Bermuda Commercial Bank Limited

Basel II, Pillar 3 Disclosure - September 30, 2015

BCB
Bermuda Commercial Bank Limited

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Background

Introduction

The disclosure and analysis provided in this document relate to Bermuda Commercial Bank Limited (“BCB” or “the Bank”) which is incorporated in the island of Bermuda as a limited liability company. It is intended to be read in conjunction with the relevant Annual Audited Financial Report which includes important details about the Bank’s capital adequacy, risk management, and other information. The disclosures are prepared on a consolidated group basis.

BCB’s accounting policies conform to International Financial Reporting Standards (IFRS).

The Bank has a banking licence under the Bank and Deposit Companies Act, 1999. These disclosures are solely in the context of the local regulatory requirements and guidelines provided by the Bermuda Monetary Authority (”BMA” or “the Authority”) under Pillar 3 “Market Discipline of New Capital Adequacy Framework”. The Pillar 3 disclosures have been designed to complement the minimum capital requirements in Pillar 1 as well as the Supervisory Review and Evaluation Process in Pillar 2. The accepted aim of Pillar 3 is to promote market discipline by allowing market participants access to information of risk exposures and risk management policies and processes adopted by the Bank.

Frequency

The disclosures in this report are required to be updated on a semi-annual basis and more frequently if significant changes to policies are made. This report has been updated as at September 30, 2015 and policies disclosed within are effective at this time. All disclosures are published semi-annually in conjunction with BCB’s annual (September 30) reporting processes.

Report Conventions

The disclosures in this report are not required to be audited by an external auditor. However, the disclosures have been prepared on a basis consistent with information submitted to the Bermuda Monetary Authority (BMA).

Basel II & Basel III

Until the end-December 2015, Bermudian Banks are required to follow the Basel II capital adequacy framework, of which this disclosure forms a part, after which it will adopt the Basel III framework. This incorporates transitional arrangements until full implementation in 2019. These reforms strengthen capital and liquidity rules with the goal of promoting a more resilient banking sector that is able to absorb shocks arising from economic and financial stress.

BCB monitors its capital position against both the Basel II and Basel III frameworks and all businesses are operating cognisant of this. New transactions at BCB are also now evaluated on a fully implemented Basel III basis.

BCB has adopted the Basic Indicator Approach as being most appropriate for the scale and scope of the Bank's operations. Accordingly the Bank has agreed its Capital Adequacy and Risk Profile (CARP) document with the BMA. BCB's position at September 30, 2015 already exceeds the Basel Committee's 2019 fully implemented Basel III requirements, i.e. minimum ratios plus capital conservation buffer.

Overview of the Bank

BCB was founded more than 40 years ago, when a group of Bermudians formed a local savings and loan institution. The Bank has evolved to become the only Bermudian Bank focused on servicing the local and international corporate and commercial business communities as well as high net worth clients. The Bank has mastered the art of banking providing the highest standards of service to clients worldwide. BCB has been guided by a corporate philosophy centred on the provision of innovative, quality service with minimal risk tailored to the specific needs of its clients.

Effective October 1, 2012, BCB became a wholly-owned subsidiary of Somers Limited ("Somers"), formerly known as Bermuda National Limited. BCB delisted from the Bermuda Stock Exchange and Somers became the listed entity on the Bermuda Stock Exchange.

In September 2015, the Bank acquired a majority shareholding in Private & Commercial Finance Group plc ("PCFG"). Established in 1994, PCFG is an AIM-quoted finance house which has two main operating divisions:

- Consumer Finance which provides finance for motor vehicles to consumers; and
- Business Finance which provides finance for vehicles, plant and equipment to SMEs.

The management of risk is an important criterion to all users of financial services. The Bank has established a policy of managing its risk by following a conservative policy in balance sheet management. The Bank maintains a conservative leverage ratio and follows other principles and policies on risk management which are aligned to BMA regulations.

Scope of Application

The capital adequacy framework implemented in Bermuda and these disclosures apply to BCB and its subsidiaries.

BCB is incorporated in Bermuda with limited liability. The Bank has a number of wholly-owned and controlled subsidiaries. These subsidiaries are subject to consolidation requirements under IFRS and under the capital adequacy framework.

Subsidiary Undertakings

Name	Location
BCB Charter Corporate Services Limited	Bermuda
BCB Paragon Trust Limited	Bermuda
BCB Luxembourg S.A.R.L.	Luxembourg
BCB Asset Management Limited	Bermuda
BCB Resource Fund Limited	Bermuda
BCB Management Limited	Bermuda
BCB Management Services Limited	Bermuda
Bercom Nominees Limited	Bermuda
Private & Commercial Finance Group plc	United Kingdom
VT Strategies Holdings Limited	Bermuda

As at September 30, 2015, all subsidiaries were wholly-owned by BCB, except for PCFG which was 75.47% owned. All of the above subsidiaries are included in the Bank's consolidated financial statements.

The Bank and its subsidiaries are subject to annual audit, on a consolidated basis, by an external audit firm and the Annual Consolidated Financial Report is published in hard copy and is also available on the BCB website. Further, the Bank and its subsidiaries are subject to supervisory oversight and onsite inspection by the BMA.

Capital Structure

The capital structure of the Bank comprises of (a) Tier 1 capital which includes share capital, retained earnings, share premium, less goodwill and intangibles and (b) Tier 2 general provisions / general loan-loss reserves.

Composition of Capital as at Sept 30, 2015 (in $US thousands)

Tier 1 Regulatory Capital	
Ordinary shares / common stock (issued and paid up)	16,808
Share premium account	22,131
Reserves	68,642
Goodwill and other intangible assets	(9,951)
Total Tier 1 Capital	**97,630**
Tier 2 Regulatory Capital	
General provisions (eligible for inclusion)	0
Total Tier 2 Capital	**0**
Total Tier 1 & 2 Capital	**97,630**
Capital Deductions	
Investments in other commercial entities	0
Other	101
Total Capital Deductions	**101**
Total Eligible Capital Base	**97,529**

Capital Adequacy

Sufficient capital must be in place to support business activities, according to both the Bank's internal assessment and the requirements of the Authority.

BCB's goal is to maintain sound and optimal capital ratios at all times. The Bank constantly reviews the current position and projected developments in both its capital base and capital requirements. The main source of the Bank's supply of capital is shareholder investment and retained earnings.

The capital management process is based on the following steps:

- The monitoring of the regulatory capital and ensuring that the minimum regulatory requirements and the established internal targets are met.
- The estimation of the capital requirements based on ongoing forecasting and strategic planning.
- The reporting of the regulatory capital situation to both the Senior Management Group and the BMA.

Responsibility for overseeing these steps is vested with the Asset and Liability Committee ("ALCO").

Ratios for Tier 1 and Total capital of BCB as at September 30, 2015 are set out below.

BCB Tier 1 capital ratio	21.13%
BCB Total capital ratio	21.11%

BCB's capital ratios are above both the regulatory minimum capital ratios required by the BMA, and the Board imposed internal minimum capital requirement.

Risk Weighted Assets (RWA)

RWA are a risk based measure of exposures used in assessing overall capital usage of the Bank. When applied against eligible regulatory capital the Bank's overall capital adequacy is determined. RWA are calculated in accordance with BMA Prudential Standards. The Bank's total RWA as at September 30, 2015 is set out below.

BCB risk weighted assets	$461.99 million

The following table shows BCB's overall minimum Pillar I capital requirement for credit, operational, and market risk, based on 8% of risk weighted assets:

Minimum Capital Requirement based on 8%	Sep 30, 2015 ($'000)
Cash	4
Claims on Sovereigns	90
Claims on Corporates	8,885
Claims on Banks and Securities Firms	4,834
Securitisations	2,503
Retail Loans	9,023
Residential Mortgages	37
Past Due Loans	1,175
Other Balance Sheet Exposures	5,739
Non-market Related Off Balance Sheet Credit Exposures	241
Total Credit Risk Capital Requirement	**32,530**
Operational and Market Risk Capital Requirements	4,430
Total Pillar 1 Capital Requirement	**36,960**
Eligible Capital	**97,529**
Excess over capital requirement	**60,569**
% Capital excess	**164%**

Risk Management and Control Framework Overview

The management of risk is core to the Bank's activities. The Board has overall responsibility for maintaining internal controls to ensure that effective risk management and oversight processes operate across the Bank. The Bank has defined its approach in its Enterprise Risk Management Framework ("ERMF") which has been reviewed and approved by the Board. This is based on the concept of three lines of defence.

The first line of defence for risk management rests with business managers whose primary role includes the day-to-day monitoring, management and, where required, mitigation of risk. The second line of defence rests with Risk and Compliance who are responsible for establishing and maintaining the Bank's risk management framework; and for providing oversight and challenge of the effectiveness of the business's management and mitigation of risk. Internal Audit, the third line of defence, provides independent assurance on the activities of the firm including the risk management framework; and assesses the appropriateness and effectiveness of internal controls.

1st Line of Defence	2nd Line of Defence	3rd^t Line of Defence
The Businesses Management Risk Committee Asset & Liability Committee (Report to the Board Risk Committee)	**Risk and Compliance** Board Risk Committee (Reports to the Board)	**Internal Audit** Audit Committee (Reports to the Board)
Chief Executive delegates to divisional and operating business heads day-to-day responsibility for risk management, regulatory compliance, internal control and conduct in running their divisions or businesses.	Board Risk Committee delegates to the Chief Risk Officer day-to-day responsibility for oversight and challenge on risk related issues.	Audit Committee mandates the Internal Auditor with day-to-day responsibility for independent assurance.
Business management has day-to-day ownership, responsibility and accountability for risks: • Identifying and assessing risks; • Managing and controlling risks; • Measuring risk; • Mitigating risks; • Reporting risks; and • Incident management.	**Risk & Compliance function provides support and independent challenge** on: • Risk framework; • Risk assessment; • Risk appetite and strategy; • Performance management; • Risk reporting; • Adequacy of mitigation plans; and • Bank's risk profile.	**Internal audit provides independent assurance** on: • First and second line of defence; • Appropriateness/effectiveness of internal controls; and • Effectiveness of policy implementation.

The ERMF is designed to allow business opportunities to be realised while maintaining an appropriate balance of risk and return within the Bank's risk appetite and capacity to take risk.

The key principles underlying the ERMF are:

1. Promotion of a culture in which risks are identified, assessed and reported in a transparent and objective manner;
2. Rigorous assessment and measurement of risk relative to the Bank's approved risk appetite;
3. To protect the Bank's long-term viability and produce sustainable income streams.

The Board has delegated certain risk management oversight responsibilities to the Board Risk Committee, the Audit Committee, and the Governance Committee; each of which are chaired by an independent director.

The Board Risk Committee's principle responsibility is to define the Bank's risk appetite and to support the Board's oversight of risk management, ensuring that the Bank has in place strong risk management processes and systems of internal control.

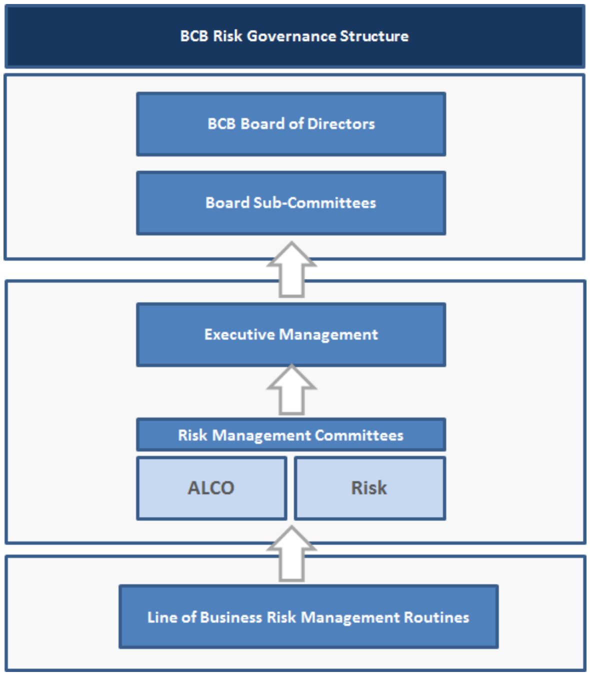
The Audit Committee provides oversight of the internal audit function and reviews the results of the audit programs and progress, where applicable, of the remediation of issues identified.

The Governance Committee has oversight responsibilities with respect to corporate governance, code of conduct and human resources matters.

These Committees are supported by two management level risk committees, the ALCO and the Management Risk Committee ("MRC").

The ALCO is tasked with the oversight of the Bank's management of its balance sheet including its funding and liquidity positions, market risks and capital management. The ALCO also provides oversight of the Bank's portfolio of available-for-sale financial assets.

The MRC is primarily concerned with oversight of the effectiveness of strategies, policies, procedures and systems established to manage risk across the Bank. The MRC provides oversight and direction with respect to the key risk elements of the Bank's Capital Adequacy & Risk Profile ("CARP"); notably, credit and operational risks (including people, processes, systems, legal and regulatory compliance risks and external events).



Stress and Scenario Testing

The purpose of stress and scenario testing is to quantify exposure to extreme and unusual market risk occurrences. The Bank's objectives in stress and scenario testing are to review probable outcomes of plausible scenarios. The Bank's program also assesses credit and market risks to understand specific weaknesses in the solvency of the Bank. The feedback and output, aid the modelling of a comprehensive control framework that is transparent and responsive to rapidly changing market conditions.

Significant Risk Categories

Credit Risk

Credit or Counterparty Risk refers to the risk that a counterparty might fail to discharge their contractual obligations causing a loss of the Bank's assets. This risk exists where there is any transfer of value from the Bank to other parties, be it in the shape of a loan or a deposit. The Bank manages and controls credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and for geographical and industry concentrations, and by monitoring exposures in relation to such limits.

The Bank offers some loan and other credit facilities to clients, but is primarily exposed to credit risk through:

(i) the lending activities of PCFG's Consumer and Business Finance divisions. The Consumer Finance Division provides hire purchase finance to retail customers to help them acquire vehicles, principally motor cars. The Business Finance division provides hire purchase and leased finance to sole traders, partnerships and limited companies to help them to acquire vehicles, plant and equipment. As such, PCFG's lending is secured and amortised over the life of the assets.

    PCFG's portfolio of loans and finance receivables is managed by an experienced in-house team supported by their finance and lease management system. In order to ensure that arrears are minimised, emphasis is placed on retaining a diversified portfolio using prudent underwriting standards.

(ii) the placement of funds with other banks. The size of these deposits is limited and controlled by both the Bank's internal risk policies and by the Large Exposure limits stipulated by the BMA. All counterparty banks must be approved by the Bank's ALCO. The maximum amount that may be deposited with any single bank or money market fund is governed by a number of controlling variables including the S&P, Fitch and Moody's ratings for that bank. Counterparty banks with a rating lower than single-A are not used to place deposits. These limits will be reviewed periodically and will be adjusted as the capital of the Bank changes or if the rating of a counterparty bank falls below the single-A level.

(iii) its portfolio of available-for-sale financial investments, including its holdings of high quality liquid assets.

The Bank's internal policies create a well diversified and controlled balance sheet by limiting investments or placement by counterparty, currency, geography and industry. The Bank remains compliant with the Large Exposure limits required by the BMA for money market funds and places no more than the equivalent of 25% of its capital in any single fund or instrument.

The table below details BCB's consolidated regulatory credit risk exposures based on the BMA's Revised Framework for Regulatory Capital Assessment guidance:

Analysis of Exposures Class	Exposure Position as at Sep 30, 2015 ($'000)
Cash	670
Claims on Sovereigns	137,106
Claims on Corporates	116,009
Claims on Banks and Securities Firms	226,810
Securitisations	31,584
Retail Loans	150,388
Residential Mortgages	458
Past Due Loans	14,685
Other Balance Sheet Exposures	81,969
Balance Sheet Exposures	**759,679**
Non-market Related Off Balance Sheet Credit Exposures	5,501
Total Credit Risk Exposures	**765,180**

Market Risk

Market risk is the risk that a change in the value of an underlying market variable (such as interest or foreign exchange rates) will give rise to a reduction in the Bank's income or an adverse movement in the value of the Bank's financial assets.

Currency Risk: The Bank holds a substantial portion of its investments in currencies other than USD and hence is exposed to adverse changes in foreign exchange rates. These investments are principally hedged back into US dollars. Our currency hedging strategy and process is reviewed regularly to test the results and appropriateness of hedges in place.

Interest Rate Risk: This risk occurs from a mismatch of interest rate exposures tied to the Bank's assets and liabilities. Adverse movements in interest rates can result in a reduction in the Bank's net interest margin. The Bank invests a portion of its balance sheet in a diversified portfolio of fixed income securities. Duration is the price sensitivity of a fixed income security to changes in interest rate. The Bank manages the duration of its bond portfolio to mitigate interest rate risk.

Interest Rate Re-Pricing Risk: Like many banks, BCB is exposed to price in terms of the changes to the interest rates earned on its short-term deposits placed with other banks. These cash holdings generate interest income for the Bank and historically have been a significant source of the Bank's income. Currently, however, rates for short term (1 to 7 days) deposits placed with other banks in the USD, GBP, and EUR money markets are earning less than 0.25%, on average.

These historically low deposit rates are expected to remain the status quo for the near-term. Thus they will impact on the Bank's earnings (please refer to the 2015 Annual Financial Report for details).

Equity Risk: The Bank holds a limited number of equities within its financial investments portfolio. The total value of these at September 30, 2015 is $36,730,430. The Bank uses fair market values to value these available-for-sale holdings.

Commodities Risk: The Bank holds no commodities on its own behalf.

Funding & Liquidity Risk

Liquidity risk is the risk that the Bank is not able to meet its financial obligations as they fall due, or can only do so at excessive cost. Funding and Liquidity Risks exists where demand from clients to withdraw funds from their accounts exceeds the cash available to fund those withdrawals because either there are no alternative sources of funds available to the Bank or it has failed to maintain sufficient liquid assets to be able to manage the outflow.

The Bank manages its liquidity risk through cash and liquidity management techniques that maximize its liquidity, and through controls on the percentage of its balance sheet that can be converted to cash within specific short-term bands. At September 30, 2015, cash and cash equivalents represented 37.59% of total assets and the Bank is committed to maintaining a prudent level of liquid assets which will be managed in parallel with the Bank's liability profile.

Concentration Risk

Concentration risk arises in various parts of the Bank's balance sheet and revenue stream. For examples concentration risks include;

- Reliance on too few or closely related forms of revenue that expose the profitability of the Bank to risk from adverse movement in income.
- Reliance on a few, large obligors from a common industry sector, which expose the balance sheet to the risk of material and disproportionate loss should an event of default occur.
- Relatively small deposit and client base leaves the Bank vulnerable to losing deposit funding due to reputation risk.

Given the small size of the Bank there is concentration risk in the client portfolio. However, PCFG's loan portfolio serves to increase diversification across the Bank's portfolios, including revenue streams.

Industry concentration risk exists in that the Bank serves primarily the corporate and commercial sectors. While the client mix is generally diverse the large balances tend to be held by investment fund clients. During the recent global recession these clients all experienced reduced subscription and higher levels of redemptions that drove down the fund asset base (reducing fee income in some cases) and banking deposit levels.

The Bank calculates the Herfindahl-Hirschman Index (HHI) on client deposit concentration by client group. Client Group is used rather than individual accounts as the risk is more properly assigned to the controlling entity. As the Bank serves commercial, corporate, and high-net worth clients it is common for a controlling entity to have control over multiple legal entities and accounts.

The Herfindahl-Hirschman Index (HHI) is a simple approach for quantifying undiversified idiosyncratic risk. The HHI is defined as the sum of the squares of the relative portfolio shares of all groups. Well-diversified portfolios with a large number of small entities have an HHI value close to zero whereas heavily concentrated portfolios can have a considerably higher HHI value. In the extreme case of a single entity, the HHI takes the value of one.

BCB uses both the raw Herfindahl Index (HI) and its reciprocal. The formula is;

HI: $$H = \sum_{i=1}^{N} s_i^2$$

Reciprocal: $$H_r = {}^{1}\!/_{H}$$

The calculation is run against the aggregate balances of client groups (where a client controls multiple accounts) or individual clients that do not hold more than one account.

The following table explains how the HHI score is related to concentration and is derived from generally accepted definitions of concentration;

H is below 0.01 indicates a highly unconcentrated index.
H is below 0.1 indicates an unconcentrated index.
H is between 0.1 and 0.18 indicates moderate concentration.
H is above 0.18 indicates high concentration

As of September 30, 2015, the HHI for BCB's client portfolio is;

Herfindahl-Hirschman Index (HHI):	0.045
Equivalent Number of Groups:	22.065

A HHI score of 0.045 indicates that BCB's client concentration risk is 'unconcentrated', but not 'highly unconcentrated'. However in practice this level tends to result in a 'lumpy' dispersion of balances with some resulting volatility in balance levels.

Legal & Regulatory (Compliance) Risks

Like all banks, BCB is a regulated entity that is supervised by the BMA. The activity of the Bank is subject to limits imposed through regulations and through legislation. The Bank must comply with these regulations and legislation or face sanction, fines, loss of license or restrictions on operations.

BCB is also indirectly impacted by the regulatory regimes of other countries with which it transacts business and to a degree is obligated to comply with those regulations. For example while BCB has no operations in the US it does use US banks for its deposits and US Dollar clearing. As such the US counterparty banks make requirements of BCB, such as completion of Patriot Act forms, compliance with periodic reviews, and compliance with US prohibition of transactions with entities sanctioned by the US (known terrorists and other Specially Designated Nationals).

BCB actively manages compliance risk through a dedicated Compliance Department that ensures that all business transacted by the bank meets domestic and international requirements, and internal policies. The Compliance Department monitors changes in legislation and updates Bank policy and operations as needed. The Bank maintains compliance though a number of programs that includes;

- Real-time automated screening of all wire transactions against official watch lists to detect potential activity with known sanctioned entities.
- Review of all new business for risk and approval as well as continuous periodic review of existing business on a risk-basis for compliance with regulations.

- Activity monitoring using automated systems to detect patterns of suspicious activity.
- Periodic training and update for all staff for anti-money laundering, anti-fraud, and internal policies & procedures.

The Compliance function reports to the Chief Risk Officer and submits quarterly reports to the Board of Directors.

Additionally the Bank is subject to supervisory review and on-site inspection from the BMA, and elements of the Compliance function are subject to audit by both the Bank's internal and external auditors.

Operational Risk

Operational risk is deemed as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external causes, whether deliberate, accidental or natural. Operational risk by its nature cannot be entirely eliminated but it can be managed and mitigated to levels that are deemed acceptable by management.

Operational risk is the responsibility of the MRC and includes business process controls, data systems, and compliance (including anti-money laundering / anti-terrorist financing). The MRC meets at least monthly to review the Bank's material risks, controls, and incident management. The Committee:

- Reviews and challenges risk information received from the Group's risk functions to ensure that the Group is not exceeding the risk appetite set by the Board;
- Ensures rigorous stress and scenario testing of the Group's business and receive reports that explain the impact of crystallisation of identified risks and threats to the Group to ensure that a sufficient level of risk mitigation is in place;
- Reviews and take appropriate steps to satisfy itself that the due diligence process followed for proposed strategic acquisitions or disposals is thorough;
- Considers the adequacy and effectiveness of the technology infrastructure supporting the risk management framework.

The Bank's control environment includes a program of risk and audit reviews and risk-based in-depth client reviews. The Bank also utilises automated systems to mitigate risk associated with criminal activity through the Bank's products and services. These systems include application risk scoring systems for new business uptake and real-time wire activity scrubbing against official watch-lists.

The key operational risks for banks tend to be fraud (internal or external), errors, and problems related to data systems. Compliance risk is a rapidly rising area of concerns for banks.

A core element of an operational risk mitigation program for the Bank includes data security. Banks by their nature are heavily data-dependant and the requirements for protecting the confidentiality, integrity, and availability of data are critical. BCB does not outsource its technical operations and data remains in Bermuda. The Bank maintains business recovery architecture with a fail-over time of a few minutes. The backup site readiness is monitored continuously and tested at least annually. The recovery site is in Bermuda and is considered by the Bank as a practical commercially reasonable approach.

BCB has implemented PC Desktop End Point Security that centrally disables access to any portable device, guarding against data theft and the introduction of data or software that could be harmful to the network.

Logical access control is in place at the individual application level as well as at the network level. Password complexity and mandatory changes are enforced programmatically. User profiles limit what a user can access, see or change. Application database systems are also locked down and strictly controlled.

Anti-virus software protects all desktop machines and servers, and where applicable application and systems updates and patches are tested and applied.

Operational Risk Assessment

The fundamental process of assessing operational risk relies on the identification and measurement of risks, the mitigation of risks, and an evaluation of the efficacy of the mitigation. These risks can be inherent in a process, represent vulnerabilities, or manifest themselves through actual incidents. Operational risks and the mitigation of these are evaluated in terms of probability and severity. The Bank also manages reported incidents to ensure that controls remain appropriate.

Under the Basic Indicator Approach, the Bank’s capital charge for operational risk is calculated using gross income data derived from the last three completed financial years for which audited financial statements have been prepared:

Basic Indicator Approach ($'000)
as at September 30, 2015

Item	Last year	1 year prior	2 years prior
Gross Income			
Net interest income	18,174	15,977	15,220
Net non-interest income	5,742	6,730	5,169
Total	**23,916**	**22,707**	**20,389**

Average of positive total annual incomes	22,337
Alpha	15%

BIA Requirement

- Capital Charge	3,351
- Risk Weighted Asset Equivalent	41,883