumer protection, financial, market, liquidity, credit, and operational risks and systems. These incorporate relevant Zurich Financial Services group policies. The boards of the other entities within the Group incorporate these policies as their own board policies, noting any differences for local circumstances and requirements.

The Boards of Dunbar Bank, Zurich Bank International and Zurich Trust Limited meet at least quarterly and oversee the management and performance of their entity and the strategic issues facing each business. Copies of these minutes are made available to the Zurich Bank Board. The Zurich Bank Board also focuses on the management and performance of the Group as a whole and considers the strategic issues the whole business unit faces.

The Board of each of Zurich Bank Group's operating companies includes that entity's Chief Executive Officer, its Chief Financial Officer or a senior finance representative, and at least two non-executive directors. Non-executive directors fall into two categories:

- Zurich non-executives, being employees of Zurich Financial Services group who do not have executive responsibilities within the Zurich Bank Group;
- Independent non-executives, with no executive responsibilities within Zurich Financial Services group.

The Board of each of Zurich Bank Group's operating companies has established various subcommittees to assist it in managing various aspects of the business. All board committees have harmonised Zurich Bank and local Board approved Terms of Reference that are updated at least annually and promulgated throughout each entity.

## **2.3 Board Committees**

### *Audit Committee*

An Audit Committee, comprising non-executive directors, has been established for each wholly owned operating subsidiary entity by its Board under standard Group Terms of Reference. These audit committees are responsible for reviewing the legal entity's financial statements, the reporting accountants' reviews, any internal audit or compliance reports, any reports from the relevant regulator and any other reports on the effectiveness of the system of internal controls. They agree the internal audit plan, ensure an appropriate risk management and control framework and ensure the Group's adherence to its anti money laundering policy.

### *Remuneration and Nominations Committee*

Zurich Bank is a non-complex organisation as defined by CEBs Guidelines on Remuneration Policies and Practices. Zurich Bank (together with its subsidiaries) is a wholly owned subsidiary of Zurich Financial Services group and adheres in principle to the ZFS Remuneration Rules (the 'ZFS Rules'). In addition, Zurich Bank's Board has established a Remuneration and Nominations Committee, comprising Independent Non-Executive Directors, with responsibility for recommending remuneration policy to the Zurich Bank Board and Zurich Financial Services group, reviewing the results of that policy for the Group and for approving Board appointments to all legal entity Boards. It also confirms that the expertise and independence of outside board members has been adequately reviewed, including their affiliations, relationships and transactions with Zurich Financial Services group and that there is sufficient executive and non-executive financial expertise on each Board Committee.

### *Balance Sheet and Risk Committee*

Each bank board has established a Balance Sheet and Risk Committee, comprising directors and senior management, to oversee the allocation of its risk capital, the implementation of financial, market, liquidity and credit risk policy for their legal entity and to approve transactions within limits delegated by the relevant board. Each Balance Sheet and Risk Committee may further delegate authority for approval of individual transactions or counterparties to a sub-committee such as the Risk Mitigation and Restructuring Committee.

## **2.4 Management Structure**

### *The Executive Committee*

The Executive Committee provides a forum for discussion of key issues. Regardless of the level of Executive Committee involvement, strategic and operating plans will be presented to the relevant board(s) for approval.

### *Credit Committee*

The Balance Sheet & Risk Committee of Zurich Bank International has established a credit sub-committee comprising certain directors and senior management to review and approve its exposures up to the level delegated by the Board. The Credit Committees operate under board approved terms of reference. The Credit Committee is also responsible for ongoing monitoring of the credit portfolio and reports on the portfolio monthly to the Balance Sheet & Risk Committee.

### *Risk Mitigation & Restructuring Committee*

Dunbar Bank and Zurich Bank have each established a Risk Mitigation & Restructuring Committee to manage and monitor the risk mitigation and restructuring actions required in respect of certain of each bank's asset portfolios.

### *Provisioning Panel*

The Zurich Bank and Dunbar Bank Provisioning Panels are each responsible for recommending any provisions requirements in respect of the portfolios to the Zurich Bank and Dunbar Bank Balance Sheet & Risk Committees respectively.

### *ICAAP Steering Group*

The Balance Sheet & Risk Committees have established a sub-committee, the ICAAP Steering Group, to prepare and keep up-to-date its ICAAP document.

### *Risk Forum*

The Balance Sheet & Risk Committee of Dunbar Bank and Zurich Bank International have established Risk Fora to review and monitor operational risk reports and report material matters to the Balance Sheet & Risk Committee. In the case of Zurich Bank and Dunbar Bank, such reports are reviewed at the Balance Sheet & Risk Committee directly.

### *Retail Liabilities Committee*

Each Balance Sheet & Risk Committee has established a single committee to manage its retail liabilities business. Operating under board approved terms of reference, this committee reports to the Balance Sheet & Risk Committees on a monthly basis.

### *Liquidity Steering Group*

The Zurich Bank and Dunbar Bank Balance Sheet & Risk Committees have each established this sub-committee, to coordinate liquidity matters and to ensure compliance with the regulatory liquidity regime including the production of the ILAA document, as required by the FSA.

## **2.5 Zurich Bank Group Central Functions**

### *Risk*

The risk function operates as a single function across the Group and monitors all risk types including credit risk, market risk, liquidity risk and operational risk.

The Group has developed and approved a Risk Manual, which defines the framework within which the banks can operate.

Boards set out details of each entity's risk appetite by reference to Zurich Financial Services group and the Group policy consistent with the capital allocated to the Group as part of the Zurich Financial Services group planning process.

This risk appetite is used to define limits, allocate capital and construct a risk framework for the Group. These elements are all assessed in accordance with the Group's policies. The Group's Chief Risk Officer is responsible for maintaining and managing these limits and overseeing the risk framework.

### *Compliance*

Compliance ensures that each entity meets all its regulatory obligations. This includes everything from approving client literature and day to day compliance monitoring to identifying, analysing and implementing new requirements.

### *Internal Audit*

Zurich Financial Services' Group Audit department is responsible for providing the internal audit resource for the entire Zurich Financial Services group.

### *Legal*

Legal support is provided by the Group's Legal department and, if required, by Zurich Financial Services' Group Legal department.

### *Finance*

Financial control including all statutory, management and regulatory reporting is largely carried out for all entities in the Group by a central finance function.

### *Treasury*

Each bank in the Group has outsourced its treasury execution and market risk reporting to an affiliated Zurich Financial Services' treasury operations centre in Dublin.

### *Operations*

Generally, operations are undertaken within the Zurich Bank Group. However, certain tasks are outsourced. In these instances, the Group retains the management and monitoring of operational activity.

### *Human Resources*

Zurich Bank has its own HR function and the Head of HR is responsible for implementing the Group policy, as determined by Zurich Bank's Remuneration and Nominations Committee, across entities. Local Zurich Financial Services group HR support is provided to support business as usual activities such as payroll processing and recruitment.

### 3. Capital Structure

The regulatory capital of the Group is divided into two tiers:

- Tier 1 capital and
- Tier 2 capital.

Tier 1 capital comprises:

- ordinary issued share capital plus share premium,
- retained earnings or losses,
- intangible assets and certain deductions required by the Central Bank of Ireland.

Tier 2 capital comprises qualifying subordinated loan capital, qualifying collective impairment allowances and supervisory deductions. The subordinated loan capital of the Group includes £94m (£35m and Eur69m) of floating rate subordinated 10 year notes which have been issued to a member of the Zurich Financial Services group, which will mature on 30 December 2019. In addition, a £30m perpetual subordinated loan was received by the Group in June 2010 from Zurich Financial Services. The Subordinated Debt may not be repaid without the prior consent of the Central Bank of Ireland.

The following table sets out the Group's capital structure. Tier 1 represents original own funds and Tier 2 constitutes additional own funds.

**Table 3.1 Capital structure:**

	<b>Group 2010 £'000</b>
<b>Tier 1 capital</b>	
Share capital & share premium	438,000
Retained losses	(228,799)
Intangible assets	(1,463)
<b>Total qualifying Tier 1 capital</b>	<b>207,739</b>
<b>Tier 2 capital</b>	
Subordinated debt	124,235
Collective impairment allowance	22,287
<b>Total qualifying Tier 2 capital</b>	<b>146,522</b>
<b>Total regulatory capital</b>	<b>354,261</b>

## **4. Capital Adequacy**

### **4.1 Objectives and Policies**

The objectives of the Group's capital management policy are:

- to comply with the capital requirements set out by the regulators of the respective entities;
- to safeguard the Group's ability to continue as a going concern so that it can continue to provide returns for shareholders and benefits for other stakeholders; and
- to maintain a strong capital base to support the development of the business.

The Group's ICAAP (Internal Capital Adequacy Assessment Process) document sets out the framework for the Group's overall capital and regulatory risk management. This document is regularly reviewed and updated and is submitted for review and approval to the Board. On an ongoing basis, the Balance Sheet and Risk Committee will consider the ICAAP document to ensure that the Group is adequately capitalised considering its latest assessment of the markets in which it is operating and that it has an appropriate asset allocation and origination strategy.

Capital adequacy and the use of regulatory capital are continually monitored by the Group's management, employing techniques based on the guidelines developed by the Basel Committee and the European Union (EU) directives, as implemented by the Central Bank of Ireland for supervisory purposes. These techniques include stress testing and scenario analysis.

The Group manages its capital in accordance with the capital requirements set by the Central Bank in Ireland which reflects the EU Capital Adequacy Directive. These requirements set a floor under which capital levels must not fall. The Group seeks to maintain sufficient capital to ensure that these requirements are not breached.

### **4.2 How the Capital Adequacy objectives are met**

The Group meets its objectives in terms of capital management through the holding of capital ratios above the minimum levels set by the Central Bank of Ireland. The Group stress tests the capital held to ensure that under stressed conditions it continues to comply with regulatory minimal ratios. It also seeks to minimise refinancing risk by managing the maturity profile of non-equity capital.

Capital management forms an integral part of the overall Group annual financial planning exercise which takes place each autumn for the following three full years. Thereafter the financial forecast is updated once a quarter, or more often where necessary, to reflect any material changes to the operating or financial environment.

### **4.3 Capital Requirements**

The tables overleaf summarise the composition of regulatory capital for the Group.

The Group has adopted the Basel II standardised approach to calculating capital requirements for its entire portfolio.

**Table 4.3.1 Detailed capital ratio calculation for the Group including capital required by portfolio**

	<b>Group 2010 £'000</b>
<b>Tier 1 capital</b>	
Share capital and premium	438,000
Retained losses	(228,799)
Less: Intangible assets	(1,463)
<b>Total qualifying Tier 1 capital</b>	<u>207,739</u> <b>A</b>
<b>Tier 2 capital</b>	
Subordinated debt	124,235
Collective impairment allowance	22,287
<b>Total qualifying Tier 2 capital</b>	<u>146,522</u>
<b>Total regulatory capital</b>	<u>354,261</u> <b>B</b>
<b>Risk Weighted Assets - Capital required</b>	
<b>Credit risk</b>	
Institutions	921
Corporates	2,270
Retail	1,043
Secured by real estate property	29,856
Past due items	71,245
Items belonging to regulatory high-risk categories	961
Short-term claims on institutions and corporate	8,941
Collective investments undertakings (CIU)	2,921
Other items	3,026
<b>Market risk</b>	
Foreign exchange risk	572
<b>Operational risk</b>	<u>10,064</u>
<b>Total Pillar 1 Capital Required</b>	131,820 <b>C</b>
Pillar 2 capital requirement	165,499
<b>Total Pillar 1 &amp; Pillar 2 Capital Required</b>	<u>297,319</u> <b>D</b>
Tier One Ratio (A/(D/8%))	5.6%
Total Pillar 1 & Pillar 2 Capital Ratio (B/(D/8%))	9.5%

Pillar 2 capital is Zurich Bank's internal capital assessment over and above Pillar 1 credit, market and operational risk capital elements. This is arrived at by deducting the Pillar 1 capital requirement from the Group's overall internal capital assessment.

#### 4.4 Post year-end Capital Resources and Requirements

There have been no capital movements since July 2010.

The total regulatory capital at 30 June 2011 was £353m.

	<b>Group Jun-11 £'000</b>	
Tier 1 capital	182,208	<b>A</b>
Tier 2 capital	134,392	
<b>Total regulatory capital</b>	<u>316,600</u>	<b>B</b>
Credit risk	102,435	
Market risk	1,939	
Operational risk	10,030	
<b>Total Pillar 1 Capital Required</b>	<u>114,404</u>	
Pillar 2 capital requirement	165,586	
<b>Total Pillar 1 &amp; Pillar 2 Capital Required</b>	<u>279,990</u>	<b>D</b>
Tier One Ratio (A/(D/8%))	5.2%	
Total Pillar 1 & Pillar 2 Capital Ratio (B/(D/8%))	9.0%	

## **5. Credit Risk**

### **5.1. Credit Risk Management Objectives and Policies**

Credit risk is defined as the current or prospective risk to earning and capital arising from an obligor's failure to meet the agreed terms of any contract with the Group.

Note 3.1 of the Annual Report contains detailed information on the following elements of credit risk management:

- A. Strategies and processes
- B. Structure and organisation
- C. Risk measurement systems
- D. Policy and monitoring processes for hedging/mitigating risk

### **5.2. Credit Risk Management General Disclosures**

#### **A. Impairment and provisioning policies**

The Group Impairment and Provisioning policy sets out the framework for the management and monitoring of past due and impaired loans.

The criteria that the Group uses to assess whether an individual financial asset is impaired are disclosed in Note 3.1.3 of the Annual Report.

Responsibility for approving impairment provisions is delegated to the Balance Sheet & Risk Committee. All new property provisions and changes to existing property provisions greater than £1m/€1m up to £5m/€5m will be referred to the Group's Non Executive Chairman for information. All new property provisions and changes to existing property provisions greater than £5m/€5m will be referred to the Group's Non Executive Chairman for approval. The Board receives a report of all movements in impairment provisions against individual assets.

#### **B. Gross credit risk exposure**

Maximum exposure to credit risk before collateral held or other credit enhancements, as at 31 December 2010, is disclosed in Note 3.1.4 of the Annual Report. As the period end position is representative of the risk positions of the Group during the period, average gross exposures are not disclosed.

#### **C. Geographic distribution of credit exposures**

Note 3.1.6(a) of the Annual Report discloses the main credit exposures at their carrying amounts, as categorised by geographical location, as at 31 December 2010.

#### **D. Industry/counterparty type distribution of credit exposures**

Note 3.1.6(b) of the Annual Report discloses the main credit exposures at their carrying amounts, as categorised by industry sector, as at 31 December 2010.

### E. Residual contractual maturity by credit exposure

The Group has availed of the provision to use maturity groupings as disclosed in the Annual Report. Note 3.2.4 of the Annual Report discloses the Group's financial instruments at carrying amounts, categorised by the earlier of contractual repricing or maturity dates as at 31 December 2010.

### F. Amount of impaired and past due loans by major industry/counterparty type

Note 3.1.5 of the Annual Report discloses the amount of impaired and past due loans by major industry type as at 31 December 2010.

### G. Charges for specific provisions by major industry/counterparty type

<b>Specific Allowance for Impairment</b>	<b>Group Secured on property £'000</b>	<b>Group Other £'000</b>	<b>Group Total £'000</b>
<b>Balance at 1 January 2010</b>	142,113	365	142,478
Additional provisions made during the year	220,122	725	220,846
Release of interest income to income statement	(12,652)	-	(12,652)
Exchange Differences	(2,716)	-	(2,716)
<b>Total charged to income statement</b>	<b>204,754</b>	<b>725</b>	<b>205,478</b>
Loans written off during the year as uncollectible	-	(448)	(448)
Amounts recovered during the year	66	-	66
<b>Balance at 31 December 2010</b>	<b>346,933</b>	<b>642</b>	<b>347,574</b>

  

<b>Portfolio Allowance for Impairment</b>	<b>Group Secured on property £'000</b>	<b>Group Other £'000</b>	<b>Group Total £'000</b>
<b>Balance at 1 January 2010</b>	15,508	541	16,049
Additional provisions made during the year	4,607	209	4,815
Exchange Differences	1,423	-	1,423
<b>Total charged to income statement</b>	<b>6,030</b>	<b>209</b>	<b>6,239</b>
Loans written off during the year as uncollectible	-	-	-
<b>Balance at 31 December 2010</b>	<b>21,538</b>	<b>750</b>	<b>22,288</b>

### H. Amount of impaired and past due loans by geographical area

Note 3.1.6(a) of the Annual Report discloses the amount of impaired and past due loans by geographical area as at 31 December 2010.

### I. Specific and general provisions by geographical area

Note 3.1.6(a) of the Annual Report discloses the amount of specific and general provisions by geographical area as at 31 December 2010.

### J. Reconciliation of changes in allowances for loan impairment.

See above "Specific and general provisions by major industry/counterparty type".

### 5.3. Credit Risk Disclosures for the Standardised Approach

Credit risk portfolios are subject to the standardised approach under Pillar I and scenario analysis under Pillar II. The Group uses Moody's Investors Services as its nominated External Credit Assessments Institution for monetary financial institution and corporate exposures. Exposures to which credit ratings are assigned are mapped to risk weights using mapping guidelines issued by the Central Bank of Ireland. These guidelines are identical to those issued by the Committee of European Banking Supervisors (CEBS).

The Group has received cash collateral from an affiliate as a risk mitigation technique in relation to a total return swap. This cash collateral is used to reduce the regulatory capital requirements for credit risk.

The table below illustrates the effect of collateral held on regulatory capital requirements for credit risk:

	<b>Capital required before Mitigation 2010 £'000</b>	<b>Risk Mitigation 2010 £'000</b>	<b>Capital Required 2010 £'000</b>
<b>Credit risk</b>			
Institutions	1,600	(679)	921
Corporates	3,908	(1,638)	2,270
Retail	1,043		1,043
Secured by real estate property	29,856		29,856
Past due items	71,245		71,245
Items belonging to regulatory high-risk categories	961		961
Short-term claims on institutions and corporate	8,941		8,941
Collective investments undertakings (CIU)	2,921		2,921
Other items	3,026		3,026
	<b>123,501</b>	<b>(2,317)</b>	<b>121,184</b>

The following table sets out the Group's total exposures (including undrawn commitments) after credit risk mitigation analysed across the credit quality assessment steps. None of these exposures are deducted from capital in arriving at the Group's solvency requirements.

<b>Credit quality assessment step</b>	<b>Total exposure value after CRM £'000</b>
Step 1	730,760
Step 2	41,826
<b>Total rated</b>	<b>772,586</b>
Unrated	1,371,644
<b>Total</b>	<b>2,144,230</b>

Moody's ratings of Aaa to Aa3 applies to the credit quality assessment step 1 and ratings of A1 to A3 applies to step 2. There is a total of £62.9 million credit risk mitigation; £20.5 million of which relates to the unrated portion of the corporate exposure class and the remaining £42.4 million relates to exposure to institution rated at 20%. Therefore the total exposure value before CRM is £2,207 million.

## 5.4. Credit Risk Mitigation

### A. Credit risk mitigation policies and processes

Note 3.1 of the Annual Report contains detailed information on the Group's credit risk mitigation policies and processes.

### B. Policies and processes for collateral valuation and management

Note 3.1.2 of the Annual Report contains detailed information on the Group's policies and processes for collateral valuation and management.

For the purpose of financial reporting and solvency calculation the Group does not use on and off balance sheet netting. The collateral amounts held, which are used in the solvency calculation, are the cash collateral amounts related to the total return swap and the equity index swaps. As these are cash deposits they can be readily valued. Zurich Treasury Services Limited, under a service level agreement, manages the amount of this collateral and ensures it is sufficient to cover the exposure arising from these derivatives. The collateral relating to the total return swap is reported as part of the monthly submission to the Balance Sheet and Risk Committee.

It is normal practice for the Group to take security over the relevant property being financed. This will generally take the form of a first legal charge; however, where the customer is a corporate entity an additional floating charge may be put in place. Guarantees are often taken as security for the purposes of providing loans on property. Given the nature of the Group's business, a substantial portion of the collateral it takes over loans to customers is exposed to movements in the UK and Irish property markets. This concentration is however mitigated by the loan book being diversified across residential and commercial customers and over different industry segments.

The Group has a number of Credit Support Annexes (CSAs) in place with derivative counterparties. A CSA is used to document collateral arrangements between two derivative counterparties and often uses standard documentation issued by the International Swaps and Derivatives Association (ISDA). These CSA's provide additional credit protection for the Group where a derivative contract is in an asset position by requiring the counterparty to place cash collateral with the Group.

The Group did not enter into any Credit Default Swaps during 2010.

### C. The total exposure covered by eligible financial collateral

The gross exposure covered by eligible financial collateral is as follows:

	<b>Group 2010 £'000</b>
Future credit exposure plus positive MTM	120,401
Cash collateral held	(62,914)

## **5.5. Counterparty Credit Risk**

### **A. Counterparty credit risk policies and processes**

Note 3.1 of the Annual Report contains detailed information on the Group's policies and processes for managing counterparty credit risk.

Counterparty credit risk is the risk of loss resulting from a counterparty default on derivative contracts with the Group. Current credit exposures for derivatives is defined as the aggregated amount of the positive mark to market of the trade plus the potential credit exposures (PCE) and adjusted for collateral. PCE is calculated as the principal notional amount multiplied by a conversion factor based on the maturity of the transaction and the type of derivative contract. This is sometimes known as 'pre settlement' risk.

The Zurich Bank Credit department sets the credit limits for financial institution counterparties for the Group. The Group may set limits for, and transact with, those financial institutions on Zurich Financial Services' Group Credit Risk Management authorised counterparty list for financial institution counterparties as published on the Group intranet and updated from time to time. The Zurich Bank Credit Department will monitor daily utilisation to ensure the aggregate of Group exposures do not exceed the limits.

Cash deposits are generally the only form of collateral accepted by the Group in relation to exposures arising from derivative contracts. The terms governing this collateral are set out in the relevant CSA or trade documentation.

It is not the policy of the Group to be exposed to "wrong way risk" in relation to its derivative counterparties. Wrong way risk occurs when exposure to a counterparty is negatively correlated with the credit quality of that counterparty.

None of the Group's main CSAs have downgrade triggers. Thus, a downgrade in the Group's credit rating would not have a significant adverse effect on the amount of collateral which it would need to place with derivative counterparties. Therefore, this is not deemed a significant risk for the Group.

## B. Notional and fair value of positive derivative contracts

Note 15 of the Annual Report discloses the notional and fair value of all derivative contracts as at 31 December 2010. The Group does not enter into credit default swaps. The total return swap purchased from a Zurich Financial Services group company in relation to the portfolio of investments in hedge fund of funds is set out in section 5.4 above.

The following table sets out the counterparty credit risk exposures to derivative transactions:

<b>Counterparty credit risk - banking book</b>					
	Positive fair value of contracts £'000	Add-ons £'000	Gross positive fair value of contracts (incl. add-ons) £'000	Financial collateral held £'000	Net derivatives credit exposure £'000
OTC derivatives	62,475	57,757	120,231	(62,744)	57,487

Over the counter (OTC) derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange.

## **6. Market Risk**

Market risk is the risk to the Group's earnings or shareholder value arising from adverse movements in prices (i.e. bond, security or commodity) or foreign exchange rates.

### **6.1. Market Risk Management Objectives and Policies**

Note 3.2 and Note 3 of the Annual Report contains detailed information on the following elements of market risk management:

- A. Strategies and processes
- B. Structure and organisation
- C. Risk reporting and/or measurement systems
- D. Policy and monitoring processes for hedging/mitigating risk

### **6.2 Market Risk Capital Requirements**

The Group does not operate a trading book but for regulatory purposes it is required to hold capital against market risk in the banking book for foreign currency risk. The capital requirements for market risk, as at 31 December 2010, are set out in Table 4.3.1 above.

## **7. Operational Risk**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, human error, unauthorised activity and systems or external events.

### **7.1. Operational Risk Management Objectives and Policies**

Note 3.5 of the Annual Report contains detailed information on the following elements of operational risk management:

- A. Strategies and processes
- B. Structure and organisation
- C. Risk reporting and/or measurement systems
- D. Policy and monitoring processes for hedging/mitigating risk

### **7.2 Operational Risk Capital Requirements**

The capital requirements for operational risk, as at 31 December 2010, are set out in Table 4.3.1 above. The Group has adopted the Basic Indicator Approach for the purposes of calculating the capital requirements for operational risk. This approach calculates the capital required for operational risk by taking 15% of the Group's average operating income over the last three years.

## 8. Equity Risk

Equity risk is the risk of a loss in earnings due to volatility in the valuation of equity investments.

### 8.1. Equity Risk Management Objectives and Policies

The Group's strategy is to minimise its exposure to equity risk. Limits are set by the Board and are monitored on a daily basis by Zurich Treasury Services Limited under a service level agreement. Monthly monitoring reports are presented by the Treasurer to the Balance Sheet and Risk Committee. Where the Group is exposed to equity risk as part of its structured deposit raising activities, this is substantially hedged with equity index swaps entered into with approved financial institutions. The effectiveness of these hedges is monitored on an ongoing basis.

Although the Group holds a portfolio of hedge funds in the amount of £37 million at 31 December 2010, these investments are covered by a total return swap, which exchanges the equity risks and benefits for a fixed return over Libor from a Zurich Financial Services group entity. These hedge funds are unlisted and none were issued by public bodies or banks. The Group only bears a minimal amount of equity risk directly through its investment in associates and this is held for strategic purposes. Further details on the accounting treatment of associates can be found in note 2.2 of the Annual Report.

### 8.2 Equity Risk Quantitative Disclosures

#### A. Composition of movements

See table below for hedge fund movements in 2010. None of these investments are publicly quoted. There were no unrealised gains or losses recognised in the income statement, as they were eliminated by an equivalent unrealised gain or loss on the total return swap.

	<b>2010</b>
	<b>£'000</b>
Opening Market Value	249,549
Sales	(163,367)
Gains/Loss through P&L	(49,667)
<b>Closing Market Value</b>	<b>36,515</b>

As at 31st December 2010 £0.4m (2009:£74m) of hedge fund holdings at market value was classified as receivables from investment brokers for which a redemption request has been made

#### B. Capital requirements

As the Group only bears a minimal amount of equity risk directly and does not have a trading book, its capital requirement in the banking book is calculated using the Standardised Approach.

## 9. Interest Rate Risk in the Banking Book (IRRBB)

Interest rate risk in the banking book (IRRBB) is the Group's sensitivity to earnings volatility arising from movements in interest rates.

### 9.1. Interest Rate Risk Management Objectives and Policies

Note 3.2.4 and Note 3 of the Annual Report contains detailed information on the following elements of interest rate risk management:

- A. Strategies and processes
- B. Structure and organisation
- C. Risk reporting and/or measurement systems
- D. Policy and monitoring processes for hedging/mitigating risk

### 9.2. Nature and key assumptions, including assumptions regarding loan prepayments and behaviour of non-maturity deposits

Interest risk arises for the Group in two main ways:

- Mismatches in the cash flows, repricing dates and basis used for the calculation of interest across the different assets and liabilities held by the Group
- Fluctuations in interest income earned on shareholder funds and fixed rate loans / deposits.

An interest rate sensitivity (PV01) test is performed daily to calculate the effect of a one basis point increase in interest rates on earnings for each bank within the Group. This is presented by the Treasurer to the Balance Sheet and Risk Committee for consideration on a monthly basis. For the purpose of this calculation it is assumed that cash flows will occur on their contractual dates.

The table below shows the results as at 31 December 2010

<b>Impact of a +0.01% rise in interest rates on the banking book</b>		
	<b>2010</b>	<b>2010</b>
	<b>Absolute amt</b>	<b>% of Own funds</b>
<b>Currency</b>		<b>%</b>
EUR	298	0.0001%
GBP	6,517	0.0018%
USD	251	0.0001%
<b>Total</b>	<b>7,067</b>	<b>0.0020%</b>

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