Pillar 3 Risk Report 2013

BANQUE
INTERNATIONALE
À LUXEMBOURG

Pillar 3 Risk Report 2013

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Introduction

BIL Group – 2013 key events

In 2013, BIL Group's Risk Management department monitored changes in the Bank's activities and risk profile. On the one hand, the Bank continued the work begun in 2012 regarding its monitoring and controlling frameworks; on the other hand, it underwent a reorganisation in order to be in a better position to meet the coming internal and external challenges.

Risk appetite framework

In 2013, BIL Group's risk appetite framework was reviewed in order to support the Bank's strategic objectives. Risk appetite expresses the maximum level of risk an institution is able and willing to take in order to reach its business and strategic objectives, given the expectations of key stakeholders (shareholders, debt holders, supervisors, rating agencies, customers, etc.).

In August 2013, the Board of Directors approved a new risk appetite framework in line with BIL's business model and strategy, which was based on five pillars: capital, earnings stability, liquidity, reputation and operational effectiveness. Each pillar had its own objectives from which a series of macro and micro indicators have been derived. These figures, to which triggers are assigned, are continuously monitored and regularly reported to the Board Risk Committee.

Corporate structure and risk profile

During the year, the Bank continued to deploy its "BIL is Back" strategy, which focuses on offering a wide range of products and services to a diversified customer base in Luxembourg, as well as in neighbouring and more distant countries.

To achieve its goals, BIL has taken some strategic decisions to optimise the group's structure and provide efficient services:

- The opening of the Belgian branch during the summer of 2013 involved substantial efforts by all Bank departments, including Risk Management, which adapted its procedures and guidelines. While the branch has hired its own on-site risk manager, the main daily risk functions are carried out at Head Office.
- For BIL Manage Invest SA, the risk management process fulfils the requirements of the Alternative Investment Fund Managers Directive (AIFMD) and the delegated regulation supplementing Directive 2011/61/EU on Alternative Investment Fund Managers issued by the European Commission. The Risk Management department is governed by the BIL Manage Invest risk management policy. This policy includes all the necessary procedures enabling the management company to assess and monitor the risks to which the AIFs it manages are or might be exposed.

Other events have slightly modified the Bank's risk profile, which remains broadly stable overall. This is especially the case for the banking portfolio, which increased in size during 2013. The main purpose of this portfolio is to create value while serving as a liquidity reserve for the Bank (in order to satisfy the requirements of the Basel III liquidity coverage ratio – LCR). The portfolio is primarily composed of top-quality assets with low capital requirements (risk-weighted assets – RWA). A small share of the portfolio may be dedicated to riskier assets, i.e. non-LCR or non-central bank-eligible assets. The risk profile is monitored by the Financial Risk Management department according to its portfolio guidelines, which provide a set of limits in terms of duration, liquidity level, geographic area, currency, RWA, rating and concentration.

Internal governance

Following the dismantling of the Dexia group at the end of 2012 and the subsequent acquisition of BIL by its major shareholder, Precision Capital, the Bank had to adapt to the new situation by setting up an adequate risk management structure able to handle all the functions, tools and processes that were previously undertaken by the former Dexia Group, especially as regards the ongoing use of the Basel II Pillar I advanced internal rating-based (AIRB) approach and the implementation of the Pillar II internal capital adequacy assessment process (ICAAP) requirements.

In 2013, the transitional period that had followed the acquisition of BIL came to an end. Subsequently, the Bank decided to reorganise its Risk Management department in order to create a sound and sustainable structure allowing the efficient handling of the forthcoming challenges imposed by changes in the business and regulatory environment. To achieve this task, BIL hired a Head of BIL Group Risk Management, whose main responsibility will be to implement this strategy (please refer to section 2.2 for further details).

Basel II framework

Basel II refers to the revision of the 1988 regulatory framework defining the capital requirements for banking institutions. The main objectives of the capital agreement ("Basel II framework") put in place by the Basel Committee on Banking Supervision are to improve the regulatory framework in order to:

- Further strengthen the soundness and stability of the international banking system,
- Promote the adoption of stronger risk management practices by the banking industry,
- Prevent any competitive regulatory inequality among internationally active banks.

To achieve these objectives, the Basel framework is based on three pillars:

The first pillar – minimum capital requirements – defines how banking institutions calculate their regulatory capital requirements in order to cover credit, market and operational risks.

The second pillar – supervisory review – provides national regulators with a framework to help them in assessing the adequacy of banks' internal capital for covering credit risk, market risk and operational risk, but also other risks not identified in the first pillar, such as concentration risk.

The third pillar – market discipline – encourages market discipline by establishing a set of qualitative and quantitative disclosures allowing market participants to make a

better assessment of capital, risk exposure, risk assessment processes, and hence the capital adequacy of the institution.

New regulatory environment: Basel III

The implementation of the forthcoming Basel III framework and its European implementation (the CRD IV package) are in progress within the Bank. The Basel III regulations will set new standards for capital and liquidity calibration, with best practice and homogeneous criteria at an international banking level. The Basel III regulatory framework significantly increases both quantitative and qualitative requirements, with a new capital definition and new capital buffers (Pillar I), an expanded supervisory process with the introduction of a leverage ratio and new liquidity ratios (Pillar II), as well as additional disclosure requirements (Pillar III).

BIL Group Pillar III Risk Report

On a yearly basis, BIL Group publishes a Pillar III disclosure report to comply with the requirements of Directive 2006/48/EC (the Capital Requirements Directive or CRD). Pillar III refers to specific regulatory disclosure requirements, as set out in the Basel II framework and incorporated into EU law via Annex XII of the current CRD, and transposed into Luxembourg law by CSSF Circular 06/273, Chapter XIX.
The aim of this report is to help banks improve their risk disclosures in order to restore investor confidence and enhance market discipline.
The Bank considers the publication of this report to be a major step forward in improving the transparency of banks' risk profiles.

Structure

The BIL Group's Pillar III disclosure report is divided into six sections and two appendices.
The first section covers capital management and adequacy within the Bank. The second section describes the existing risk management framework. The third section deals with the credit risk cartography, function and policies, with a focus on governance. The fourth section explains methodological procedures for the management of market risk with a breakdown by component. The fifth section presents the operational risk framework and risk figures. Finally, the last section discloses information relating to remuneration policies and practices.
The appendices include two glossaries of relevant terms to facilitate understanding of the report.

Metrics

The metrics used to measure risk exposure may differ from accounting metrics.
The credit risk exposure measure known as exposure-at-default (EAD), which is used for the calculation of regulatory capital requirements includes (a) current and potential future exposures, and (b) credit risk mitigants (CRM) covering those exposures (under the form of netting agreements, collateral and guarantees).
Moreover, BIL has defined an internal measure, known as maximum credit risk exposure (MCRE). This metric corresponds to the EAD with a credit conversion factor (CCF) of 100%, after deduction of specific provisions and financial collateral (netting agreements).
Finally, and unless otherwise stated, the figures disclosed in this report are expressed in euro. More specifically, figures shown in tables are expressed in millions of euro.
Data is provided at a consolidation level including subsidiaries and branches of BIL Group.

1. Capital management and capital adequacy

BIL monitors its solvency using rules and ratios established by the Basel Committee on Banking Supervision and the European Capital Requirements Directive.
These ratios (i.e. the capital adequacy ratio and Tier 1 ratio) compare the amount of regulatory capital (in total and Tier 1 capital) with the total weighted risks. From a regulatory point of view, within the Basel II framework, they should amount to a minimum of 4% for the Tier 1 ratio and 8% for the capital adequacy ratio.
As at December 31, 2013, the Bank increased its core capital, leading to a Tier 1 ratio of 14.93% and a capital adequacy ratio of 20.77%. The aim of capital management is to guarantee BIL's solvency and maximise its profitability, while ensuring compliance with internal capital objectives and capital regulatory requirements. The Bank's ratios comfortably exceed the required levels, thereby reflecting its ability to respond to the new Basel III requirements.
The CSSF requires BIL to disclose the calculation of capital necessary for the performance of its activities in accordance with the prudential banking regulations, on the one hand, and in accordance with the prudential regulations on financial conglomerates on the other hand.
BIL has complied with all regulatory capital rules for the period reported.

1.1 Regulatory capital adequacy (Pillar 1)

1.1.1 Accounting and regulatory equity

In line with the regulatory requirements, BIL has limited the scope of Pillar III to its banking activities. Therefore, the scope of consolidation relating to Pillar III differs from the scope of consolidation of the financial statements (as provided in the BIL Group annual report).
The difference between the accounting methods and the prudential methods as at December 31, 2013 is limited to the insurance company BIL-Ré, which is accounted for by the equity method for prudential purposes, instead of full consolidation for accounting purposes. The corresponding difference is not material.

	31/12/12		31/12/13	
	Financial statements	Regulatory purposes	Financial statements	Regulatory purposes
Total shareholders' equity	1,105	1,105	1,169	1,169
of which core equity	*958*	*958*	*1,050*	*1,050*
of which gains and losses not recognised in the statement of income	*147*	*147*	*119*	*119*
Non-controlling interests	–	–	–	–
of which core equity	–	–	–	–
of which gains and losses not recognised in the statement of income	–	–	–	–
Discretionary participation features of insurance contracts	–	–	–	–
TOTAL	**1,105**	**1,105**	**1,169**	**1,169**

Notes:
– *Comments on regulatory requirements are described in note 6 of the Risk Management Report published in the 2013 annual report.*
– *For regulatory purposes, insurance companies are accounted for by the equity method. Therefore, non-controlling interests differ from those published in the financial statements. Discretionary participation features relate only to insurance companies.*

As at end-2013, shareholder's equity had increased by 64 million (+6%). This increase was mainly due to the net profit of 113 million recorded in 2013 and to the allocation of 22 million from the 2012 net profit to BIL's hybrid capital.

1.1.2 Regulatory capital

According to the Basel II rules, the Bank's regulatory capital consists of:
- Tier 1 capital: share capital, share premiums, retained earnings including current year profit, foreign currency translation adjustment less intangible assets, accrued dividends on own shares and a portion of loss carryforwards;
- Tier 2 capital including the eligible portion of subordinated long-term debt.

According to regulatory requirements:
- the AFS reserve for bonds and cash flow hedge reserves is not included;
- the AFS reserve for equities is added to Tier 2 capital if positive, with a haircut, or deducted from Tier 1 capital if negative.

The following table shows BIL Group regulatory capital calculated under Basel II at the year end.

	31/12/12	31/12/13
TOTAL REGULATORY CAPITAL (AFTER PROFIT APPROPRIATION)	**820**	**904**
Tier 1 capital	**605**	**650**
Core shareholders' equity	1,088	1,168
Cumulative translation adjustments (Group share)	-11	-12
Prudential filters	-173	-148
Non-controlling interests eligible in tier 1	–	–
Dividend payout (minority interests)	–	–
IRB provision shortfall 50% (-)	–	–
Available-for-sale reserve on equities (-)	–	–
Items to be deducted:	-70	-98
Intangibles and goodwill	-65	-68
Holdings > 10% in other credit and financial institutions (50%)	-1	-1
Participations in insurance undertakings	–	-27
Subordinated claims and other items in other credit and financial institutions in which holdings > 10% (50%)	–	–
Excess on limit for holdings, subordinated claims and other items in credit and financial institutions in which holdings < 10% (50%)	–	–
Subordinated claims and other instruments held by insurance in which holdings >10% (50%)	–	–
IRB provision excess (+); IRB provision shortfall 50% (-)	-4	-2
Deferred tax assets	-229	-261
Innovative hybrid tier-1 instruments	–	–
Tier 2 capital	**215**	**254**
Perpetuals and excess on innovative hybrid tier-1 instruments for recognition in Tier 1 capital	–	–
Subordinated debt	171	176
Available-for-sale reserve on equities (+)	95	108
Items to be deducted:	-51	-30
Holdings > 10% in other credit and financial institutions (50%)	-1	-1
Subordinated claims and other instruments held by insurance in which holdings >10% (50%)	–	–
Excess on limit for holdings, subordinated claims and other items in credit and financial institutions in which holdings < 10% (50%)	–	–
Subordinated claims and other items in other credit and financial institutions in which holdings > 10% (50%)	–	–
IRB provision excess (+); IRB provision shortfall 50% (-)	-4	-2
Participations in insurance undertakings	-46	-27

At year-end 2013, total regulatory capital amounted to 904 million. The increase compared with 2012 was mainly due to the 2013 net profit of 113 million.

1.1.3 Regulatory capital adequacy

The following table shows the weighted risks and capital requirements for each type of risk at year-end 2012 and year-end 2013. The minimum capital requirements correspond to 8% of the weighted risks.

			31/12/12		31/12/13	
Type of risk	**Basel II approach**	**Exposure class**	**Weighted risks**	**Capital requirements**	**Weighted risks**	**Capital requirements**
Credit risk	**Advanced**	Corporate	634	51	732	59
		Equities	99	8	97	8
		Financial institutions	194	16	328	26
		Project finance	25	2	2	0
		Public sector entities	1	0	0	0
		Retail	846	68	785	63
		Sovereign	108	9	272	22
		Other	0	0	0	0
		Total	**1,908**	**153**	**2,217**	**177**
	Standardised	Corporate	531	43	545	44
		Equities	114	9	95	8
		Financial institutions	24	2	90	7
		Monolines	-	-	-	-
		Project finance	-	-	-	-
		Public sector entities	417	33	227	18
		Retail	13	1	2	0
		Securitisation	-	-	-	-
		Sovereign	-	-	12	1
		Other	361	29	320	26
		Total	**1,460**	**117**	**1,321**	**106**
		Total credit risk	**3,367**	**269**	**3,538**	**283**
Market risk	**Internal Model***	Interest Rate & Foreign Exchange Risk	68	5	-	-
		Total	**68**	**5**	**-**	**-**
	Standardised	Interest rate risk	20	2	64	5
		Foreign exchange risk	-	-	8	1
		Position risk on equities	-	-	-	-
		Other market risks	57	5	47	4
		Total	**77**	**6**	**119**	**10**
		Total market risk	**145**	**12**	**119**	**10**
Operational risk	**Standardised**		**695**	**56**	**697**	**56**
TOTAL			**4,207**	**337**	**4,354**	**348**

** In 2013, interest rate and foreign exchange risks were treated according to the Basel II standard approach.*

1.1.3.1 Weighted risks

Since January 1, 2008, the Bank has used the Basel II framework to calculate its capital requirements with respect to credit, market and operational risk, and to publish its solvency ratios.

At the end of 2013, the Bank's total weighted risks amounted to 4.35 billion, compared with 4.21 billion at the end of 2012. The difference is notable but not substantial, and mostly relates to weighted credit risks (+171 million), while weighted market risks fell by 26 million and weighted operational risks increased by just 2 million.

In more detail, weighted credit risks on sovereigns, financial institutions and corporates were impacted significantly by new investments and reviews of the Basel II parameters throughout the year.

At the same time, other segments have seen their exposure reduced. This is mainly the case for the private banking segment, whose exposure fell by 57 million in 2013.

When it comes to market risk, the Bank has adopted the standard method for the calculation of its weighted risks. This choice is based on the Bank's very moderate trading activity, which is solely intended to assist BIL customers by providing the best possible service relating to the purchase or sale of bonds, foreign currencies, equities and structured products. The effect of the changeover to the standard method had a moderate but favourable impact on the weighted market risks. Their lower level in 2013 compared with 2012 is also explained by a reduction in the volume of structured products.

	30/06/12	31/12/12	30/06/13	31/12/13	2012 vs. 2013	contribution to the decrease
Weighted credit risks	7,033	3,367	3,494	3,538	5.07%	171
Weighted market risks	137	145	147	119	-17.94%	-26
Weighted operational risks	788	695	695	697	0.27%	2
TOTAL WEIGHTED RISKS	**7,958**	**4,207**	**4,336**	**4,354**	**3.49%**	**147**

1.1.3.2 Capital adequacy ratios

	30/06/12	31/12/12	30/06/13	31/12/13
Core shareholders' equity (Tier 1)	433	605	558	650
Total regulatory capital	736	820	813	904
Weighted risks	7,958	4,207	4,336	4,354
Core shareholders' equity (Tier 1) ratio	**5.44%**	**14.39%**	**12.88%**	**14.93%**
Capital adequacy ratio	**9.25%**	**19.49%**	**18.75%**	**20,77%**

The three weighted risks categories added together constitute the denominator in the calculation of the solvency ratios.
In comparison to the end of 2012, the ratios as at year-end 2013 had improved, thanks to the strengthening of the regulatory capital, despite the rise in total weighted risks.
A new global regulatory framework was published by the Basel Committee on Banking Supervision in December 2010 in order to improve the quality and transparency of the capital structure. The Basel III framework is expected to be fully incorporated during the first quarter of 2014.

1.2 Internal capital adequacy (Pillar II)

The main objective of the ICAAP is to self-assess capital adequacy in respect of the risks to which the institution is or might be exposed, given its business model and strategy, as well as to its defined risk appetite and risk-bearing capacity.
According to CSSF Circular 07/301 (i.e. ICAAP), financial institutions have to set up "healthy, efficient and exhaustive strategies and processes, allowing institutions to assess and maintain at any time the amount, type and allocation of internal capital they deem appropriate to cover the type and level of risks to which they are or could be exposed".
To do this, the BIL ICAAP process includes several topics/tasks:

- A risk appetite framework, which translates business strategy into risk appetite objectives;
- Risk identification and cartography, carried out according to the following steps:
  - compilation of a risk glossary,
  - identification of risks,
  - assessment of risk materiality,
  - production of a risk cartography;
- Risk assessment, in conjunction with risk identification and cartography. One of the main components of risk assessment is economic capital (ECAP). Economic capital can be understood as the methods or practices allowing banks to consistently assess risk and attribute capital in order to cover the economic effects of risk-taking activities.
- Capital adequacy and process, which mainly links economic capital needs with available financial resources (AFR), representing the loss-absorbing financial capacity and availability over a one-year horizon.
- Stress testing is a risk management technique used to evaluate the potential effects on an institution's financial position of a specific event and/or movement in a set of financial variables. The traditional focus of stress testing relates to exceptional but plausible events. The aim of the global stress test is to identify the potential impacts of external and internal events on our business model so that the management can take the necessary action (including changes in business strategy) to ensure that regulatory ratios are maintained above the minimum requirements and to secure the Bank's survival during a period of stress.
- Business integration: the best example of ICAAP business integration is its use in all kinds of decision-making processes, where capital consumption indicators assist in driving new initiatives.

1.2.1 Background

In 2012, BIL decided to develop a new ICAAP report from scratch, taking the view that the BIL Group's business model and risk profile were significantly different from those of Dexia. The resulting report is quite different from Dexia's, particularly in terms of scope and quantification of risks. During this first year, the focus was clearly placed on understanding all risks in an exhaustive manner, whether these were qualitative or quantitative, credit, operational, market or enterprise-wide.
The result of this work led to the first independent ICAAP report, published in June 2013. During the second half of 2013, BIL mainly focused on two areas: the risk appetite framework and the enhancement of the ECAP calculation through the construction of the capital engine and the reallocation process.

1.2.2 Risk Appetite

Risk appetite expresses the maximum level of risk an entity is willing to take in order to reach its business and strategic objectives, given key stakeholders' expectations and the mandates they granted.

The starting point for the risk appetite framework is the strategic business plan. This strategic business plan contains a 'vision' of the Bank's target business profile over the next few years, as "a universal bank with a strong anchoring in the Luxembourg market and selected international activities that use service excellence as a key differentiating factor". Thus, the essence of the business strategy is the focus on relationship banking characterised by a high level of customer satisfaction and operational excellence. Under the proposed business model, growth is primarily intended to come from an increase in customer deposits, while exposure to credit markets is expected to remain low.

On the asset side, no target has yet been set for a preferred customer and asset mix, as the first priority for BIL is to win back lost customers and market share. This should be achieved through a well-coordinated campaign, attractive products and consistent messages.

Going forward, a capital-light business will be promoted and new customer segments (e.g. ultra high net worth individuals) and geographies will be targeted. Excess liquidity is invested in a low-risk lending book and low capital-consuming investment portfolio.

By setting strategic objectives and guidelines for achieving these objectives, the Board has established a number of high-level principles for the selection and avoidance of risks. These principles can be represented by five pillars:

- Capital
- Earnings stability
- Liquidity
- Reputation
- Operational effectiveness

The five pillars, which are representative of the group's risk appetite, are translated into a set of ratios/indicators used to define limits in terms of financial fundamentals. This framework is based on a mix of accounting (gearing), regulatory (Tier 1, weighted risks) and economic (economic capital) ratios, and also includes liquidity and funding structure ratios, as well as reputational and operational indicators. Limits are set for each of these ratios and are approved by the Board of Directors each year. The Risk department, in conjunction with the Finance department and/or other business lines, is responsible for monitoring and improving these ratios, if necessary, by offering the Management Board suggestions on how to ensure limits are respected.

1.2.3 Risk Cartography

Within BIL Group, the identification of risks is carried out using a four-step process that encompasses:

- The preparation of a risk glossary, which provides definitions for all of the risks to which BIL Group may be exposed (the Risk Glossary is available in Annex 2 of this report);
- The identification of risks through a series of interviews with the various stakeholders of all the Group's main business and support lines;
- The assessment of risk materiality, according to the nature and the global impact on BIL Group, taking into account risks as well as mitigating factors;
- The creation of the risk cartography, using the appropriate severity level as applied to all risks described in the Risk Glossary (immaterial / low / medium / significant / high).

The main findings of the final version of the risk cartography are the following:

- Credit risks are mostly significant for a universal bank like BIL, since granting loans plays an important role in supporting Luxembourg-based customers and businesses. Accordingly, the Bank holds an important loan portfolio with a wide range of counterparty types (i.e. retail, SMEs, corporate, corporate real estate, banks and sovereigns). Moreover, and in line with its business strategy, the Bank has built up an investment bond portfolio, which is also exposed to credit risk. Consequently, credit risk can be considered as being significant for the Bank.
- Business and strategic risks, as well as legal and compliance risks, are also relevant for BIL, due to the ambitious strategic plan that is deployed in an economically volatile environment in which regulators, through directives and controls, are playing an increasingly important role. These two risks are considered, respectively, to fall into the significant and medium categories.
- Interest rate risk and spread risk are both categorised as medium. The main reasons for the assignment of these categories are the following:
  - From a macroeconomic point of view, markets are still a cause for concern (subdued growth, volatility in emerging markets, etc.),
  - The size of BIL's investment portfolio, as well as its ALM interest rate exposures, which increased in 2013.

1.2.4 Economic capital

In the context of BIL Group, ECAP can be defined as the amount of capital that would be necessary to cover the unexpected risks inherent in the Bank's activities and thus ensure the continuity of its business over a given time period with a certain level of confidence. ECAP could thus be interpreted as the worst-case loss the Bank's shareholders could face with a 99.93% confidence interval, corresponding to a long-term rating of A- over a one year horizon.

The process for quantifying economic capital is based on the following two steps:

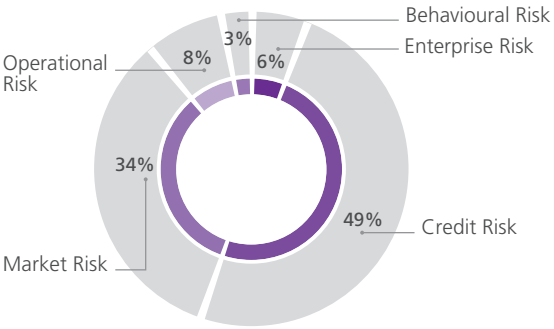
1. Measurement of risk capital (RC) by type of risk, on the basis of dedicated statistical methods. Each risk is thus individually assessed,
2. Aggregation based on an inter-risk diversification matrix to obtain a global ECAP figure and its reallocation to the various levels of risk (entities, business lines, etc.).

In 2013, the focus shifted to the second step, in order to establish a global measure of risk.

Firstly, an ECAP engine was developed to aggregate the risk capital estimated for each risk and then allocate it to all risk levels (entities, business lines, etc.). This tool is based on the Markowitz approach: the total estimated capital is diversified using a calibrated correlation matrix.
The calibration of the ECAP engine is split into two parts:
- Construction of synthetic indices (or proxies) reflecting the Bank's P&L for each risk.
- Calculation of the inter-risk correlations and construction of the correlation matrix.

Secondly, in conjunction with the "controlling and financial planning" department, the allocation of diversified ECAP is reviewed each quarter for each business line and each entity.
As at December 31, 2013, BIL Group's economic capital amounted to 584 million, allocated according to the following structure:

Distribution of all risks (Pillar II)



The distribution of economic capital is explained by the structure of the Group's business. The predominance of credit risk is justified by the nature of the Bank as a commercial institution.

1.2.5 Available financial resources

The available financial resources (AFR) represent the financial capacity available to cover risk exposures and absorb losses over a one-year horizon. As at December 31, 2013, total AFR amounted to 743 million.
The core principles of the AFR definition are:
- Principle 1: long-term, loss-absorbing and available resources, with the AFR measure based on BIL Group's own funds.
- Principle 2: consistency with economic capital. As ECAP is a measure of the Bank's unexpected losses, AFR is not aimed at absorbing the existing incurred losses for which provisions have been booked.
- Principle 3: continuity of operations. Resources should comply with a going concern scenario.
- Principle 4: solidarity between the different entities within the group. Minority interests are considered as making up part of the available financial resources (up to a certain level in line with current Basel III understanding).

The Bank's AFR are based on its own funds, in line with Basel III requirements, and are adjusted according to regulatory and economic considerations in order to ensure consistency with the key principles of the AFR measure.

1.2.6 Economic capital adequacy

1.2.6.1 Governance

From an operational point of view, economic capital is calculated, analysed and reported to the Management Board on a quarterly basis via the ECAP and Quarterly Risk Reports. Economic capital needs are allocated to each business line and business unit to enhance managerial decision-making and to allow a more accurate capital adequacy distribution in line with levels fixed by the Bank in terms of risk appetite and budget plans.
To ensure efficient implementation and monitoring of the Bank's risk profile and capital needs, a dedicated committee has been set-up: the Strategic Risk Committee (SRC). This committee supports the Executive Management on strategic and cross-functional matters that are common to the Risk and Finance departments. The Committee meets quarterly.
The main areas within the scope of the SRC are:
- Internal governance on cross-function matters involving the Risk and Finance departments;
- The risk appetite framework – results and changes;
- Risk identification and cartography;
- Capital structure analysis with a particular focus on available financial resources and their link with economic capital;
- Risk assessment – ECAP results and changes;
- Capital adequacy, capital planning and the budgetary process;
- The stress test framework and corresponding scenario for Basel II Pillar I and Pillar II requirements;
- Business integration – in relation to Pillar I and Pillar II matters, and more generally, with the objective of supporting the other departments of the Group regarding quantitative/functional developments;
- Regulatory monitoring of risk and finance issues: impact analysis / business requirements / implementation / changes;
- Monitoring of risks related to BIL Group branches/subsidiaries;
- Development, production and presentation of a set of cross-functional reports: Basel II Pillar III disclosure, the coordination and consolidation of Risk Management department contributions to the annual/semi-annual reports, long form reports, rating agency requests, etc.
- The recovery plan framework, which mainly covers recovery warnings and triggers, recovery stress tests, recovery options and plan implementation;
- Ad hoc analysis of common risk and finance issues, including the Bank's current and future financial situation, liquidity position etc.

For any divergence or critical issue, the Strategic Risk Committee will escalate the matter to the Escalation Committee (Risk Policy Committee).
In terms of governance, the Finance department is responsible for the AFR methodology and calculation and Strategic Risk Management is responsible for ECAP.

1.2.6.2 Capital adequacy

BIL Group capital adequacy is represented in the following table:

Risk category	Risk type	Pillar II	Pillar I	%
Credit	Credit risk	241	283	41%
	Concentration risk	43		7%
	Total credit	**284**	**283**	**49%**
Market	Price risk	47	10	8%
	Interest rate risk	34		6%
	Spread risk	107		18%
	Currency risk	7		1%
	Funding risk	6		1%
	Total market	**200.6**	**10**	**34%**
Operational	Operational risk	45.0	56	8%
Behavioural	Outflow risk	17.4	0	3%
Enterprise risk	Business risk	37.6	0	6%
Total capital requirements		**584**	**348**	**100%**
Capital supply		**743**	**904**	
AFR/ECAP ratio		**127%**		

As at end-2013, the ratio of economic capital resources to economic capital consumption had reached the comfortable level of 127%.

2. Risk Management

2.1 Risk management responsibilities

The responsibilities of BIL Group's Risk Management department are the following:

- **To ensure that all risks are under control** by identifying, measuring, assessing, mitigating and monitoring them on an ongoing basis: global risk policies and procedures define the framework for controlling all types of risks by describing the methods used and the defined limits, as well as the escalation procedures in place.
- **To provide the authorised management and the Board of Directors** with a comprehensive, objective and relevant overview of the risks, dedicated reports are sent and presentations are made to the Chief Risk Officer (CRO) on a regular basis.
- **To ensure that the risk limits are compatible** with the Bank's strategy, business model and structure through an effective risk appetite framework, which defines the level of risk the Bank is willing to take in order to achieve its strategic and financial goals.
- **To ensure compliance with banking regulation requirements** by submitting regular reports to the CSSF (and the BCL, EBA and ECB), taking part in regulatory discussions and analysing all new requirements related to risk management that could affect the regulatory monitoring of Bank's activities.

2.2 Risk organisation and governance

BIL Group's risk management framework is based on a clear organisational structure with a transparent decision-making process that facilitates prudent management of risks.

BIL's risk management model is based on the following principles:

- Independence of the risk function with respect to the business,
- Collegial decision-making to ensure that opinions are challenged,
- Precise policies and procedures detailing limits of risk, responsibilities, monitoring and reporting of risks taken by the Bank,
- Central control, whereby all departments, subsidiaries and branches report both hierarchical and technical matters to Risk Management at BIL's Head office,
- Implementation of the same risk monitoring and data control system in all entities of the BIL's Group.

2.2.1 Organisation

In 2013, the Bank decided to reorganise its Risk Management department in order to build up a sound and sustainable structure allowing it to efficiently handle the forthcoming challenges imposed by changes to the business and regulatory environment.

At the Executive Management level, the overall Risk Management framework remains under the Chief Risk Officer's responsibility, and the CRO is responsible for providing the Executive Management with any relevant information on risks, enabling the management of the Bank's overall risk profile.

The head of BIL Group Risk Management, hired in September 2013, initiated the new configuration according to the following organisational chart:

Credit risk management
The Credit Risk department is in charge of defining credit risk policies and guidelines, analysing counterparties and monitoring the Bank's credit risk portfolio (see section 3.1.1 relating to the credit risk organisation for further details).

Financial risk management
The Financial Risk Management department is in charge of defining policies and guidelines on financial market activities, and of identifying, analysing, monitoring and reporting on risks and results (see section 4.1.1 relating to the financial risk organisation for further details).

Operating risk management
The activity of this department covers the management of operational risks as well as customer-related risks (see section 5.1.1 relating to the operating risk organisation for further details).

Strategic risk management
The Strategic Risk Management department deals with all the activities related to the modelling and monitoring of the Bank's group-wide risks. This department also coordinates regulatory reports such as the Basel II Pillar II ICAAP Report and Pillar III Disclosure Report.

2.2.2 Governance
Each of the departments described above ensures that the CRO and Executive Management have an accurate understanding of every type of risk within the Bank, and are aware of major issues concerning sources of risk. Each of these departments is involved in risk governance and is responsible for defining policies, guidelines and procedures encompassing risks within its scope.

The Management Board ensures that risk taking and risk management standards fit with the principles and targets set by the Board of Directors. The existence of risk management committees does not relieve the Board of Directors or the Management Board of the general supervision of the Bank's operations and risks. They have very specific remits and help with developing and implementing good governance and decision-making practices.

The Board Risk Committee is a specialised committee supporting the Board of Directors on subjects related to risk. Among its roles, the Board Risk Committee reviews and recommends changes to the BIL Group Risk Management framework and the global risk limits and capital allocation to the Board of Directors; it reviews global risk exposure, major risk management issues and capital adequacy requirements covering all the Group's risks; it reviews, assesses and discusses any significant risk or exposure and relevant risk assessments with the independent auditor on an annual basis; it reports to the Board of Directors on a regular basis and makes recommendations on any of the above or other matters.

Risk committees are constituted and receive their mandate from Executive Management within a precise and defined scope. They facilitate the development and implementation of sound practices of governance and decision-making. These committees are described in more detail below.

2.2.2.1 Responsibilities of the Risk Committees

Responsibilities	Committee
Strategic decisions on risk management Risk appetite	Board of Directors Board Risk Committee Management Board Committee
Decisions on/approval of procedures and risk policies within the scope of risk management	Risk Policy Committee
Decisions on/approval of credit commitments	Commitments Committee/Comité des Engagements Lending Committee/Comité des Crédits Employee Loans Committee/Comité de Crédit aux Employés
Decisions on/approval of defaults or provisioning	Default Committee/Comité des Défauts
Decisions on market limits	ALM Committee/Comité ALM
Funding and liquidity crisis management	Contingency Funding and Liquidity Committee
Decision/approval of new products, and on operational risk matters	New Products and Operational Risk Committee/Comités des Risques Opérationnels et des Nouveaux Produits
Strategic risk (ICAAP, risk appetite, economic capital, recovery plans, etc.)	Strategic Risk Committee
Security of information	Security Committee/Comité de Sécurité
Crisis management	Crisis Committee/Comité de Crise

2.2.2.2 Risk policies, guidelines and procedures

The risk management framework is also governed by an integrated set of policies, guidelines and procedures. These documents establish a uniform methodology and terminology within BIL Group's risk management. They clarify the risk identification, risk assessment and risk monitoring processes. This set of documents facilitates a robust framework for risk management.

3. Credit risk

Credit risk represents the potential loss (reduction in value of an asset or payment default) that BIL may incur as a result of a deterioration in the solvency of any counterparty.

3.1 Credit risk governance

3.1.1 Organisation

The Credit Risk department is composed of five different teams.

- Country and Bank Analysis and Retail, Mid-corp, Corp and Private Bank Analysis

These two teams are in charge of the assessment and monitoring of the risk related to banks and sovereign counterparties on the one hand, and retail, corporate and institutional counterparties on the other hand. Both teams are in charge of assigning internal ratings to BIL counterparties and monitoring the corresponding portfolio.

- GIP (Gestion intensive et particulière)

This team actively manages and monitors the assets deemed to be "sensitive" in order to prevent and minimise the potential losses for the Bank in the event of the default of the counterparty.

- Data Management and Risk Systems

The teams are in charge of the development and maintenance of the data and risk systems used for the calculation of credit risk capital requirements and the corresponding regulatory reports.

- Risk Reporting

This team is responsible for producing regulatory and internal reports related to credit risk, such as the COREP, Large Exposures Report and Quarterly Risk Report, and for responding to ad hoc requests from regulatory authorities.

Furthermore, some of the Strategic Risk Management teams are involved in the calculation of the capital requirements for credit risk:

- IRS (internal rating systems) modelling and integration

This team is in charge of modelling the Bank's internal rating systems (developed within the AIRB framework) and their subsequent integration within the businesses. Its responsibilities also include monitoring key credit risk indicators (non-performing loans, provisioning) as well as carrying out the Bank's credit risk-related stress tests.

- Risk Controlling

This team is required to validate the adequacy and performance of credit risk models (model validation), as well as their correct use by the credit risk teams regarding both use test requirements and the dissemination of their corresponding outputs within the Bank's information systems (risk systems quality control).

3.1.2 Policy

BIL's Risk Management department has established a general policy and procedure framework in line with the Bank's risk appetite. This framework guides the management of credit risk from an analysis, decision-making and risk monitoring perspective. The Risk Management department manages the loan issuance process by delegating the necessary tasks within the limits set by the Bank's management, and by chairing credit and risk committees. As part of its credit risk monitoring tasks, the Credit Risk Management department oversees changes in the credit risk of its portfolios by regularly analysing loan applications and reviewing ratings. The Risk Management department also draws up and implements the policy on provisions, decides on specific provisions and assesses defaults.

3.1.3 Committees

BIL's Risk Management department oversees the Bank's credit risk, under the supervision of the Management Board and specialised committees.

The Risk Policy Committee defines the general risk policies, as well as specific credit policies in different areas or for certain types of counterparty, and sets up the rules for granting loans, and monitoring counterparty ratings and exposures. The Risk Policy Committee validates all changes in procedures or risk policies, the internal rating system, and the principles and methods of calculation for credit risk.

To streamline the decision-making process, the Management Board delegates its decision-making authority to credit committees or grants joint powers. This delegation is based on specific rules, depending on the category, rating level and credit risk exposure of the counterparty. The Board of Directors remains the ultimate decision-making body for the largest loan applications or those presenting a level of risk deemed to be significant. The Credit Risk Management department carries out an independent analysis of each application presented to the credit committees, which includes determining the counterparty's rating, and stating the main risk indicators; it also carries out a qualitative analysis of the transaction.

Alongside oversight of the issuance process, various committees are tasked with monitoring specific risks:

- **The Default Committee** identifies and tracks counterparties in default, in accordance with Basel II regulations, by applying the rules adopted by BIL, determines the amount of specific provisions allocated and monitors the cost of risk. The same committee supervises assets deemed to be "sensitive" and placed under surveillance by being filed as "Special Mention" or put on "Watchlists".
- **The Rating Committee** ensures that the internal rating systems are correctly applied and that rating processes meet predefined standards.

3.1.4 Risk measurement

Credit risk measurement is primarily based on internal systems introduced pursuant to Basel II. Each counterparty is assigned an internal rating by credit risk analysts, using dedicated rating tools. This internal rating corresponds to an evaluation of the level of default risk presented by the counterparty, expressed by means of an internal rating scale. It is a key factor in the loan issuance process. Ratings are reviewed at

least once a year, making it possible to identify counterparties requiring the close attention of the Default Committee.
To manage the general credit risk profile and limit the concentration of risk, credit risk limits are set for each counterparty, establishing the maximum acceptable level for each one. Limits by economic sector and by product may also be imposed by the Risk Management department. The latter actively monitors limits, which it can reduce at any time, in light of changes in the related risks. The Risk Management department may freeze specific limits at any time in order to take the latest events into account.
Since July 2013, as requested by CSSF Circular 12/552, BIL has defined and integrated into its guidelines the notion of "forbearance". Credit files considered as being "forborne" are those for which restructuring measures have been granted due to the deterioration of the creditworthiness of the debtor. These measures include, in particular, the granting of extensions, postponements, renewals or changes in credit terms and conditions, including the repayment plan. Once these criteria are met, the credit files are flagged as being restructured and are added to a list that is closely monitored by the "Gestion Intensive et Particulière" team.
This notion of forbearance has moreover evolved according to the EBA final draft implementing technical standards on forbearance and non-performing exposures published in October 2013. While the CSSF notion of a restructured credit file has been implemented, and dedicated monitoring tools have been put in place to monitor the files concerned, BIL Group is in the process of adapting its internal forbearance definition in order to fully comply with that suggested by the EBA. Specifically, analyses have been led internally on individual credit files, with the aim of defining and identifying relevant operational criteria for the forbearance classification. This work continued during the first quarter of 2014 and led to the creation of dedicated methodologies that will be refined in order to meet the EBA's requirements.

3.2 Credit risk exposure

Credit risk exposure refers to the Bank's internal concept of maximum credit risk exposure (MCRE):
- the net carrying value of balance sheet assets other than derivative products (i.e. the carrying value after deduction of specific provisions),
- the mark-to-market valuation of derivative products;
- total off-balance sheet commitments. The total commitment corresponds to unused lines of liquidity or to the maximum amount that BIL is obliged to honour under guarantees issued to third parties.

The substitution principle applies where the credit risk exposure is guaranteed by a third party whose risk weighting is less. Therefore, counterparties presented hereafter are final counterparties, i.e. after taking into account the eligible guarantees.
As at December 31, 2013, the Bank's total credit risk exposure amounted to 20.47 billion, 0.1 billion below the level at the end of 2012. Although the exposure remained stable, the overall risk profile changed slightly, since a portion of the Bank's excess liquidity has been invested through the Treasury Portfolio, whose size increased by 1.6 billion through the year. The impacts of these investments are described in more detail in the following sections.
Several metrics will be used throughout this report to express different views on the Bank's risk exposures. The following table can be used as a reminder of the global exposure, broken down by regulatory method and by measure of risk:

APPROACH	MCRE	EAD	RWA
AIRB	17,673	17,521	2,217
Standardised	2,792	2,721	1,321
TOTAL	**20,466**	**20,242**	**3,538**

3.2.1 Exposure breakdown by class at year-end and annual average exposure

This table represents the year-end total and annual average exposure expressed as the MCRE.
The year-end total exposure includes figures obtained using both the standardised approach and advanced methods.
The average exposure is computed as the monthly average of the individual asset class exposures.

	2012 Year-end exposure	2012 Average exposure	2013 Year-end exposure	2013 Average exposure
Corporate	3,084	3,168	3,861	3,435
Equities	145	123	134	136
Financial institutions	1,061	2,589	2,133	1,878
Project finance	110	112	35	103
Public sector entitities	827	761	919	907
Retail	7,167	7,073	6,896	7,125
Sovereign	7,296	3,841	5,374	5,994
Other	890	1,598	1,114	1,066
TOTAL EXPOSURE	**20,581**	**19,263**	**20,466**	**20,645**

The main differences between the average and the year-end exposures for the year 2013 are explained as follows:

- Sovereign exposure was gradually reduced over the year, especially due to the decrease in exposure to the SNB (Swiss National Bank), explaining the difference between the year-end and the average exposure.
- Exposure to corporates increased by almost 800 million in a year. This is mainly explained by new investments and loans granted.
- Retail exposure decreased in the last quarter of the year since some loans matured.
- Exposure to financial institutions increased throughout the year. This represents the main impact of the new investments in the Bank portfolio.
- Other exposure is mainly composed of deferred tax assets (around 415 million in Luxembourg and circa 175 million in Singapore), tangible assets, intangible assets and accrued income for around 350 million, and supra-national exposure for 44 million.

3.2.2 Exposure breakdown by class and geographic area

The table below shows the total exposure expressed in terms of MCRE broken down by exposure class and geographic area at year-end 2012 and 2013. It comprises figures obtained using both the standardised and the advanced methods.

	Eurozone		Rest of Europe		USA & Canada		Rest of the world		Total exposure	
	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13
Corporate	3,013	3,781	26	41	42	36	3	4	3,084	3,861
Equities	136	127	7	7	1	1	1	0	145	134
Financial institutions	700	1,347	181	369	56	174	124	242	1,061	2,133
Project finance	0	0	76	4	0	0	34	31	110	35
Public sector entities	827	910	0	1	0	0		8	827	919
Retail	6,412	6,530	487	243	14	21	254	101	7,167	6,896
Sovereign	3,494	3,506	3,683	1,693	0	0	119	175	7,296	5,374
Other	837	891	50	47	1	1	2	175	890	1,114
TOTAL EXPOSURE	**15,420**	**17,093**	**4,510**	**2,404**	**113**	**232**	**538**	**736**	**20,581**	**20,466**

As at December 31, 2013, the Bank's exposure was mainly concentrated in Europe (95%, 19.5 billion), primarily in Luxembourg (51%), France (11%), Belgium and Germany (both 6%).

- Corporate activity is concentrated in Luxembourg (78%).
- Retail activity is concentrated in Luxembourg (75%) and its neighbouring countries (10% in France, 4% in Germany and in Belgium).
- The main sovereign exposures of the Bank are to the Swiss National Bank (1 billion), Luxembourg and the Central Bank of Luxembourg (0.8 billion), Belgium (0.8 billion), France (0.7 billion) and the European Financial Stability Facility Fund (0.6 billion).

Corporate exposure increased by almost 800 million over the year to reach 3.8 billion. This is mainly explained by new investments and loans granted in the eurozone, mostly in Luxembourg (420 million, with the exposure now at 3 billion) and Germany (218 million, with the exposure rising to 404 million).

The changes in the sovereign and financial institution sectors are linked in both cases to the change in the Bank's portfolio risk profile, as the reduction of the deposit amount at the SNB (rest of Europe) was offset by new investments in financial institutions (eurozone, especially France (+376 million) and Ireland (+103 million)).

The exposure to the rest of the world increased by 173 million due to a tax credit in respect of the Inland Revenue Authority of Singapore (Singapore branch).

3.2.3 Exposure breakdown by class and obligor grade

The table below shows the total exposure (expressed in terms of MCRE) broken down by exposure class and obligor grade at year-end 2012 and 2013. It comprises figures obtained using both the standardised and the advanced methods.

	AAA+ to AA-		A+ to BBB-		Non-investment grade	
	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13
Corporate	22	27	1,353	1,649	1,547	1,941
Equities	0	0	110	75	1	26
Financial institutions	212	429	754	1,449	16	156
Project finance			34	31	76	4
Public sector entities	366	407	450	250	3	2
Retail	21	22	3,668	3,572	3,165	3,014
Sovereign	6,583	4,252	713	1,052	0	0
Other	436	635	5	5	0	0
TOTAL EXPOSURE	**7,640**	**5,771**	**7,088**	**8,083**	**4,809**	**5,144**

	Non-rated		Default		Total exposure	
	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13
Corporate	116	165	46	79	3,084	3,861
Equities	34	33		0	145	134
Financial institutions	2	99	77	0	1,061	2,133
Project finance					110	35
Public sector entities	7	261	1	0	827	919
Retail	11	2	302	285	7,167	6,896
Sovereign		70			7,296	5,374
Other	450	474		0	890	1,114
TOTAL EXPOSURE	**620**	**1,104**	**425**	**364**	**20,581**	**20,466**

As at December 31, 2013, 67.7% of the exposure was classified as investment grade, compared with 72% in 2012. This movement does not reflect a decrease of the exposure quality; it is explained by the shift from rating counterparties using the advanced method to using the standardised approach for the public sector, insurance and mutual funds. The exposures measured by the standardised method are classified under the non-rated category.
The non-investment grade exposure is mainly composed of mid-corporate and retail exposures.

3.2.4 Exposure breakdown by class and economic sector

The table below shows the total exposure (expressed in terms of MCRE) broken down by exposure class and economic sector at year-end 2012 and 2013.

It comprises figures obtained using both the standardised and the advanced methods.

	Economic Sector	Corporate		Equities		Financial institutions		Project finance		Public sector entities	
		31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13
Industry	Industry	633	781							229	130
Construction	Construction	679	962					34	31		0
Trade-Tourism	Trade-tourism	411	432							84	0
Services	Transportation and storage	47	156	25	25						3
	Information and communication	85	66	14	1			76	4		0
	Financial and insurance activities	399	559	100	108		2,043				0
	Real estate activities	677	715	4	0	1,061				37	55
	Professional, scientific and technical activities	78	95	0	0		0			0	0
	Administrative and support service activities	33	35	0	0					5	5
	Public administration and defence-compulsory social security									295	584
	Human health and social work activities	19	42				0			145	117
	Arts, entertainment and recreation	14	11							2	3
	Other service activities	4	6		1		0			21	9
	Other services	0	1							3	2
Others	Other	4	1	2	0		89			6	10
TOTAL EXPOSURE		**3,084**	**3,861**	**145**	**134**	**1,061**	**2,133**	**110**	**35**	**827**	**919**

	Economic Sector	Retail		Sovereign		Other		Total exposure	
		31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13
Industry	Industry	65	218					927	1,129
Construction	Construction	101	318					814	1,311
Trade-Tourism	Trade-tourism	115	390					527	822
Services	Transportation and storage	14	36					170	219
	Information and communication	11	45			1	1	187	116
	Financial and insurance activities	16	1,438	3,319	1,356	50	53	4,944	5,556
	Real estate activities	79	708					796	1,478
	Professional, scientific and technical activities	22	247					99	343
	Administrative and support service activities	37	63				0	76	103
	Public administration and defence-compulsory social security	0	24	3,348	3,404	392	589	4,036	4,601
	Human health and social work activities	7	209					171	368
	Arts, entertainment and recreation	3	55					20	70
	Other service activities	26	37					52	53
	Other services	2	33	628	614			633	650
Others	Other	6,669	3,075			448	471	7,130	3,646
TOTAL EXPOSURE		**7,167**	**6,896**	**7,296**	**5,374**	**890**	**1,114**	**20,581**	**20,466**

3.2.5 Exposure breakdown by class and residual maturity

The table below shows the total exposure (expressed in terms of MCRE) broken down by exposure class and residual maturity at year-end 2012 and 2013.
It comprises figures obtained using both the standardised and the advanced methods.

	Less than 3 months		3 months to 1 year		1 year to 3 years		3 years to 5 years	
	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13
Corporate	509	458	267	468	426	410	239	378
Equities			0		0		0	
Financial institutions	583	395	62	32	65	447	72	536
Project finance	33		60	34	0	0	0	0
Public sector entities	44	27	100	26	55	32	40	91
Retail	769	592	384	534	453	455	385	343
Sovereign	679	569	140	591	83	310	598	637
Other	25	63	1	1	3	4	4	4
TOTAL EXPOSURE	**2,643**	**2,104**	**1,013**	**1,686**	**1,084**	**1,657**	**1,338**	**1,987**

	More than 5 years		No defined maturity		Total exposure	
	31/12/12	31/12/13	31/12/12	31/12/13	31/12/12	31/12/13
Corporate	910	1,306	733	840	3,084	3,861
Equities	145	134	0	0	145	134
Financial institutions	104	459	175	265	1,061	2,133
Project finance	18	1	0	0	110	35
Public sector entities	539	700	49	44	827	919
Retail	4,308	4,179	868	793	7,167	6,896
Sovereign	2,684	2,193	3,113	1,074	7,296	5,374
Other	52	53	806	990	890	1,114
TOTAL EXPOSURE	**8,760**	**9,026**	**5,743**	**4,006**	**20,581**	**20,466**

This table shows that 36% of the total risk exposure does not exceed five years, and 10% of it is of very short term, below three months.
Over the longer term, 44% of the total risk exposure exceeds five years. This represents retail banking mortgage activity and the financing of local corporate business.

Exposures classified as "no defined maturity" represent 19.6% of the total exposure and are essentially composed of:
- facilities for the corporate and retail exposure classes,
- nostri accounts with central banks for the sovereign exposure class.

3.3 Forbearance, impairment, past due and provisions

3.3.1 Definitions

BIL records allowances for impairment losses when there is objective evidence that a financial asset or group of financial assets is impaired, in accordance with IAS 39 paragraphs 58 to 70. The impairments represent the management's best estimates of losses at each balance sheet date.

3.3.1.1 Loans and receivables

An interest-bearing financial asset is impaired if its carrying amount exceeds its estimated recoverable amount.
The amount of the impairment loss for assets carried at amortised cost is calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate or current effective interest rate determined under the contract for variable-rate instruments. The recoverable amount of an instrument measured at fair value is the present value of expected future cash flows discounted at the current market rate of interest for a similar financial asset.
Off-balance sheet exposures such as credit substitutes (e.g. guarantees and standby letters of credit) and loan commitments are usually converted into on-balance sheet items when triggered. However, there may be circumstances, such as uncertainty about the counterparty, where the off-balance sheet exposure should be considered as impaired. Loan commitments should be classified as impaired if the creditworthiness of the customer has deteriorated to an extent that makes repayment of any loan and associated interest payments doubtful.

Allowances for impairment losses are recorded on the assets side under "Loans and advances due from banks" and "Loans and advances to customers" in the following way:

Specific impairment

The amount of the impairment on specifically identified assets is the difference between the carrying amount and the recoverable amount, i.e. the present value of expected cash flows, including amounts recoverable from guarantees and collateral, discounted using the effective interest rate at the time of impairment or using the effective interest rate at the reclassification date for reclassified assets. Low-value assets that share similar risk characteristics are generally aggregated. When an asset is assessed as being impaired, a specific impairment loss will be recognised.

Collective impairment

Losses incurred where there is no specific impairment but objective evidence of losses in segments of the portfolio or other lending-related commitments at the balance sheet date are covered by collective impairments. BIL estimates these based on the historical patterns of losses in each segment and the credit ratings allocated to the borrowers, and reflecting the current economic environment in which the borrowers operate. For this purpose, BIL has developed credit risk models using an approach combining appropriate default probabilities and loss-given defaults that are subject to regular backtesting and are based on Basel II data and risk models, consistent with the "incurred-loss" model. Assumptions are made to define the way inherent losses are modelled and to determine the required parameters, based on historical experience.

Accounting treatment of the impairment

BIL recognises changes in the amount of impairment losses in the statement of income and reports them as "Impairment on loans and provisions for credit commitments". The impairment losses are reversed through the statement of income if the increase in fair value relates objectively to an event occurring after the impairment was recognised.

When an asset is determined by management to be uncollectable, the outstanding specific impairment is reversed via the statement of income under the heading "Impairment on loans and provisions for credit commitments" and the net loss is recorded under the same heading. Subsequent recoveries are also accounted for under this heading.

3.3.1.2 Financial assets available for sale (AFS)

BIL recognises the impairment of AFS assets on an individual basis if there is objective evidence of impairment as a result of one or more events occurring after initial recognition.

Determination of the impairment

Equities

For equities listed on an active market, any significant decline in their price (more than 50% at reporting date) or a prolonged decline (five years) compared with the acquisition price is considered as objective evidence of impairment. In addition, management can decide to recognise impairment losses should other objective evidence be available.

Interest-bearing financial instruments

In the case of interest-bearing financial instruments, impairment is triggered based on the same criteria as applied to individually impaired financial assets valued at amortised cost.

Accounting treatment of the impairment

- When AFS financial assets are impaired, the total AFS reserve is recycled and these impairment losses are reported by BIL in the statement of income as "Net income on investments". Further decreases in fair value are recorded under the same heading as for equity securities.
- When an impairment loss has been recognised on interest-bearing financial instruments, any subsequent decline in fair value is recognised in "Net income on investments", if there is objective evidence of impairment. In all other cases, changes in fair value are recognised in "Other comprehensive income".
- Impairments on equity securities cannot be reversed in the statement of income due to later recovery of market prices.

With regard to past due items, BIL uses the IFRS standards definition, i.e. a financial asset is past due when a counterparty has failed to make a payment when contractually due. This is considered on a per-contract basis. For instance, if a counterparty fails to pay the required interests at due date, the entire loan is considered as past due.

3.3.2 Information on forborne exposure

According to the EBA definition, forborne exposures are debt contracts in respect of which forbearance measures have been extended. Forbearance measures consist of concessions towards a debtor facing or about to face difficulties in meeting its financial commitments ("financial difficulties"). While the CSSF definition of restructured credit is similar to that defined by the EBA, the latter provides institutions with more details regarding the way this should be addressed across different jurisdictions.

In order to comply with the EBA definition, BIL Group has set up a dedicated project aimed at (1) identifying the criteria leading to the forborne classification, (2) classifying the Bank's existing exposures between the forborne and non-forborne ones and (3) implementing these criteria across the systems.

For non-retail counterparties, dedicated analyses have been conducted at the single credit file level in order to identify those that should be classified as forborne according to the EBA's definition. For retail counterparties, a specific methodology has been implemented in order to catch all the forborne candidates. In a nutshell, this methodology first tries to identify the loans for which concessions have been granted to the debtors and then analyses if these concessions coincided with financial difficulties at the debtor level (based on criteria such as past due, rating, etc.).

From an accounting perspective, impairment events include significant financial difficulties of the obligor and the granting of a concession by the lender to the borrower that the lender

would not otherwise consider due to the borrower's financial difficulty. The granting of a forbearance measure is likely to constitute an impairment trigger, meaning that the loan should be assessed for impairment either individually or as part of a collective assessment.
The early repayment indemnity is recognised directly in profit or loss (if restructuring terms are substantively different from the initial ones) or spread over the term of the new loan.
As at the end of 2013, forborne exposures according to the CSSF definition amounted to 386.1 million (taking into account the 9.6 million of specific provisions). The amount of forborne exposures will be disclosed from 2014 onwards, in line with the EBA's requirements.

3.3.3 Impaired and past due exposure by large category of product

The following table shows the amount of past due exposures and the specifically impaired exposures at year-end.

		Past-due but not impaired assets			Carrying amount of individually impaired financial assets	Guarantees held for past due or individually impaired assets and debt instruments
	Date	< 90 days	> 90 days < 180 days	> 180 days		
Loans and advances (at amortised cost)	31/12/12	232	68	136	263	520
	31/12/13	173	87	130	292	475

Neither the AFS nor the HTM portfolios contained past due or impaired assets.

3.3.4 Impaired and past due exposure by geographic area

The following table shows the amount of past due credit risk exposure broken down by geographical area.

	31/12/12			31/12/13		
	Past due financial assets (impaired or not)		Total	Past due financial assets (impaired or not)		Total
	< 90 days	> 90 days		< 90 days	> 90 days	
Eurozone	85	97	182	157	203	360
Rest of Europe	147	107	253	11	8	20
Rest of the world	0	0	0	4	5	9
USA & Canada	0	0	0	0	0	0
TOTAL	**232**	**204**	**436**	**173**	**216**	**389**

3.3.5 Provisions for impaired exposure to credit risk by type of asset

The following table shows the amount of provisions for impaired exposures to credit risk broken down by type of asset at year-end 2013 and for comparison at year-end 2012.

	As at 01/01/12	Utilisation	Allowances	Write-backs	Other adjustments	As at 31/12/12	Recoveries recorded directly in profit and loss	Charges recorded directly in profit and loss
Specific allowances for financial assets individually assessed for impairment	**-228.01**	**9.16**	**-29.15**	**6.40**	**1.75**	**-239.85**	0.00	-3.78
Loans and advances to customers	-207.56	8.27	-27.92	6.40	1.54	-219.27	0.00	-3.78
Financial assets available for sale	-20.45	0.89	-1.24	-	0.20	-20.59	-	-
of which equities and other variable-income instruments	-20.45	0.89	-1.24	-	0.20	-20.59	-	-
Allowances for incurred but unreported losses on financial assets and specific allowances for financial assets collectively assessed for impairment	**-19.90**	-	**-4.34**	**2.84**	**0.00**	**-21.40**	-	-
Loans and advances to credit institutions	-	-	-0.00	-	-	-0.00	-	-
Loans and advances to customers	-19.90	-	-4.34	2.84	0.00	-21.40	-	-
TOTAL	**-247.91**	**9.16**	**-33.49**	**9.24**	**1.75**	**-261.26**	**0.00**	**-3.78**

	As at 01/01/13	Utilisation	Allowances	Write-backs	Other adjustments	As at 31/12/13	Recoveries recorded directly in profit and loss	Charges recorded directly in profit and loss
Specific allowances for financial assets individually assessed for impairment	**-239.85**	**8.48**	**-41.76**	**16.95**	**6.45**	**-249.74**	0.00	-6.40
Loans and advances to customers	-219.27	6.23	-40.52	16.95	6.02	-230.60	0.00	-6.40
Financial assets available for sale	-20.59	2.25	-1.24	-	0.43	-19.14	-	-
of which equities and other variable-income instruments	-20.59	2.25	-1.24	-	0.43	-19.14	-	-
Allowances for incurred but unreported losses on financial assets and specific allowances for financial assets collectively assessed for impairment	**-21.40**	-	**-1.46**	**2.75**	**0.00**	**-20.10**	-	-
Loans and advances to credit institutions	-0.00	-	-0.00	-	0.00	-0.00	-	-
Loans and advances to customers	-21.40	-	-1.45	2.75	0.00	-20.10	-	-
TOTAL	**-261.26**	**8.48**	**-43.22**	**19.70**	**6.45**	**-269.84**	**0.00**	**-6.40**

3.4 Internal ratings based approach (IRBA)

The exposure data included in the quantitative disclosures is used for calculating the Bank's regulatory capital requirements. It is measured using the EAD metric.

3.4.1 Competent authority's acceptance of approach

In a letter sent on December 21, 2007 by the former Belgian regulator (the Banking, Finance and Insurance Commission), Dexia SA was authorised to use the advanced internal rating-based (AIRB) approach for the calculation and reporting of its capital requirements for credit risk from 1 January 2008.
This acceptance was applicable to all entities and subsidiaries consolidated within the Dexia Group, which are established in a member state of the European Union and are subject to the Capital Requirement Directive, which includes BIL.
Following the dismantling of Dexia Group, BIL Group has decided to keep the AIRB approach and thus continued to maintain and enhance its framework throughout 2013.

3.4.2 Model management and global governance

3.4.2.1 Parameters

Internal rating systems have been set up to evaluate the three Basel II credit risk parameters: probability of default (PD), loss given default (LGD) and credit conversion factor (CCF). For each counterparty type to which the advanced method is applicable, a set of three models, one for each parameter, has been or will be developed as part of the roll-out plan.
The PD models estimate the one-year probability of default of given obligors. Each model has its own rating scale and each rating on the scale corresponds to a probability of default used for regulatory and reporting purposes. The correspondence between the rating and PD for each scale is set during the calibration process, as part of the model development, and is reviewed and adjusted during the yearly backtesting, when applicable. The number of ratings on each scale depends on the characteristics of the underlying portfolio (the number of counterparties, their homogeneity, whether it is a low default portfolio or not) up to a maximum of 17 non-default classes. In addition, each scale has been attributed two internal default classes.
The LGD models estimate the ultimate loss incurred on a facility of a defaulting counterparty before taking the credit risk mitigants into account. The unsecured LGD depends on different factors such as the product type, the level of subordination or the rating of the counterparty.
CCF models estimate the portion of off-balance sheet commitments that would be drawn before a counterparty goes into default.
Internal estimates of Basel II parameters are increasingly used within BIL in addition to the calculation of the regulatory risk-weighted exposure amounts. They are mainly used in the decision-making process, credit risk management and monitoring, and provisioning methodology.

3.4.2.2 Segmentation and principles used for estimating the PD, LGD and CCF

BIL Group uses a wide range of models to estimate PD, LGD and CCF in respect of the following types of counterparty.

Segmentation

- Sovereigns

The scope of the model encompasses sovereign counterparties, defined as central governments, central banks and all debtors whose liabilities are guaranteed irrevocably and unconditionally by central governments or central banks.
In addition, in-depth analysis of some public sector counterparties shows that they share the same credit risk as the "master" counterparties to which they are assimilated (usually local authorities or sovereigns). They are consequently attributed the same PD and LGD as their "master" counterparties.

- Project finance (specialised lending)

This model is applied to all segments of BIL's project financing activity. The specialised lending portfolio is a subgroup of the corporate portfolio which has the following characteristics: the economic objective is to finance or acquire an asset; the flows generated by this asset are the sole or practically the sole source of repayment; this financing represents a significant debt in respect of the liabilities of the borrower; the main distinguishing criterion of risk is essentially the variability in flows generated by the financed asset, rather than the borrower's ability to repay.

- Banks

The scope of the model encompasses worldwide bank counterparties, defined as legal entities that have banking activities as their usual profession. Banking activities consist of the receipt of funds from the public, credit operations and putting these funds at customers' disposal, or managing means of payment. Bank status requires a banking licence granted by the supervisory authority.

- Corporates

Two models have been designed for corporate and mid-corporate counterparties:

Corporates

The scope of the model encompasses worldwide corporate counterparties. BIL defines a corporate as a private or a publicly traded company with total annual revenue higher than 50 million (250 million if Belgium and Luxembourg companies) or belonging to a group with total annual revenue higher than 50 million that is not a bank, a financial institution, an insurer or a public/private satellite.

Mid-corporates

This model is approved in accordance with the AIRB approach for mid-corporates from Belgium and Luxembourg. BIL defines a mid-corporate as a private company with total revenue lower than 50 million (250 million if Belgium and Luxembourg companies) and belonging to a group with consolidated total

revenue lower than 50 million and with total assets higher than 2 million that is not a bank, a financial institution, an insurer or a public/private satellite.

- Retail

Retail – individuals
These models are applied to retail customers (individuals). Individuals are defined as retail counterparties not engaged in a self-employed activity or a liberal profession (i.e. doctors, lawyers, etc.) and are not linked to the activity of a legal entity.

Retail – small professionals
These models are applied to small professional retail customers defined as individuals engaged in a self-employed activity or a liberal profession, or small companies generating revenue lower than a certain threshold (0.25 million).

Retail – small companies
The models are applied to small companies that are defined as companies generating revenue higher than a certain threshold (0.25 million), but which are still considered as retail counterparties based on certain criteria (i.e. not considered as mid-corporate or corporate counterparties). However, where these companies have a credit exposure higher than 1 million, they will be considered as non-retail counterparties from a regulatory reporting point of view.

- Equity and securitisation transactions

No internal model has been developed specifically for equity or securitisation transactions.

Main principles used for estimating the PD, LGD and CCF

- Main principles used for estimating the PD

Types of counterparty	Through-the-cycle models	Time series used	Internal/external data
Sovereigns	Models are forward looking and through the cycle. They are designed to be optimally discriminative over the long term. The through-the-cycle aspect of the rating is also addressed in a conservative calibration of the PD.	> 10 years	External
Banks		> 10 years	External
Corporates		> 10 years	Internal + external
Specialised lending		6 years	Internal
Mid-corporates		6 years	External + internal
Retail		> 5 years	Internal
Equity	Mix of single risk weight and PD/LGD approach.	N/A	N/A
Securitisation*	Standardised approach.	N/A	N/A

** The Group had no exposure to securitisation transactions as at 31/12/13*

- Main principles used for estimating the LGD

Types of counterparty	Main hypotheses	Time series used	Internal/external data
Sovereigns	Expert score function based on Fitch country loss risk methodology and internal expert knowledge to distinguish between high and low loss risk.	> 10 years	Internal + external
Banks	Statistical model derived from the LGD corporate model which includes additional risk factors specific to banking counterparties (country of residence, business profile, etc.).	> 10 years	Internal + external
Corporates	Statistical model based on external rating agencies loss data. The LGD is based on counterparty rating, exposure seniority level, geographic region and macroeconomic factors.	> 10 years	Internal + external
Specialised lending	This model is of the 'Workout LGD' type: the LGD computation was developed according to the Bank's workout data on internal project finance default facilities over a 10-year period. Cash flows are estimated on the basis of the historical recovery process, and the LGD is computed using discounted cash flows.	10 years	Internal
Retail and mid-corporates	The retail LGD model is based on statistical estimates of prior LGD and haircuts to compute LGD in line with the comprehensive CRM technique as part of the AIRB approach.	> 5 years	Internal
Equity	Mix of single risk weight and PD/LGD approach.	N/A	N/A
Securitisation*	Standardised approach.	N/A	N/A

** The Group had no exposure to securitisation transactions as at 31/12/13*

- Main principles used for estimating the CCF

BIL has yet to use CCF models for regulatory purposes, and the foundation parameters are thus currently applied. A dedicated action plan will be defined in 2014 in order to develop these types of model internally.

3.4.2.3 Model management process and internal governance

BIL has set up an internal organisation adequately scaled and skilled to allow the introduction, monitoring, maintenance and progressive development of the AIRB framework. This is reflected in a well-defined process, which is described below.

Credit Risk Control Unit (CRCU)

As required by Basel II/III, the Credit Risk Control Unit (CRCU) is responsible for the oversight of the IRS and for the proper application of the current framework. The CRCU is run by the Risk Controlling team. CRCU activities fall into two main categories:

- **Model validation**, which is aimed at controlling the adequacy of rating models to the level of risk the Bank is exposed to. In particular, this team:
  - Controls the consistency of the assumptions and methodological choices made during the model development steps of the model lifecycle;
  - Performs backtesting and/or benchmarking on a regular basis and at least annually to control model performance as well as the appropriateness and soundness of the model assumptions over time;
  - Ensures that the rating models have been properly implemented and that appropriate testing has been carried out.
- **Risk systems quality control**, which is aimed at ensuring that the ratings allocated are consistent with the internal rating procedures. In particular, this team ensures:
  - The accuracy of data used in the rating process;
  - That rules on which the rating models are based are adhered to;
  - That the ratings and the related data are properly disseminated within the different internal systems;
  - That overrides are clearly justified and documented.

Model Management Unit (MMU)

The Model Management Unit (MMU) is run by the IRS Modelling and Integration team. This team is responsible for the development, the implementation and the management of all the rating models under the scope of the current framework.

Credit Risk Management Unit (CRMU)

The Credit Risk Management Unit (CRMU) is run by the Country and Bank Analysis team and the Retail, Mid-Corp, Corp and Private Bank Analysis team. The Credit Risk Management department and, more precisely, the credit risk analysts are the main users of the IRS; they are responsible for the assessment and monitoring of credit risk. Specifically regarding the model management framework, CRMU is in charge of assessing the ratings of the Bank's counterparties (i.e. PD) as well as their corresponding exposure facility type (i.e. LGD and CCF) and of documenting these results in the context of the loan approval process (i.e. mention on the "Fiche de Décision Crédit").

As a key member of the Default Committee, this unit is actively involved in default decisions and monitoring.

Moreover, credit analysts bring qualitative input to the model development stage and during backtesting and stress testing exercises.

Audit

As part of its audit plan for the Bank, the Internal Audit function reviews whether the Bank's control systems for internal ratings and related parameters are sufficiently robust. The main objective of the review is to ensure compliance with the legal and regulatory requirements related to the credit risk modelling framework and the effective assessment and management of all risks/weaknesses. In particular, internal audit may review Credit Risk Control Unit activities, ensuring that the oversight process is properly managed.

3.4.2.4 Committees

Several committees have been established to consolidate the credit risk model management framework and to provide adequate follow-up and decisions.

Internal Rating System Performance Committee (IRSPC)

The Internal Rating System Performance Committee (IRSPC) looks after all matters related to the regulatory Basel II/III Pillar I credit rating models and corresponding rating tools.

Rating Committee (RC)

The objective of the Rating Committee is to discuss and make decisions about the following topics:

- Rating methodology
- Rating system framework
- Rating process reviews

Risk Policy Committee (RPC)

The Risk Policy Committee (RPC) is responsible for the implementation and the maintenance of the risk governance framework within the Bank. In particular, the RPC is tasked with ensuring that the policies and procedures related to risk concerns are comprehensive and consistent.

Default Committee

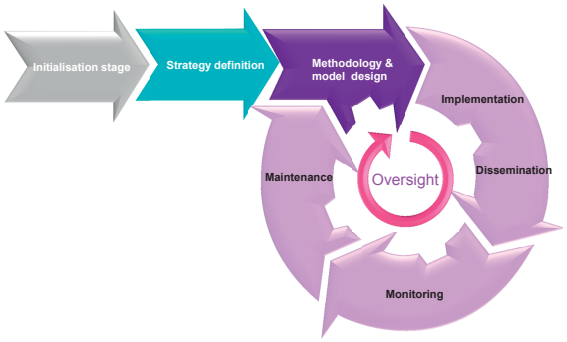
For BIL and its main subsidiaries and branches, this committee examines each case of default, classifies it (distinguishing between "true default" and "technical default"), assigns counterparties default level D1 or D2 according to general default indicators and parameters specific to each customer segment, and decides on the reclassification as a non-default counterparty.

Escalation Committee

When cases are discussed during IRSPC meetings, disagreements may arise between the MMU, CRCU or CRMU, leaving the case without decision. These cases are then submitted to Escalation Committee for a final decision.

3.4.2.5 Model management process

The lifecycle of a model can be summarised as follows:



Initialisation stage

The scope of credit risk models is supposed to be modified in accordance with business changes; new models or model changes could thus be required over time.

New model development requests are submitted to the IRSPC, which centralises and documents them and takes a decision on their relevance.

If the decision is to develop a model, the change request is handled by the MMU.

Strategy definition

Once the IRSPC has decided that a new model should be developed or reviewed, a pre-analysis is performed by the MMU.

Based on the results of this analysis, a strategy will be proposed by the MMU and submitted to the IRSPC. At this stage, validation of the strategy is required. Depending on the prescribed strategy, the CRCU and/or Model Validation team should provide their opinion.

Methodology and model design

The MMU is responsible for the definition and the implementation of the approach used for the model design. The model choice is left to the discretion of the MMU.

At the end of this stage, a model vetting review should be performed prior to the internal implementation of the new model. Model vetting consists of a detailed review of the model methodology, the modelling assumptions and the data and programmes on which the model is based. This review is under the responsibility of CRCU, which can conduct the review itself or delegate it externally.

Implementation and dissemination

Once the methodology of the model has been validated, its technical implementation is performed. The technical implementation is based on a business requirement definition (BRD) which is defined by or under the responsibility of the MMU. Acceptance of the rating tool should be validated by the IRSPC.

Model monitoring

In order to ensure that the model provides the same level of performance over time, two sets of controls are performed. One regards the ability of the model to provide accurate and conservative predictions, while the other is aimed at ensuring the reliability of the rating and the related data.

- **Quantitative validation**

The quantitative validation of a rating model consists of performing a set of tests (i.e. backtesting).

In addition, a benchmarking analysis can be performed to compare internal estimates with figures across banks and/or with external benchmarks (e.g. external ratings, vendor models, or models developed by supervisory authorities).

Quantitative validation is performed once the year by the CRCU (Model Validation team) and their results are assessed by the IRSPC. A set of recommendations will be drafted if issues are identified. The conclusion of the backtesting can lead to a recalibration or review of the model if its performance does not reach the expected level.

In this case, the model review follows the same steps as those of the development of a new model (methodology and model design/implementation and dissemination/model monitoring).

- **Backtesting**

The primary purpose of credit risk model backtesting is to ensure the adequacy of the Bank's regulatory capital with regard to the credit risks to which it is exposed. Since capital adequacy relies on internally estimated credit risk factors (PD, LGD and EAD), the Bank has to provide evidence that its risk assessment is accurate or at least sufficiently conservative.

A second purpose of backtesting is the evaluation of the predictive power of the rating system and the assessment of its capacity to detect reduced performance at an early stage. Reduced performance of the rating system as a decision-making tool may expose the Bank to model risk by impacting the risk assessment of the defined risk buckets, and consequently reduce the Bank's profitability. The performance is tracked by analysing the ability to predict defaults and losses, by discriminating between high and low risk, and by analysing the stability of IRS results.

The backtesting process relies on three kinds of assessment:

- Calibration: calibration is used to assess the accuracy of the risk factor estimate. In the context of rating systems, it denotes the mapping of the probability of default (PD) to the rating grades. A rating system is well calibrated if the estimated PDs deviate only marginally from the actual default rates. The predicted LGD or CCF is compared to the actual loss rate or proportion of used facilities respectively.
- Discriminatory power: the discrimination of rating systems denotes their ex-ante capability to identify borrowers that are in danger of defaulting. Thus, a rating system with maximum power would be able to predict all borrowers that subsequently default. In practice, however, such perfect rating systems do not exist. A rating system is said to have high discriminatory power if default rates

are distributed and ordered consistently across the rating scale and if these default rates are significantly different. The 'good' grades subsequently turn out to contain only a small percentage of defaulters and a large percentage of non-defaulters, with the opposite applying to the 'poor' grades.

- Stability: the stability analysis concerns the population and its data characteristics, and the assumptions used to design the model. Its purpose is to ensure that the model inputs remain consistent with the original model specifications, that the economic environment or the changes in the Bank's activity do not affect the performance of the model, and that the possible drift of the model output distribution is not explained by a change of the model behaviour or population.

Prior to the dismantling of Dexia Group, the backtesting of models was performed by its Modelling team. In view of the size and particular characteristics of the BIL credit portfolio, backtesting approaches have been reviewed and tailored to BIL concerns, especially the limited volume of internal data. BIL-specific backtesting was applied for the first time in 2013. On the whole, the results of backtesting performed on the BIL portfolio are in line with the results of previous backtesting exercises performed by Dexia Group. The calibration of risk parameters appears as globally conservative for the main portion of the credit portfolio.

- **Stress testing**

Pillar I stress tests are defined within the Basel II requirement framework. They provide an assessment of the risk parameter levels (weighted risk, expected loss and realised loss) and the related deviations during periods of stress.

The different stress tests impact either the quality of the portfolio as a whole or the risk parameters. They are organised as follows:

- Sensitivity stress tests: the sensitivity of the weighted risks and expected and realised losses in relation to changes in explanatory risk parameters (PD, LGD, CCF).
- Scenario stress tests: the impact of unlikely but plausible scenarios on the weighted risks and expected and realised losses. These scenarios can be macroeconomic or expert-based and are checked via the benchmarking of the hypotheses when possible.

Sensitivity tests and scenario-based stress tests are performed for the main internal rating systems (IRS).

In 2013, following the Dexia spin-off, the first BIL stress tests were performed on the BIL stand-alone credit portfolios.

- **Quality control**

Quality control consists of the operational validation of the IRS. It is aimed at ensuring the reliability of the ratings and the data involved in the rating process. In particular, quality control encompasses:

- Rating process oversight,
- Rating dissemination through the Bank's different systems, by ensuring that the ratings are recorded and updated consistently and according to the expected frequency,
- Default and loss management.

Quality control reviews are performed once a year, or more frequently if required, and their results are discussed at meetings of the Rating Committee. In the event of problems or anomalies, recommendations are issued or corrective measures are requested.

Model maintenance

Model management is an iterative process used to ensure the consistency and the objectivity of risk assessments over time. The process may be improved or updated.

The MMU is in charge of collecting the change requests and providing an opinion regarding the relevance and the feasibility of the demand. The change requests (including the rationale for the request, the possible ways of fulfilling the request, the benefit that the request would bring versus the expected cost) are discussed during meetings of the IRSPC, which decides whether or not to proceed with the request.

Model management oversight and validation process

Model management oversight relies on a set of controls and validations throughout the model management process. The table below summarises the steps for this oversight process.

Oversight	Description	Owner	Decision-maker	Frequency
Model development and update decision	All new model developments or model updates have to be validated on the basis of a documented request.	Member of IRSPC	IRSPC	Each time a new model or updated is requested.
Decision on a change in the rating process	All changes in the rating process are to be discussed and validated.	Credit Risk Management Unit or Model Management Unit	RC – Operational changes IRSPC – Methodological changes	Each time a change in rating process is requested.
New model or model update vetting	When a new model is developed, a comprehensive review must be performed in order to validate the accuracy of 1) the model methodology and underlying assumptions, 2) the data and the programmes used in the development and 3) the mathematical foundation of the model.	Model Validation (review could be performed by an external vendor)	IRSPC	Each time a new model is developed or updated.
Validation of rating tool implementation	When a new rating application is implemented or developed, a comprehensive set of tests should be performed in order to ensure the consistency and the reliability of the ratings. These tests relate to programming and data flow. Validation should be based on the documented testing results.	Model Management Unit	IRSPC	Each time a new rating application is developed or updated.
Validation of the operational rating process	The reliability and consistency of the rating process is controlled on a regular basis in order to ensure an appropriate level of rating quality.	Quality Control Unit	RC	At least once a year per IRS.
Quantitative model validation	The ability of the model to provide an appropriate assessment of risk is controlled on a regular basis through the backtesting process.	Model Validation	IRSPC	At least once a year per IRS.
IRS compliance audit	A comprehensive review ensures the compliance of IRS with regulatory requirements, especially regarding the robustness of the oversight process.	Internal Audit	Internal Audit	At least once a year.

Business integration of internal estimates

Internal estimates of Basel II parameters are increasingly used within BIL Group, and cover a large number of applications in addition to the calculation of the regulatory capital requirements. They are notably used in the following areas:

- Decision-making process

Basel II parameters are the key elements considered by the Credit Committee in assessing the opportunity to accept or reject a transaction. Basel II parameters are thus integrated into the credit files to assess credit proposals.

- Credit risk management and monitoring

Basel II parameters are actively used for the individual monitoring of distressed transactions and counterparties by the Default Committee.

The counterparty internal ratings, the LGD, the level of expected loss and the risk weighted assets are the key Basel II parameters used for internal reports or specific analysis, with the aim of improving credit risk management best practices.

- Provisioning methodology

The implementation of Basel II parameters has made it possible to develop more synergies between accounting and prudential issues (IFRS/Basel II), while drawing on the processes, data and tools of the Basel II project.

The Basel II definition of default and the accounting concept of impairment have converged in relation to specific impairments. As a consequence, only defaulted assets identified as such in the Basel II-compliant risk management systems are identified as impaired assets for both accounting and risk management purposes. Moreover, Basel II parameters are used to compute specific provisions for mass retail products and to calibrate additional provisions in relation to the healthy portfolio as well as specific sectors.

3.4.3 Average PD, LGD and risk weight by exposure class and obligor grade

The following table shows the total EAD, undrawn commitments, exposure-weighted average PD, LGD and CCF and exposure-weighted average risk weights broken down by exposure class and obligor grade at year-end 2013. The exposure is calculated using the advanced method.

EXPOSURE CLASS AS OF 31/12/13	Obligor Grade	Total exposure	Undrawn commitments	Off-balance sheet exposure after CCF application	EAD	Average CCF
Corporate	AAA to AA-	20	10	8	12	20%
	A+ to A-	468	81	58	410	28%
	BBB+ to BBB-	1,040	334	215	826	36%
	Other	1,600	491	294	1,306	40%
	Default	94	21	14	80	32%
CORPORATE	**TOTAL**	**3,222**	**936**	**589**	**2,633**	**37%**
Equities	AAA to AA-	-	-	-	-	-
	A+ to A-	2	-	-	2	-
	BBB+ to BBB-	66	-	-	66	-
	Other	1	-	-	1	-
	Default	0	-	0	0	-
EQUITIES	**TOTAL**	**69**	**-**	0	69	-
Financial Institutions	AAA to AA-	577	85	68	510	20%
	A+ to A-	1,399	3	2	1,397	50%
	BBB+ to BBB-	607	1	1	607	50%
	Other	158	0	0	158	52%
	Default	-	-	-	-	-
FINANCIAL INSTITUTIONS	**TOTAL**	**2,741**	**89**	**70**	**2,671**	**22%**
Project finance	BBB+ to BBB-					
	Other	4	0	0	4	50%
PROJECT FINANCE	**TOTAL**	**4**	**0**	**0**	**4**	**50%**
Public sector entities	AAA	342	31	17	324	45%
	BBB+ to BBB-	1	0	0	1	42%
	Default	0	0	0	0	50%
PUBLIC SECTOR ENTITIES	**TOTAL**	**343**	**31**	**17**	**325**	**45%**
Retail	AAA to AA-	22	15	8	13	44%
	A+ to A-	1,084	198	113	971	43%
	BBB+ to BBB-	2,510	273	155	2,356	43%
	Other	3,099	298	168	2,932	44%
	Default	417	20	10	406	48%
RETAIL	**TOTAL**	**7,133**	**804**	**454**	**6,678**	**43%**
Sovereign	AAA	3,602	172	94	3,507	45%
	A+ to A-	570	0	0	570	-
	BBB+ to BBB-	467	-	-	467	-
	Other	0	-	0	0	-
SOVEREIGN	**TOTAL:**	**4,638**	**172**	**94**	**4,544**	**45%**
Other	AAA to AA-	591	-	-	591	-
	A+ to A-	0	-	-	0	-
	BBB+ to BBB-	0	-	-	0	-
	Other	4	-	-	4	-
	Default	-	-	-	-	-
OTHER	**TOTAL**	**595**	**-**	**-**	**595**	**-**
DEFAULT	**TOTAL**	**511**	**41**	**25**	**486**	
GRAND TOTAL		**18,746**	**2,033**	**1,225**	**17,521**	

EXPOSURE CLASS AS OF 31/12/13	Obligor Grade	Average PD	Average LGD	Average RW	Provisions	EAD 31/12/12
Corporate	AAA to AA-	0.03%	37%	9%	-	
	A+ to A-	0.07%	25%	12%	-	
	BBB+ to BBB-	0.45%	34%	47%	-	816
	Other	5.27%	10%	22%	2	1,150
	Default	100%	9%	0%	31	49
CORPORATE	TOTAL	5.80%	20%	28%	33	2,238
Equities	AAA to AA-	0.00%	0%	0%	-	
	A+ to A-	0.12%	90%	111%	-	1
	BBB+ to BBB-	0.18%	90%	135%	0	70
	Other	4.11%	87%	411%	0	0
	Default	100%	90%	0%	-	0
EQUITIES	TOTAL	0.26%	90%	140%	0	70
Financial Institutions	AAA to AA-	0.03%	15%	6%	-	435
	A+ to A-	0.06%	21%	11%	-	1,029
	BBB+ to BBB-	0.25%	10%	12%	-	1,241
	Other	1.30%	23%	45%	-	16
	Default	-	-	-	-	116
FINANCIAL INSTITUTIONS	TOTAL	0.17%	18%	12%	-	2,837
Project finance	BBB+ to BBB-					34
	Other	2.68%	26%	64%	-	68
PROJECT FINANCE	TOTAL	2.68%	26%	64%	-	102
Public sector entities	AAA	0.00%	8%	0%	-	154
	BBB+ to BBB-	0.59%	9%	12%	-	16
	Default	100%	7%	0%	0	4
PUBLIC SECTOR ENTITIES	TOTAL	0.03%	8%	0%	0	174
Retail	AAA to AA-	0.04%	23%	3%	-	17
	A+ to A-	0.10%	9%	3%	-	999
	BBB+ to BBB-	0.50%	9%	8%	0	2,516
	Other	6.74%	9%	20%	2	3,117
	Default	100%	14%	0%	132	416
RETAIL	TOTAL	9.24%	10%	12%	134	7,064
Sovereign	AAA	0.00%	6%	0%	-	5,684
	A+ to A-	0.07%	25%	13%	-	559
	BBB+ to BBB-	0.34%	35%	42%	-	144
	Other	1.15%	0%	0%	-	0
SOVEREIGN	TOTAL:	0.04%	11%	6%	-	6,388
Other	AAA to AA-	0.00%	5%	0%	-	394
	A+ to A-	0.05%	6%	0%	-	0
	BBB+ to BBB-	0.60%	39%	0%	-	0
	Other	30.83%	5%	9%	-	3
	Default	0%	0%	0%	-	-
OTHER	TOTAL	0.20%	5%	0%	-	397
DEFAULT	TOTAL	100%			162	585
GRAND TOTAL					167	19,270

3.4.4 Advanced retail exposure by type of product and obligor grade

The following tables provide an analysis of the retail segment exposures broken down by loan types and expressed in EAD under the AIRB approach.

	31/12/12					
	A+ to A-	AAA to AA-	BBB+ to BBB-	Other	Default	Grand total
Mortgage loans	380	1	909	604	35	1,929
Bridge loans	215	2	677	637	44	1,575
Credit cards	85	9	331	922	209	1,555
Investment loan	80	–	215	339	18	652
Facilities	108	1	126	255	88	578
Private Loans	43	0	80	88	11	223
Lombards	–	–	39	112	0	151
Leasing	12	2	27	34	1	75
Student loans	5	–	25	17	2	48
Other	71	2	87	110	8	278
GRAND TOTAL	**999**	**17**	**2,516**	**3,117**	**416**	**7,064**

	31/12/13					
	A+ to A-	AAA to AA-	BBB+ to BBB-	Other	Default	Grand total
Mortgage loans	651	2	1,577	1,106	65	3,402
Bridge loans			1	2	0	3
Credit cards	141	8	383	875	186	1,594
Investment loan	13	0	20	68	5	106
Facilities	105	2	220	492	122	940
Private Loans	25	0	68	117	24	233
Lombards	0	0	0	139	0	139
Leasing	1	0	18	42	0	61
Student loans	7	0	25	15	1	48
Other	28	0	45	76	2	152
GRAND TOTAL	**971**	**13**	**2,356**	**2,932**	**406**	**6,678**

The overall exposure by rating did not change significantly between 2012 and 2013.
However, a data reclassification project was carried out in 2013, leading to changes in some loan categories, particularly impacting mortgage and bridge loans. The effect on the two classes is clear: the mortgage loan exposure increased by 1,473 million, whereas the bridge loan exposure decreased by 1,572 million.

3.5 Standardised approach

3.5.1 Introduction

As previously stated, BIL Group uses the AIRB approach to calculate its regulatory capital requirements. Nevertheless, the Bank applies the standardised approach for some portfolios corresponding to cases specifically authorised by regulation such as:

- Small business units with non-material exposures;
- Portfolios without enough data to build a sound model;
- Portfolios for which BIL has adopted a phased roll-out of the AIRB approach.

As requested by the regulator, more than 85% of the exposures are treated under the AIRB approach.
BIL has informed the regulator of the models to be developed in the coming years for specific business segments and Basel II credit risk parameters.

3.5.2 External credit assessment institutions (ECAI)

The standardised approach provides weighted risk figures based on external ratings. In order to apply the standardised approach for risk weighted exposure, BIL Group uses the external ratings assigned by the following rating agencies: Standard & Poor's and Moody's.
The rating used for the regulatory capital calculation is the lower of the two ratings. If no external rating is available, the standardised approach provides specific risk weights defined by the regulator (depending on the counterparty type).

Credit rating agencies and credit quality step under the standardised approach

Standard and Poor's	Moody's	Regulatory credit quality step
AAA to AA-	Aaa to Aa3	1
A+ to A-	A1 to A3	2
BBB+ to BBB-	Baa1 to Baa3	3
BB+ to BB-	Ba1 to Ba3	4
B+ to B-	B1 to B3	5
CCC+ and below	Caa and below	6
NR	NR	7

Risk weights are mainly determined in relation to the credit quality step and the exposure class.

3.5.3 Standardised exposure-at-default and average risk weights

The following table shows the EAD under the standardised approach, before and after credit risk mitigation, broken down by asset and external rating classes. It also indicates the corresponding weighted average risk weights, the undrawn commitment amounts and the exposure of debtors in default (for which the amount of provisions is given by the impaired exposure).

31/12/13	Obligor Grade	Exposure before CRM (EAD)	Exposure after CRM	Average Risk Weight	Undrawn Commit-ment	Impaired Exposure	EAD 31/12/12
Corporate	AAA to AA-	-	-	0%	-	-	-
	No external rating	669	452	82%	110	8	571
CORPORATE		**669**	**452**	**82%**	**110**	**8**	**571**
Equities	A+ to A-	0	0	50%	-	-	-
	BB+ to B-	-	-	0%	-		1
	No external rating	65	65	145%	-	19	74
EQUITIES		**65**	**65**	**145%**	-	19	75
Financial Institutions	AAA to AA-	71	71	9%	-	-	-
	A+ to A-	-	-	0%	-	-	2
	BBB+ to BBB-	-	-	0%	-	-	-
	No external rating	106	84	86%	33	49	38
FINANCIAL INSTITUTIONS		**177**	**155**	**61%**	**33**	**49**	**40**
Project finance	No external rating	30	30	100%	1	-	-
PROJECT FINANCE		**30**	**30**	**100%**	**1**	**-**	**-**
Public sector entities	AAA to AA-	327	327	8%	3	-	221
	A+ to A-	8	8	50%	-	-	-
	BB+ to B-	16	16	20%	-	-	-
	Below B-	0	0	150%	-	-	-
	No external rating	222	180	88%	13	3	394
PUBLIC SECTOR ENTITIES		**573**	**531**	**40%**	**16**	**3**	**615**
Retail	No external rating	2	2	100%	0	0	13
RETAIL		**2**	**2**	**100%**	**0**	**0**	**13**
Sovereign	AAA to AA-	639	639	0%	-	-	642
	A+ to A-	61	61	20%	11	-	-
SOVEREIGN		**699**	**699**	**2%**	**11**	**-**	**642**
Other	AAA to AA-	70	70	0%	52	-	25
	A+ to A-	0	0	50%	-	-	1
	BBB+ to BBB-	0	0	50%	-	-	-
	BB+ to B-	0	0	0%	-	-	-
	Below B-	-	-	0%	-	-	-
	No external rating	435	357	73%	0	-	444
OTHER		**506**	**428**	**63%**	**52**	**-**	**470**
GRAND TOTAL		**2,721**	**2,363**		**224**	**78**	**2,427**

The mitigation impact of collateral is mainly noticeable among the corporate, financial institution and public sector entity asset classes, where it is represented by eligible collateral, such as pledges of commercial or other physical assets for corporates and public sector entities, and pledges of financial assets for the financial institutions and "other" asset classes.

The "other" asset class mainly consists of tangible assets and accrued income.

The sovereign exposures, rated from AAA to AA-, correspond to supranational institutions exposures (mainly the European Stability Mechanism).

3.6 Credit risk mitigation techniques

3.6.1 Description of the main types of credit risk mitigants (CRM)

The Basel II regulation recognises three main types of CRM:

- Collateral;
- Guarantees and credit derivatives;
- Netting agreements (applicable to on-balance sheet and off-balance sheet netting agreements – see below).

Main types of collateral

Collateral is represented by financial products or physical objects used to hedge exposures. BIL Group manages a wide range of collateral types. From a regulatory point of view, three main categories of collateral exist:

- Pledges of financial assets – cash, blocked accounts, term deposits, insurance contracts, bonds and equity portfolios;
- Pledges of real estate (residential mortgages, commercial mortgages, mortgage mandates);
- Pledges of commercial assets (e.g. transfer of deliverables).

Main types of guarantees

Guarantees refer to personal guarantees, first demand guarantees, support commitments and "tri-party conventions".

Main types of netting agreements

A netting agreement is a technique for mitigating credit risk. Banks have legally enforceable netting agreements for on-balance sheet exposures (loans and deposits) and off-balance sheet exposures (derivatives) for which they may calculate capital requirements on the basis of net credit exposures subject to specific regulatory conditions.

3.6.2 Policies and processes

Collaterals and guarantees/credit derivatives

Managing the CRM involves the following tasks:

- Analysis of the eligibility of all CRM under the standardised and advanced approaches;
- Collateral valuation in mark-to-market;
- Description of all CRM characteristics in BIL Group's risk systems, such as:
  - Mortgages – rank, amount and maturity;
  - Financial collateral – valuation frequency and holding period;
  - Guarantees/credit derivatives – identification of the guarantor, analysis of the legal mandatory conditions, check as to whether the credit derivative covers restructuring clauses;
  - Security portfolio – description of each security.
- Periodic review of the descriptive data.

At an operational level, different IT tools are used to manage collateral. These IT tools are used to record any relevant data needed to identify collateral characteristics, eligibility criteria and estimated value, in accordance with the Basel II framework.

On- and off-balance sheet netting

The regulator is in charge of granting banks authorisation to use netting agreements according to certain eligibility criteria which are different for on-balance sheet and off-balance sheet netting agreements.

BIL Group does not make use of on- or off-balance sheet netting for regulatory purposes, except for over-the-counter (OTC) derivative products.

For these products, internal policies document the eligibility criteria and minimum requirements that netting agreements need to fulfil in order to be recognised for regulatory purposes under Basel II.

Appropriate internal procedures and minimum requirements have been implemented in the internal risk management process.

Information about market or credit risk concentrations

Concentration risk is related to a concentration of collateral in one issuer, country, industry or market. As a result, credit deterioration might have a significant impact on the overall value of collateral held by the Bank to mitigate its credit exposure.

Since BIL is a commercial and private bank, most of its credit risk mitigants are linked to mortgage loans and leveraged loans (categorised as Lombard loans and investment lines of credit by BIL).

- **Mortgages**

As a major Luxembourg-based bank, BIL makes a substantial contribution to the financing of local projects involving both residential and commercial real estate. As such, it is inevitably dependent on the effect Luxembourg's economic growth may have on the large amount of mortgages it takes as collateral for loans granted.

However, the Bank has strong governance and specific guidelines in place in order to adequately cover the risks involved in the granting of loans to its retail and corporate customers and to diversify the range of collateral it takes as a guarantee. This involves the approval of commitment/credit committees based on credit applications proposed by front officers, for which credit analysts give their opinion. This opinion takes into account the quality of the debtor through its rating, revenues, indebtedness level and repayment capacity, as well as the quality of the asset pledged as collateral for which a conservative loan-to-value ratio is assigned.

The Bank as well as the national regulator are well aware of this exposure and carefully monitor the concentration risk through regular reports and monitoring of limits on real estate exposure.

- **Financial collateral**

Among its range of services to wealthy customers, the Bank proposes Lombard loans and investment lines of credit. These are granted against the pledge of eligible financial assets for which cover values are assigned by the Credit Risk team reflecting the quality, liquidity and volatility of the underlying

collateral. As part of their contractual obligations and in order to limit the concentration risk within individual portfolios, customers using these kinds of facilities must not only maintain adequate cover values for their loans at all times, but are also required to comply with an obligation of diversification of their collateral portfolios.
Exposure and collateral values are continuously monitored to ensure the proper application of these instructions, and margin calls or close-out procedures are enforced when the market value of collateral falls below a predefined trigger level.

3.6.3 Basel II treatment

BIL Group recognises the mitigation impact of netting agreements (subject to eligibility conditions), by applying the netting effect of these agreements to the calculation of the EAD used to compute its risk weighted assets.
For guarantees and credit derivatives, BIL recognises the impact by substituting the PD, LGD and risk weight formula of the guarantor to those of the borrower (i.e. the exposure is considered to be directly to the guarantor) if the risk weight of the guarantor is lower than the risk weight of the borrower.
For collateral (both financial and physical), the BIL methodology relating to eligible CRM is based on the Basel II approach.

- Standardised exposures

Eligible CRM (after regulatory haircuts) are directly taken into account when calculating the EAD.

- AIRB approach exposures – two methodologies may be applied:
  - CRM are incorporated into the calculation of the LGD based on internal loss data and AIRB approach model calculations.
  - CRM are not incorporated into the LGD computed by the model. The impact of each individual CRM is taken into account in the LGD according to each transaction.

3.6.4 Exposure covered by CRM by exposure class

This section provides with an overview on the EAD covered by Basel II eligible CRM (after regulatory haircuts) broken down by exposure class at year-end 2012. The amounts shown in the table below take netting agreements into account and include collateral values for repo transactions.

31/12/12	Financial collateral	Guarantee	Physical collateral	Repo	EAD, collateralised or guaranteed	EAD, NOT collateralised and NOT guaranteed	Total EAD	Cover percentage
Corporate	82	20	–	–	101	2,707	2,809	3.6%
Equities	–	–	–	–	–	146	146	0.0%
Financial institutions	1,111	29	–	638	1,779	1,098	2,877	61.8%
Project finance	29	–	–	–	29	73	102	28.3%
Retail	488	329	–	–	817	6,261	7,078	11.5%
Sovereign	0	748	–	–	748	6,282	7,030	10.6%
Other	7	–	–	–	7	860	867	0.8%
TOTAL COLLATERALISED OR GUARANTEED EAD	**1,717**	**1,126**	**–**	**638**	**3,482**	**18,215**	**21,697**	**16.0%**

31/12/13	Financial collateral	Guarantee	Physical collateral	Repo	EAD, collateralised or guaranteed	EAD, NOT collateralised and NOT guaranteed	Total EAD	Cover percentage
Corporate	63	25	268	-	356	2,946	3,302	10.8%
Equities	-	-	-	-	-	134	134	0.0%
Financial institutions	399	131	-	363	893	1,956	2,848	31.3%
Project finance	-	-	-	-	-	34	34	0.0%
Public sector entities	0	4	42	-	46	853	898	5.1%
Retail	385	0	0	-	385	6,296	6,681	5.8%
Sovereign	0	750	-	-	750	4,493	5,244	14.3%
Other	78	-	-	-	78	1,023	1,101	7.1%
TOTAL COLLATERALISED OR GUARANTEED EAD	**925**	**910**	**310**	**363**	**2,508**	**17,734**	**20,242**	**12.4%**

It is worth noting that eligible mortgages are included in the LGD calculation and are not reported in the table above.

3.7 Counterparty risk

3.7.1 Management of counterparty risk

A counterparty risk attached to derivatives exists in all over-the-counter (OTC) transactions such as interest rate swaps, foreign exchange swaps, inflation or commodity swaps and credit default swaps.

To reduce counterparty risk, OTC derivatives are in most cases concluded under a master agreement (i.e. the International Swap and Derivative Association – ISDA) taking account of the general rules and procedures set out in the credit risk policies of the Bank. Collateral postings for derivative contracts are regulated by the terms and rules stipulated in the credit support annex (CSA) negotiated with the counterparty.

These terms may depend on the credit ratings of the counterparties. The impact of potential downgrades is managed by the Bank.

All OTC transactions are monitored within the credit limits that are set up for each individual counterparty, and are subject to the general delegation rules. Sub-limits may be put in place for each type of product.

3.7.2 Exposure to counterparty risk

The following table shows the gross EAD for the derivative contracts, the netting agreements and the amount of collateral received, and the net EAD (after taking into account the impact of netting agreements and collateral posting).

	31/12/12	31/12/13
Gross EAD	1,779	720
Netting agreements	539	242
Eligible collateral	1,179	377
Net EAD	130	101
Total RWA	47	47
Capital requirement	4	4

In 2013, BIL Group reduced its exposure on derivatives in order to deleverage its balance sheet. This is clearly visible in the exposure (EAD) amount. The amount of collateral and the effect of the netting agreements have been reduced accordingly.

The table below shows the breakdown of the net EAD (after applying the effects of netting and collateral agreements), broken down by type of derivative at year-end 2012 and 2013.

	Net EAD	
Type of derivative	31/12/12	31/12/13
Equity	0	4
Foreign exchange	21	57
Interest rate	109	41
TOTAL	130	101

3.8 Equity exposure

3.8.1 Accounting rules

IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Quoted market prices on an active market for identical instruments are to be used as fair value, as they are the best evidence of the fair value of a financial instrument. If a financial instrument is not traded on an active market, valuation models can be used. The objective of a valuation model is to determine the value that is most representative of fair value under current market conditions.

The Bank's valuation techniques maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The valuation model should take into account all factors that market participants would consider when pricing the financial instrument. Measuring the fair value of a financial instrument requires consideration of current market conditions. To the extent that observable inputs are available, they should be incorporated into the model.

- **Financial assets and liabilities measured at fair value are categorised into one of the three fair value hierarchy levels**

The following definitions used by the Bank for the hierarchy levels are in line with IFRS 13 rules:

- Level 1: quoted prices (unadjusted) on active markets for identical assets and liabilities;
- Level 2: valuation techniques based on inputs other than quoted prices included within Level 1 that are observable, either directly or indirectly;
- Level 3: valuation techniques for which significant inputs are not based on observable market data.

- **Financial instruments measured at fair value for which reliable quoted market prices are available**

If the market is active, market prices are the most reliable evidence of fair value and therefore shall be used for valuation purposes. The use of market prices quoted on an active market for identical instruments with no adjustments qualifies for inclusion in Level 1 within the IFRS 13 fair value hierarchy, contrary to the use of quoted prices on inactive markets or the use of quoted spreads.

- **Financial instruments measured at fair value for which no reliable quoted market prices are available and for which valuations are obtained by means of valuation techniques**

Financial instruments for which no quoted market prices are available on an active market are valued by means of valuation techniques. The models used by the Bank range from standard market models (discount models) to in-house developed valuation models. In order for a fair value to qualify for Level 2 inclusion, observable market data should mainly be used. The market information incorporated in the Bank's valuation models is either directly observable data (prices) or indirectly observable data (spreads), and or own assumptions about unobservable market data. Fair value measurements that rely significantly on own assumptions qualify for Level 3 disclosure.

3.8.2 Equity exposure

3.8.2.1 Equity exposures by type of asset and calculation process

The following table shows the amount of exposure to equities included in the banking book broken down by type of asset and by calculation process at year-end 2013 and for comparison at year-end 2012.

It provides an analysis of the fair value of financial instruments measured at fair value after their initial recognition, grouped in three levels from 1 to 3, according to the degree of observability of the fair value.

	31.12.12				31.12.13			
Assets	**Level 1**	**Level 2**	**Level 3**	**Total**	**Level 1**	**Level 2**	**Level 3**	**Total**
Financial assets designated at fair value - equities	-	-	36.84	36.84	-	-	-	-
Financial assets available for sale - equities[1]	117.98	39.79	26.59	184.37	113.57	29.30	28.02	170.88
TOTAL	**117.98**	**39.79**	**63.44**	**221.21**	**113.57**	**29.30**	**28.02**	**170.88**

1 Excludes variable securities recorded at cost (EUR 8.4 million as at December 31, 2013 and EUR 9.7 million as at December 31, 2012).

3.8.2.2 Equity exposure by type of market and Basel II approach

The following table shows the EAD for equities not included in the trading book, broken down by type of market and by Basel II treatment.

Equities for which BIL's stake exceeds 10% are not included in these figures, since they are deducted from own funds for the calculation of the regulatory solvency ratio.

	31.12.12		31.12.13	
Type of market	**EAD**	**RWA**	**EAD**	**RWA**
Private equity	82	105	78	94
Recognised market	73	96	65	88
Unrecognised market	9	12	10	10
Basel II treatment				
ADV	70	99	69	97
STD	94	114	84	95
TOTAL	**164**	**213**	**153**	**192**

3.8.3 Gain or losses on equity

3.8.3.1 Realised gains or losses arising from sales and liquidations

The following table shows the cumulative realised gains or losses arising from sales and liquidations in 2012 and 2013.

	31.12.12	31.12.13
Financial assets designated at fair value - equities	–	5.67*
Financial assets available for sale - equities	-0.81	-1.14
TOTAL	**-0.81**	**4.54**

** In financial terms, the realised gain on equities at a fair value of 5.67 million was offset by an equivalent amount of losses in another accounting category.*

3.8.3.2 Unrealised gains or losses included in own funds

The total unrealised gains or losses related to equity instruments amounted to 108 million as at December 31, 2013.

	31.12.12	31.12.13
Financial assets available for sale - equities	95.17	107.80
TOTAL	**95.17**	**107.80**

Amounts are net of tax.

3.9 Securitisation activity

BIL Group is no longer involved in securitisation activities: the Bank has not originated any securitisation transactions since 2006 and has no securitisation positions on its books.

4. Market risk

Market risk is the risk of losses on positions arising from adverse movements in market prices. It mainly consists of interest rate risk, equity price risk and foreign exchange risk.

- The interest rate risk consists of a general interest rate risk resulting from market movements and a specific interest rate risk. The latter, also called 'credit spread risk', is defined as the specific interest rate risk attached to an issuer and arises from changes in the spread of a specific issuer within a rating class.
- The risk associated with the equity price represents the risk arising from the reduction in value of the equity.
- The foreign exchange risk represents the potential decrease in value due to currency exchange rate movements.

Asset and liability management (ALM) is used to cover all the banking book's structural risks, namely interest rate risk, foreign exchange risk and liquidity risk.

Liquidity risk measures BIL's ability to meet its current and future liquidity requirements, both expected and unexpected, whether or not the situation deteriorates.

4.1 Market risk governance

4.1.1 Organisation

The Financial Risk Management department is split into three teams:

- Banking & Counterparty Risk Monitoring

This team is in charge of verifying counterparty limits, margin calls for collateral management purposes, banking book activity and liquidity risk. It also implements the new regulatory ratios (LCR, NSFR, liquidity monitoring tools, etc.).

- TFM (Treasury and Financial Markets) Risk Monitoring

This team's main tasks are the implementation and monitoring of the financial risks attached to financial market activities (fixed income, forex, structured products and brokerage), the calculation of the BIL Group Value-at-Risk (VaR), the detection of suspicious transactions and the reconciliation of positions and profit and loss (P&L).

- EUI (End User Integration) and Market Data Management

This team is in charge of the maintenance and the development of market risk data as well as dealing with dedicated reports and systems.

4.1.2 Policy and committees

For integrated market and ALM risk management, BIL Group has defined a framework based on the following:

- An exhaustive risk measurement approach, which is an important part of BIL's risk profile monitoring and control process.
- A robust set of limits and procedures governing risk-taking. The system of limits must be consistent with the overall risk measurement and management process, and be proportionate to the capital position. These limits are set for the broadest possible scope.
- An efficient risk management structure for identifying, measuring, monitoring, controlling and reporting risks: BIL has developed a general risk management framework suited to the type of challenges it faces. This approach offers assurance that market risks have been managed in accordance with BIL's objectives and strategy, within its general risk appetite.

The Financial Risk Management (FRM) department oversees market risk under the supervision of the Management Board and specialist risk committees. It provides support within the Risk department. On the basis of its global risk management approach, it is responsible for identifying, analysing, monitoring and reporting on risks and results (including the valuation of assets) associated with financial market activities. The policies, directives and procedures documenting and governing each of the activities are defined within BIL and applied to all of the Bank's entities.

- Head Office FRM teams define risk measurement methods for the whole Group, as well as reporting and monitoring the risks of the activities they are responsible for, at a consolidated level.
- Head Office and local FRM teams oversee day-to-day activity, implement policies and directives, monitor risks (calculation of risk indicators, limit and trigger controls, definition of new activities/new products, etc.) and report to their own Management Board, as well as to local supervisory and regulatory bodies.
- The ALM Committee decides on the structural balance sheet positioning regarding rates, foreign exchange and liquidity. It defines and revises market risk limits.
- The FRM teams are supported by two operational committees: the MOC (Monthly Operational Committee) and the OR&NPC (Operational Risk and New Products Committee), which are described below.

4.1.3 Risk measurement

The Bank has adopted sensitivity and VaR measurement methodologies as key risk indicators. Risk sensitivity measurements reflect the balance sheet exposure to a parallel movement of 1% on the yield curve. VaR measures the maximum potential loss with a 99% confidence interval, within a 10-day holding period.

BIL Group applies sensitivity and VaR approaches to measure the market risk inherent in its various portfolios and activities:

- General interest rate risk and currency risk are measured through historical VaR.
- Equity risk arising from the trading portfolio is measured through historical VaR.
- Non-linear risks are measured through historical VaR.
- Specific interest rate risk (spread risk) is measured through sensitivities.
- As a complement to VaR measures and income statement triggers, the Bank applies a broad range of other measures aimed at assessing risks associated with its various business lines and portfolios (nominal limits, maturity limits, market limits, sensitivity to various risk factors, etc.)

4.2 Market risk exposure

4.2.1 Treasury and financial market

The use of VaR in relation to interest rates and foreign exchange (excluding ALM) is shown in the table below. BIL Group's average VaR was 4.99 million in 2013, compared with 1.94 million in 2012.

		31/12/12											
VaR (10 days, 99%)		IR [1] & FX [2] (Trading and Banking) [3]				EQT [4] Trading				Spread Trading			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
By Risk factor	Average	1.29	1.04	1.02	3.67	0.02	0.02	0.01	0.01	0.12	0.19	0.25	0.00
	Maximum	2.48	1.73	1.77	6.91	0.04	0.04	0.03	0.02	0.39	0.72	0.54	0.00
Global	Average	1.94											
	Maximum	7.67											
	End of period	3.32											
	Limit	6.00											

		31/12/13							
VaR (10 days, 99%)		IR [1] & FX [2] (Trading and Banking) [3]				EQT [4] Trading			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
By Risk factor	Average	5.81	4.59	5.13	4.39	0.01	0.02	0.01	0.00
	Maximum	8.47	6.26	6.09	5.19	0.02	0.03	0.02	0.02
Global	Average	4.99							
	Maximum	8.48							
	End of period	4.61							
	Limit	8.00							

1 IR: interest rate
2 FX: foreign exchange
3 IR & FX: excluding asset & liability management (ALM)
4 EQT: equity

Prior to 2012, spread risk for the capital markets activity was measured using a VaR methodology. This measurement was replaced by a sensitivity calculation at the end of 2012. As at December 31, 2013, the spread sensitivity (+1bp) amounted to -5,481 for a limit set at 60,000.

4.2.2 Asset and liability management (ALM)

The role of ALM in terms of interest rate risk management is to reduce the volatility of the income statement, thereby safeguarding the gross income generated by the business lines.

The sensitivity of the net present value of ALM positions to a change in interest rates is currently used as the main indicator for setting limits and monitoring risks.

As at December 31, 2013, ALM sensitivity amounted to 29 million (versus -120 million as at December 31, 2012). The difference is due to the finalisation of the balance sheet structure. The limit of interest rate sensitivity was 95 million/ percent as at December 31, 2013 (versus 190 million as at December 31, 2012). This limit is reviewed in relation to the Bank's regulatory own funds.

4.2.3 Investment portfolio

BIL continued its investments in the new portfolio during 2013. The interest rate risk of the investment portfolio is managed by the Treasury department or by the ALM department, depending on various criteria (i.e. maturity, sector).
The investment bond portfolios had a total nominal exposure of 4.63 billion as at December 31, 2013 (versus 2.95 billion as at December 31, 2012). The majority is classified under the AFS reserve: 4.59 billion as at December 31, 2013 (versus 2.90 billion as at December 31, 2012); the remainder is classified under HTM: 39 million as at December 31, 2013.
As far as the AFS-classified bond portfolio is concerned, the sensitivity of the fair value (and the AFS reserve) to a one basis point widening of the spread was -2.5 million (compared with -2.1 million per basis point as at December 31, 2012).

	Notional amount		Rate (BPV)		Spread (BPV)	
Investment portfolio	**31/12/13**	**31/12/12**	**31/12/13**	**31/12/12**	**31/12/13**	**31/12/12**
Treasury	2,378	621	-0.19	-0.20	-0.84	-0.27
ALM	2,248	2,327	-0.64	-1.56	-1.68	-1.87
TOTAL	**4,626**	**2,948**	**-0.83**	**-1.76**	**-2.52**	**-2.14**

4.2.4 Model management

4.2.4.1 Backtesting

Backtesting exercises are performed in order to check the reliability of VaR figures.
BIL has adopted hypothetical backtesting as its main indicator, which takes into account different potential scenarios (incorporating changes in all market data, in interest rates only, in exchange rates only, and in equity prices).
The backtesting process provides the Financial Risk Management department with a number of exceptions representing the number of losses exceeding their corresponding VaR figures. In 2013, the hypothetical backtesting calculated on the trading portfolio revealed only one downward exception for interest rate and currency risks on September 9, 2013, attesting to the quality of the tools in place. This exception was caused by an anomaly in the foreign exchange trading portfolio following a sharp movement of the EUR/USD rate.

4.2.4.2 Systems and controls

On a daily basis, FRM calculates, analyses and reports on the risks and results at a consolidated level.
All market activities are backed by specific guidelines describing the objectives, the authorised products, sensitivity, VaR and/or outstanding limits, etc.
The systems and controls established inside the Bank are described in various procedures to ensure a comprehensive framework is in place to support those responsible for managing market risks.

4.3 Liquidity risk

The liquidity management process is based on covering funding requirements with available liquidity reserves. Funding requirements are assessed prudently, dynamically and comprehensively by taking existing and planned on- and off-balance sheet asset and liability transactions into consideration. Reserves are constituted from assets eligible for refinancing with the central banks to which BIL has access (Banque Centrale de Luxembourg).

Regular information channels have been established for management bodies. A daily report is sent to the CEO, the CRO, ALM Committee members, Risk Management, Cash & Liquidity Management and the TFM teams. An analysis of the balance sheet changes (customer deposits, etc.) is presented and commented on during the ALM Committee meetings.

4.3.1 Risk measurement

The internal liquidity management framework includes indicators enabling the assessment of BIL's resistance to liquidity risk. These indicators include liquidity ratios, which compare liquidity reserves to liquidity deficits[1]. All these indicators are assessed according to a variety of scenarios, in the major currencies. These ratios are sent to the CSSF and to the BCL, respectively on a daily and a weekly basis.

1 Referred to as the "base case ratio"

4.3.2 Risk exposure

In line with the 2012 year-end situation, BIL presented a significant liquidity surplus throughout 2013.

Additional funding needed to reach 100% of the base case ratio	2013	Q1	Q2	Q3	Q4
		Estimated - 1 month			
Average	-4,998	-5,016	-5,136	-4,985	-4,855
Max	-5,513	-5,189	-5,275	-5,093	-5,513

The negative amount of additional funding needed to reach 100% of the base case ratio shows that the Bank presents a surplus of liquidity.

From a commercial balance sheet point of view, we have observed a progressive increase in customer deposits and moderate growth in the loan portfolio.

This excess cash has been partially invested through our liquidity buffer bond portfolio. This portfolio is mainly composed of central bank eligible bonds that are also compliant with the future Basel III liquidity requirements, i.e. the LCR and NSFR.

The regulatory constraints of the LCR (100%) have been met.

4.4 Assessment of the regulatory capital requirement

The Bank no longer applies the internal VaR model to calculate the regulatory capital requirement for general interest rate risk and currency risk within trading activities. This means that market risk stress tests are no longer performed.

From 2013 onward, all market risks are treated under the Basel II standard approach. The table below presents the Bank's regulatory capital required broken down by risk type for both year-end 2012 and 2013.

		31/12/12		31/12/13	
Method	Type of risk	RWA	Capital requirement	Total	Capital requirement
Standardised	Interest rate risk	19	2	64	5
	Foreign exchange risk			8	1
	Other risk	57	5	47	4
Advanced	Foreign exchange risk	68	5		
TOTAL		144	12	119	10

5. Operational risk

Operational risk is the risk of direct or indirect losses resulting from the unsuitability or failure of internal processes, staff or systems, or due to external events. This definition includes legal risk, but excludes strategic risk. It also excludes losses resulting from commercial decisions.

5.1 Operational risk governance

5.1.1 Organisation

The activity of this department covers the management of operational risks as well as customer-related risks.

The first activity is carried out by two teams. The Operational Risk Management team is in charge of defining policies and guidelines and monitoring operational risk, while the Corporate Information Security team is responsible for security policies and guidelines, as well as business continuity management (BCP and DRP).

The second activity is managed by the Customer Risk team, which oversees, in close cooperation with Compliance, the second level controls relating to the retail and commercial banking (RCB) activity. These controls include ex-post suitability, appropriateness and adherence to contractual/regulatory constraints.

5.1.2 Policy

BIL Group's operational risk management policy involves identifying and assessing the existing risks and checks in place on a regular basis in order to ensure that the acceptance level defined for each activity is respected. If this is not the case, corrective measures must be taken to permit the return to an acceptable situation. This framework is implemented through a prevention policy, particularly with regard to information security and business continuity and, whenever necessary, through the transfer of the financial consequences of certain risks through insurance.

In terms of information security, including business continuity management, BIL Group's Management Board has validated and implemented an information security policy. This document and its related instructions, standards and practices are intended to secure BIL's information assets.

In terms of operational risk, BIL Group's management has validated the Operational Risk Global Policy, which was implemented through the application of guidelines (guidelines for reporting operational incidents and guidelines for conducting a risk and control self-assessment (RCSA)).

5.1.3 Committees

BIL Group's operational risk management framework relies on strong governance, with clearly defined roles and responsibilities. The following committees are responsible for operational risk at BIL:

- The OR&NPC is in charge of monitoring operational risk at BIL. To this end, the committee makes decisions on risks that have been identified and analysed as well as on suitable measures to be taken in order to improve weak processes; it also monitors any action taken. This committee is responsible for approving RCSA. It also supervises the launch of new products and examines their operational aspects, making decisions on any project that could have an operational impact on BIL activities.
- The Monthly Operational Committee (MOC), part of the TFM business line, supervises BIL's TFM projects and operational risks, makes decisions in terms of tackling day-to-day problems and monitors other risks related to TFM Luxembourg's activities.
- The Security Committee (SC) is mandated by the Management Board to oversee the risks to BIL's information security and to that of its subsidiaries and branches, as well as all risks relating to the loss of the confidentiality, availability or integrity of the Bank's information assets. It is also in charge of monitoring security incidents involving BIL, making decisions on any project with the potential to have an impact on the security of BIL's information assets and ensuring that the implementation and support of a global business continuity plan (BCP) follows the strategy defined by the BIL Management Committee.

5.1.4 Risk measurement and management

The operational risk framework is based on the following elements:

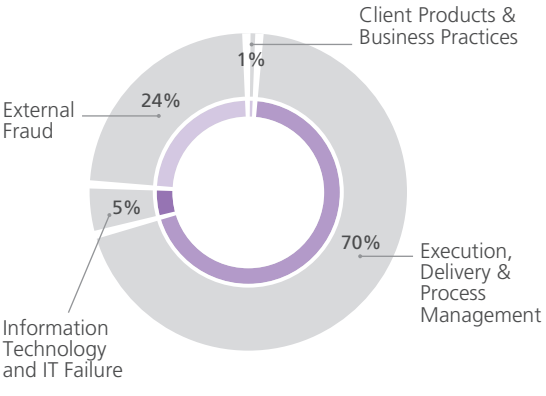
- Efficient data collection,
- Self-assessment of risks,
- Corrective actions.

5.1.4.1 Operational risk event data collection

According to the Basel Committee, the systematic recording and monitoring of operational incidents is a fundamental aspect of risk management: "historical data on banking losses may provide significant information for assessing the Bank's operational risk exposure and establishing a policy to limit/manage risk".

Regardless of the approach used to calculate capital (standardised or advanced measurement approaches), data collection is required. Having a relevant procedure in place ensures that BIL complies with the Basel Committee's requirements (guidelines for reporting operational incidents). At the same time, the recording of incidents provides information that may be used to improve the internal control system and determine the operational risk profile.

A breakdown of losses by event type is shown in the chart below:



Execution, delivery and process incidents represent 70% of the total amount of losses. Losses related to these incidents are usually due to human errors. In second place, 24% of losses occurring in 2013 were due to external fraud. While there are few incidents of this type (only 17 incidents), the amounts involved are significant. There was no internal fraud. Information, technology and IT failure incidents generally do not generate financial losses even if they tend to occur rather often. The impacts are generally in man-days lost. The "damage to assets and public safety" event type is covered by insurance.

In terms of reporting, an exhaustive monthly document is produced for each line manager (head office, subsidiaries and branches). It covers all incidents that have arisen in their business over the previous month, based on reports filed. Recipients analyse the report and verify that all incidents brought to their attention have been included.

ORM also presents a report on operational risk report to OR&NPC at the end of each quarter.

On a quarterly basis, three operational risk indicators are reported to the members of Management Board to assess the Bank's risk appetite: critical IT incidents, external fraud attempts and the ratio between income and the net amount of losses.

5.1.4.2 Self-assessment of risks and associated controls

A risk and control self-assessment (RCSA) is performed in order to identify the most significant risk areas for the Bank. This assessment provides a good overview of the various activities and existing checks and can lead to the definition of mitigation actions. The results of the assessment are reported to Management during meetings of the Operational Risk and New Products Committee.

5.1.4.3 Definition and follow-up of action plans

As part of operational risk management, corrective action plans linked to major risks and events must be monitored closely.

Two types of action plan are managed through operational risk management:

- Action plans – incidents: following a significant incident, the management may implement action plans,
- Action plans – RCSA: in the event of unacceptable risk exposure, the management may identify action plans.

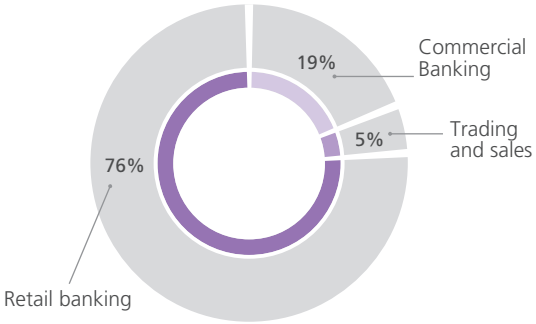
5.2 Calculation of the regulatory capital requirement

BIL applies the standardised Basel II approach to calculate regulatory capital for operational risk. This approach principally consists of applying a percentage (called the "beta factor", ranging from 12% to 18%) to an appropriate activity indicator (adjusted net banking income), calculated for each of the eight business lines defined by the Basel Committee (corporate finance, commercial banking, retail banking, trading and sales, asset management, agency services, retail brokerage, payment and settlement).

The relevant indicator is defined by the regulator and is based on the operational results of the underlying business, using an average over the past three years. The calculation is updated at the end of each year. The capital requirement for operational risk was 55.72 million at year-end 2013, as compared with 55.57 million at year-end 2012.

	Beta factor	Adjusted P&L	Capital requirement 2013	Capital requirement 2012
Commercial banking	15%	70.26	10.54	9.04
Trading and sales	18%	16.71	3.01	2.58
Retail banking	12%	351.48	42.18	43.95
TOTAL		**438.44**	**55.72**	**55.57**

The chart below presents the breakdown of the capital requirement for operational risk for the business lines (according to the Basel II definitions) as at December 31, 2013.



6. Remuneration policies and practices

6.1 Performance assessment

6.1.1 Performance management system

6.1.1.1 Main characteristics of the system

Within BIL Group and subject to minor local adjustments, all members of staff are assessed once a year on the basis of targets set at the start of the calendar year.

Targets are set according to business and individual skills:

- an assessment of business skills: depending on the fields of activity of the members of staff concerned, the business skills are linked to the achievement of quantitative and qualitative targets;
- an assessment of individual skills: this is an assessment of the achievement of individual or collective competency targets.

The evaluation interview is an important moment to take a step back, review the past year's work and prepare for the coming year.

It is the opportunity to give employees a formal appreciation of their work, to acknowledge the efforts made and to let them know that they are developing.

Over and above the motivation that this provides, giving the employees the feedback that they deserve also means enhancing Group or entity performance in a number of ways, as well as:

- guaranteeing fairness and internal coherence;
- promoting internal mobility;
- attracting and enhancing the loyalty of the talented staff we need;
- granting a fair bonus;
- concentrating on our collective efforts and achieving our corporate objectives.

The performance appraisal process is detailed in a practical guide provided to each appraiser.

The assessment scale involves five ratings from "5" to "1":

- **Rating 5:** corresponds to an exceptional level of performance and is only attributed where the member of staff concerned has exceeded all targets, consistently and throughout the year.
- **Rating 4:** corresponds to an excellent level of performance whereby staff members have exceeded their targets.
- **Rating 3:** corresponds to a good level of performance whereby staff members have reached all of their targets.
- **Rating 2:** corresponds to a poor level of performance whereby staff members have not reached all of their targets.
- **Rating 1:** corresponds to a very poor level of performance whereby staff members have not reached any of their targets.

6.1.1.2 Performance assessment process overview

The target setting interview is the first meeting between the line managers and their member of staff during which the two set targets for the year. The interview must be recorded in writing in the first quarter of the year. In practice, it very frequently coincides with the **year-end assessment interview**.

During the second or third quarter an optional second interview may take place to monitor the targets and modify them if required, depending on the business context.

At the end of the year, the line manager holds an annual performance assessment interview and attributes a performance rating according to a scale specific to the entity. The rating will be used, among other factors, to determine the variable remuneration.

6.1.1.3 Link between remuneration and performance

BIL wishes to offer attractive remuneration, a part of which must be linked to the performance of the member of staff.

BIL puts mechanisms in place that enable the allocation of variable remuneration to be aligned throughout BIL Group, in accordance with the following criteria:

- the results of the entity must impact variable remuneration;
- the performance must be exceptional and supported in by the head of the activity or business line;
- the variable remuneration and the performance must be linked.

This performance is subject to annual assessment (see above) and takes account of the level of performance and its impact on the business.

The determination of the **variable remuneration** is **closely linked to the performance of the staff member**, based on whether targets have been reached or exceeded and on the expected impact of past activity on future results.

BIL's remuneration system does not encourage an excessive risk taking. All employees in receipt of variable remuneration are assessed on the basis of quantitative and qualitative, financial and non-financial criteria.

Success and productivity are therefore taken into account in determining variable remuneration, but they are only part of the story.

All **variable remuneration is influenced by the company's financial position** and may fluctuate depending on the results of the BIL Group and of the entity.

The link between variable remuneration and employee performance is assessed with regard to previous targets and subsequent expected results based on past activity.

A personal global rating given by the appraiser determines whether the staff member is eligible for variable remuneration or not. A rating from "3" to "5" is required for a staff member to qualify for variable remuneration. Staff members awarded a rating of "1" or "2" are ineligible for variable remuneration.

6.1.2 Performance indicators

Cascading common objectives down through the Bank is a key factor in the Group achieving its strategic priorities.

In terms of performance indicators, a different approach is required for Executive Management Members (EMMs) from that applied to other staff members.

EMMs:

Key Performance Indicators (KPI) are applicable to EMMs.

Key indicators are monitored by the Remuneration and Nomination Committee, which determines the variable

remuneration for EMMs and proposes it to the Board of Directors.

Other staff members:

As mentioned above, all staff members receive cascaded objectives based on business and individual skills. These objectives are individual/collective and are based on qualitative/quantitative aspects.

The weight of each objective is assessed by the line managers and therefore varies from one employee/unit/department/business line to another.

The objectives are measured through the performance assessment process (see above) using Key Performance Indicators. The objectives must respect the SMART principle (Specific, Measurable, Attainable, Relevant, Time-bound).

6.2 Remuneration structure

6.2.1 Description of the remuneration structure

Most BIL Group staff are covered by the following remuneration structure:

- **Fix remuneration:** the fixed portion of the total remuneration is paid in cash on a periodic basis. It remunerates the competencies of the member of staff and is guaranteed irrespective of their performance.
- **Variable remuneration:** the variable portion of the total remuneration is paid in cash and determined on the basis of individual and collective, financial and non-financial performance criteria. In particular, it enables the interests of the employee to be aligned with those of the company.

Variable remuneration does not include benefits such as company cars, pension schemes and loans.

- **Benefits:** indicates all the benefits received in kind by an employee in exchange for their work and in addition to their cash remuneration. The granting of these benefits is benchmarked using a reference list of job categories.

6.2.2 Staff identified as material risk takers

According to the BIL self-assessment on risk profile, risk appetite and risk management, the following categories of staff are identified as material risk takers (MRTs):

- **Executive Management Members** (EMMs) whose activities and responsibilities may have a significant impact on the risk taking of BIL Group;
- **Management responsible for independent control functions;**
- **Local management of national and international entities** whose strategic decisions are taken under the supervision and control of EMMs.

6.2.3 Variable remuneration principles

Variable remuneration is mainly allocated to the employees and executives according to:

- the status of employees (employee/manager/executive) and their job level;
- the appraisal notes obtained through the performance appraisal annual process;
- the average presence of the employees during a reference period.

Variable remuneration is always awarded on a discretionary basis by the direct or indirect line manager, who is responsible for ensuring that bonuses are fair and consistent.

Bonuses are not formula-based, therefore variable remuneration is linked to collective and individual performances.

The total bonus pool is decided by the competent bodies, within the context of a budgeting exercise. It depends on the results of the Bank and can be set at zero. The amount is known at the start of the performance assessment process and cannot be exceeded.

6.2.3.1 Non-executive Directors

Remuneration of non-executive directors

The ordinary general meeting of BIL SA sets the remuneration due to directors for the exercise of their mandates. The meeting decides on a maximum overall amount and grants the Board of Directors the power to establish the terms and conditions for that remuneration and its attribution.

The Board of Directors determines a fixed amount and a "specific" amount for attendance.

The fixed amount remunerates the capacity of director, while a specific amount remunerates attendance at meetings of the Board of Directors or one of the specialised committees.

For directors whose term of office does not extend over a complete year, the fixed remuneration is reduced in proportion to the number of quarters during which they were in post.

Furthermore, the Board of Directors will consult experts to verify that the proposed amounts are in line with market practice.

Remuneration of the Chairman of the Board of Directors

The Board of Directors sets the gross remuneration of its Chairman.

The remuneration of the Chairman of the Board of Directors will represent double the compensation of any other director, as regards both the fixed and variable remuneration, depending on attendance at meetings of the Board of Directors and the various specialised committees.

The Chairman will not receive benefits *("tantièmes")* for his mandates at other BIL Group entities of the BIL Group. This total amount is included in the overall figure for directors' remuneration mentioned above.

6.2.3.2 Executive Management Member (EMMs)

The remuneration of members of the Executive Management of BIL SA is decided by the Board of Directors, based on a proposal from the Remuneration and Nominations Committee.

The Remuneration and Nominations Committee ratifies the remuneration of members of the management and executive committees of the main entities of the group based on a proposal from the Executive Management of BIL Group.

In carrying out this task, the Remuneration and Nominations Committee is assisted by independent external advisers who

are experts in the field of remuneration, and by the Risk, Human Resources, Compliance, Legal and Tax departments.

EMM fixed remuneration

The fixed remuneration is the basis on which the variable remuneration is calculated. This remuneration is subject to the various legal treatments required.

EMM variable remuneration

Amount of variable remuneration

The amount of variable remuneration constitutes a target which is only reached in cases where all objectives have been met.

This variable remuneration may be less/more than the variable remuneration targeted in cases where the objectives have either been exceeded or have not been met. A maximum percentage is fixed by the Remuneration and Nominations Committee. BIL Group will not fix a guaranteed amount of variable remuneration in a contractual document.

In any case, variable remuneration remains discretionary and can be set at zero by the Board of Directors based on a proposal of the Remuneration and Nominations Committee if the Group/business/individual performance targets are not met.

Composition of the variable portion

The variable portion consists of three components, each assessed on the basis of quantitative or qualitative, and financial or non-financial criteria.

- **Group component**

This component is common to all EMMs.

A factor relating to BIL Group or a BIL Group entity may influence the determination of variable remuneration.

It is calculated on the basis of the financial indicators agreed by the Board of Directors on a proposal from the Remuneration and Nominations Committee.

- **Business component**

The business component is analysed individually with respect to the targets set for EMMs for the coming year.

The performance analysis criteria will depend on the manner in which the business or support line has participated in the achievement of the group target. These criteria will permit adequate differentiation in order to highlight good performances and to sanction poor ones.

The performance analysis criteria will include the monitoring of the risk criteria specific to the executive's business line.

These performance indicators will be communicated at the beginning of the year to the members of the Executive Management of BIL SA.

- **Individual component**

The individual component is analysed separately with respect to the targets set for EMMs for the coming year, on the basis of qualitative criteria such as management skills, the manner in which the executive has participated in devising and/or implementing the transformation plan for his/her entity, support line or business line, and adherence to the values of the BIL Group, which will be reflected in specific behaviours when targets are fixed.

The performance analysis criteria will include the monitoring of the risk criteria specific to the executive's business line. These performance indicators will be communicated to EMMs at the beginning of the year.

Furthermore, if the individual assessment is below a certain level (e.g. 50%), the variable remuneration may be set at zero. This decision is taken by the Board of Directors based on a proposal of the Remuneration and Nominations Committee.

6.2.3.3 Management responsible for independent control functions (compliance, internal audit)

The performance analysis, increases in fixed remuneration and the fixing of other components of the remuneration are carried out on a standard basis for control and support functions.

The performance is analysed by the support line on the basis of the targets set by the support line in relation to Group targets. The targets are principally qualitative and are specific to the function performed. In general, unless there is a reduction of the variable remuneration in view of poor company results, the variable remuneration of control functions is set irrespective of the Group's financial results.

The control functions can therefore be carried out independently of their possible impacts on the individual's financial situation.

Likewise, as for all groups, BIL analyses the appropriateness of the levels of remuneration for the control functions in relation to those for the identical functions in companies competing with BIL.

6.2.4 Principles for the payment of variable remuneration

Procedure governing the payment of variable remuneration for Material Risk Takers (MRTs)

The application of the proportionality principle set out in CSSF circular 11/505 has changed some remuneration policy requirements for staff members responsible for control functions or the local management of national and international entities, given that nothing in their remuneration policy encourages them to take risks endangering the entity or BIL Group.

Moreover, a staff member belonging to the above-mentioned categories whose annual variable remuneration is less than or equal to 100,000 is considered to be a risk taker who has only a minor material impact on the entity's risk profile and therefore is not subject to the following provisions.

General rules for deferment and mode of payment of variable remuneration

The general rules described below are applicable to the population identified as material risk takers (MRTs).

In order to link the remuneration of identified staff to their performances and the related future consequences, performances that are used to determine their variable remuneration

are assessed over several years with respect to objectives/targets, taking into account the interests of BIL Group over the long term.
The assessment of performances that will determine the level of variable remuneration is part of the multi-annual framework used to assess long-term performance.
Payment of part of the variable remuneration will be deferred, and is subject to the fulfilment of the conditions described below. The deferred portion will be lost if those conditions are not fulfilled.

Calculation of the deferred portion of the variable remuneration

The principle of deferment is applicable to the variable remuneration.
The deferred portion corresponds to 40% of the variable remuneration.

Terms of payment of the variable remuneration

Principles applied to the non-deferred portion

The non-deferred portion (60% of the total variable remuneration) of the variable remuneration will be paid during the first six months of the year after the year in which the services are provided (N+1):

- 50% (=30% of the total variable remuneration) in cash and;
- 50% (=30% of the total variable remuneration) in the form of phantom shares, with their vesting period set to one year

Principles applied to the deferred portion

- 50% of the deferred portion (=20% of the total variable remuneration) of the variable remuneration will be paid in cash in years N+2, N+3 and N+4 (up to one third each year), provided that the conditions mentioned above are met.
- 50% of the deferred portion (=20% of the total variable remuneration) of the variable remuneration will be paid in the form of phantom shares during years N+2, N+3 and N+4 (up to one third each year) under the same conditions.

Conditions for payment of the deferred portion of the variable remuneration

Payment of the deferred portion of the variable remuneration is subject to the fulfilment of the following conditions:

- **Maintenance of the level of performance** – if the appraisal of the staff member in N+2, N+3 and N+4 shows a substantial deterioration in performance, the Remuneration and Nominations Committee may suggest to the Board of Directors that the deferred portions be reset to zero.
- **The existence of a professional relationship** (under a contract of employment or a mandate as a director and/or a member of the Executive Management) linking the beneficiary to the BIL Group on the date of payment. Notwithstanding this principle, if the contract is terminated by statutory or early retirement, or on BIL Group's initiative on grounds other than serious misconduct ('"faute grave/lourde"), or by incapacity or by death, the beneficiary whose contract is terminated may, nonetheless, claim payment of the deferred portions, unless the assessment of his performances during the twelve months prior to termination of the professional relationship has substantially deteriorated compared with year N.

The deferred portions of the variable remuneration will be lost if the beneficiary leaves the Group voluntarily or is forced to leave on the grounds of serious misconduct.

6.2.5 Specific provisions

Malus clause

The deferred portions of the variable remuneration not yet paid may be reduced to zero if the Group's overall results prove to be negative.
Moreover, the Remuneration and Nominations Committee will individually or collectively suggest to the Board of Directors that the deferred portions of the variable remuneration be reduced (even to zero) if the Committee considers – from its assessment of the beneficiary's performances – that the beneficiary took decisions or engaged in behaviour liable to harm the company, resulting in the qualitative criteria for granting the variable remuneration no longer being met.
Any fall in the company's or the Group's results will be reflected in the deferred portions of the variable remuneration granted in the form of financial instruments.

Clawback

Payment of variable remuneration is based on the premise that, during the entire period he/she was working within the group, the beneficiary fully observed the law and the rules specific to the company as well as the values of the BIL Group.
If fraud is found to have taken place after the attribution of variable remuneration, and in cases where the variable remuneration might have been granted on the basis of intentionally erroneous information, the Board of Directors reserves the right not to pay the deferred portions still due and to consider bringing a civil action with a view to recovering any variable remuneration already paid, or at least equivalent damages and interest, in cases where the company has suffered significant harm.

Special circumstances for guaranteed variable remuneration

Variable remuneration is not usually guaranteed.
However, an exception may occasionally be made for new staff members, who may be paid a maximum of one year of guaranteed variable remuneration for meeting objectives during the first year of their employment.

Severance payments

Without prejudice to the application of the legal and regulatory provisions and agreements that are binding on the company, payments associated with the early termination of an employment contract and/or a mandate as a member of a Executive Management are designed not to reward failure.
If an agreement relating to the granting of a severance package is signed with an executive, the total of the payments made (including non-competition indemnities, remuneration paid during periods of notice and compensation for

notice) shall not exceed twelve months of fixed and variable remuneration.
In specific circumstances, the Remuneration and Nominations Committee may, on the basis of a reasoned opinion, propose to the Board of Directors that it grants a severance payment exceeding twelve months, but not exceeding eighteen months, of fixed and variable remuneration.
Severance payments exceeding eighteen months of fixed and variable remuneration may only be agreed on an exceptional basis with the approval of the next ordinary general meeting.
Moreover, the agreement granting a severance package will contain a performance condition whereby the contractual severance payment will be reduced in cases where assessments of the executive's performances over the two years preceding the date of termination of the contract suggest a significant deterioration in those performances.
BIL Group will ensure that it does not grant severance payments in an amount greater than applicable under the laws, regulations and collective bargaining agreements or exceeding the benefits generally fixed by the competent courts and tribunals, without relating them to risk and performance.
In addition to compensation for notice, or remuneration relating to the period of notice, the severance package should also cover any other payment made at the occasion of the breakdown of employment relations – irrespective of the nature of the payment – including, for instance, non-competition indemnities.
These principles will be applied in compliance with mandatory legal provisions. They will not be applied in the case of incompatibility with a contractual provision existing at the date of drafting of the present policy document.
The same principles will be applicable to employees insofar as the legal rules and collective bargaining agreements (in particular, those fixing the period of notice and compensation to be applied in cases of employment contract termination) so permit and without prejudice to existing individual agreements.
The "Golden Parachute" principle is not provided for in the employment contract.

Prohibition on personal hedging

All employees, including executives, are prohibited from personal hedging or insurance strategies linked to remuneration or to their responsibilities for the purpose of offsetting the impact of the risk alignment incorporated in this remuneration policy.

6.3 Governance: roles and responsibilities in the design, implementation and ongoing supervision of the remuneration policy

Board of Directors

The Board of Directors is responsible for the review, adoption and implementation of the remuneration policy.
It is assisted and advised in respect of these matters by the Remuneration and Nominations Committee:

- on the appointment process and on the appointment/dismissal of
  - the members of BIL's Board of Directors;
  - the members of BIL's Executive Management;
- on the evaluation process and on the evaluation of the members of the Executive Management;
- on the definition of the remuneration package for the members of the Executive Management and the members of the Board of Directors;
- on the definition of the global remuneration policy of the Bank.

Remuneration and Nominations Committee

The role of the RNC is to assist and advise the Board of Directors on its decisions.

Executive Management

The Executive Management adheres to and implements the remuneration policy validated by the Board of Directors. Its role is to ensure that the remuneration policy is properly implemented at all the Group's entities.

Other participants

The trade unions are kept informed of the remuneration policy in place through the their attendance at meetings of the Board of Directors.
The "Comité Mixte" is consulted on the performance assessment process, reward process and its results.
All the control functions (Human Resources, Finance, Legal, Compliance, Risk Management, Internal Audit) are consulted on the framework for designing and implementing the remuneration policy.

6.4 Information disclosure and rules

Internal disclosure

The employees are entitled to know the rules that influence their remuneration.
Employees are informed through the intranet or by their line managers of the annual performance assessment and reward process and the main principles for awarding their remuneration.
The discretionary nature of the variable remuneration is mentioned in the employment contracts.
BIL Group has undertaken to inform members of staff in good time of any amendments that might affect them.

External disclosure

Detailed information on remuneration policy rules and practices will be made available to the public, including BIL shareholders.
BIL has undertaken to publish the remuneration policy described above in its annual report and in all publications required by the regulatory authorities.
The BIL Group remuneration policy is based on 2013 performances and activity. Therefore, amounts related to the application of the Group's remuneration policy are disclosed in the 2013 report.

6.5 Quantitative information

The table below shows aggregate data on the remuneration of material risk takers (MRTs) broken down by activity and expressed in €:

# MRTs	RETAIL	TFM	PRIVATE	CIB	OTHER
18	626,313	862,681	2,580,662	640,960	4,797,549

The figures above include fixed and variable remuneration, as well as benefits.
The following table presents quantitative data on MRT remuneration for 2013 in €, including fixed and variable remuneration, deferred remuneration paid in 2013 and remuneration to be paid in the future. It also shows amounts paid for recruitment and cessation of employment.

	Fixed remuneration 2013	Variable 2013	Benefits 2013	# MRTs	Higher amount
	4,173,854	**3,060,146**	**2,274,165**	**18**	
Amounts and nature of variable remuneration					
Cash		2,064,066			
Phantom shares		996,080			
		3,060,146			
Amounts of deferred remuneration 2013		**796,864**			
Amounts of deferred remuneration paid in 2013		**96,800**			
Amounts paid for recruitment and cessation of employment in 2013		**1,156,881**		**3**	
Amounts paid for cessation of employment in 2013		**1,056,881**		**2**	**642,537**

Appendix 1: Glossary

AFS Available For Sale
Non-derivative financial assets designated on initial recognition as available for sale or any other instruments that are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.

AIRBA Advanced Internal Rating-Based Approach
Institutions using the IRB approach are allowed to determine borrowers' probabilities of default and to rely on own estimates of loss given default and EAD on an exposure-by-exposure basis. These risk measures are converted into risk weights and regulatory capital requirements by means of risk weight formulas specified by the Basel Committee.

BANK
Corresponds to Banque Internationale à Luxembourg, including branches and subsidiaries.

ALM Asset and Liability Management
Action – for instance in a financial institution or a corporate – of managing the net risk position between assets and liabilities, particularly with respect to imbalances generated by movements in interest rates, currencies and inflation, but also maturity mismatch, liquidity mismatch, market risk and credit risk.

CCF Credit Conversion Factor
The CCF is the ratio of the currently undrawn amount of a commitment that will be drawn and outstanding at default to the currently undrawn amount of the commitment. The extent of the commitment will be determined by the advised limit, unless the unadvised limit is higher.

CDS Credit Default Swap
Swap contract in which the buyer of the CDS makes a series of payments to the seller and, in exchange, receives a pay-off if a credit instrument (typically a bond or loan) undergoes a defined "credit event", often described as a default (failure to pay).

CRD Capital Requirements Directive
The Capital Requirements Directive (CRD) for the financial services industry introduces a supervisory framework in the EU that reflects the Basel II rules on capital measurement and capital standards.

CRM Credit Risk Mitigant
A range of techniques whereby a bank can, partially, protect itself against counterparty default (for example by taking guarantees or collateral, or by buying a hedging instrument).

CSSF Commission de Surveillance du Secteur Financier
The Commission de Surveillance du Secteur Financier is Luxembourg's regulator for financial institutions.

EAD Exposure At Default
The EAD is used for calculating regulatory capital requirements including (1) potential future exposures resulting from future commitments, (2) netting arrangements and collateral agreements (3) after a possible substitution in the case of a personal guarantee.

ECAI External Credit Assessment Institutions
Under the Basel II agreement of the Basel Committee on Banking Supervision, banking regulators can allow banks to use credit ratings from certain approved credit rating agencies when calculating the risk weight of an exposure. Competent authorities will recognise an ECAI as eligible only if they are satisfied that its assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet the requirements of credibility and transparency.

EL Expected Loss
The amount expected to be lost on an exposure from a potential default of a counterparty or dilution over a one-year period.

FX Foreign Exchange
Transaction of international monetary business, as between governments or businesses of different countries.

HTM Held To Maturity
Non-derivative financial assets with fixed or determinable payments that an entity intends and is able to hold to maturity and that do not meet the definition of loans and receivables and are not designated on initial recognition as assets at fair value through profit or loss or as available for sale.

IAS International Accounting Standards
IAS stands for International Accounting Standards. IAS are used outside the USA, predominantly in continental Europe.

ICAAP Internal Capital Adequacy Assessment Process
The main objective of the Pillar II requirements is to implement procedures that will be more sensitive to an institution's individual risk profile. This is to be achieved through the implementation of internal processes (ICAAP).

IFRS International Financial Reporting Standards
International Financial Reporting Standards published by the IASB and adopted by most countries outside the USA. They have been designed to ensure globally transparent and comparable accounting and disclosure.

IR Interest Rate
Interest expressed as an annual percentage rate.
ISDA International Swap and Derivative Association
Trade organisation of participants in the market for over-the-counter derivatives. Its headquarters are in New York, and it has created a standardised contract (the ISDA Master Agreement) for derivatives transactions.

IT Information Technology
Study, design, development, implementation, support or management of computer-based information systems, particularly software applications and computer hardware. IT deals with the use of electronic computers and computer software to convert, store, protect, process, transmit and securely retrieve information.

LGD Loss Given Default
The ratio of the loss on an exposure due to the default of a counterparty to the amount outstanding at default.

L&R Loans & Receivables
Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than held for trading or designated on initial recognition as assets at fair value through profit or loss or as available for sale.

PD Probability of Default
The probability of default of a counterparty over a one-year period.

P&L Profit and Loss
The statement of income is a document showing all wealth-creating revenues and wealth-destroying charges. There are two major statement of income formats: the "by nature" statement of income format and the "by function" statement of income format. Also called: profit and loss account.

RWA Risk Weighted Assets
Used in the calculation of risk-based capital ratios. This refers to the total assets calculated by applying risk-weights to the amount of exposure.

VaR Value at Risk
The VaR represents an investor's maximum potential loss on the value of an asset or a portfolio of financial assets and liabilities, based on the investment timeframe and a confidence interval. This potential loss is calculated on the basis of historical data or deduced from normal statistical laws.

Appendix 2: Risk Glossary

A key aim of risk management is to identify all risks the Bank is or will be exposed to.
The risks identified within the Bank fall into five main categories:

Credit risk

Credit risk includes:

- Solvency risk, which is the potential loss resulting from the decreased solvency of an obligor arising from credit migration and/or default events.
- Country risk, which is the potential loss due to local political or social actions, preventing an initially solvent obligor from fulfilling its payment obligations.
- Securitisation risk, which refers to the uncertainty relating to the economic substance of a transaction and its risk transfer level.
- Residual/recovery risk, which is the potential loss due to the decrease in value of risk mitigants, or resulting from the decreased solvency of guarantors.
- Settlement risk, which is the risk that a credit institution will deliver the sold asset or cash to the counterparty, and will not receive the purchased asset or cash as expected.
- Concentration risk, which refers to exposure(s) that may arise within or across different risk categories throughout an institution with the potential to produce: (i) losses large enough to threaten the institution's ability to maintain its core operations; or (ii) a material change in an institution's risk profile.
- Counterparty risk, which is the risk that a counterparty to a financial transaction fails to comply with the terms and conditions of the contract, potentially leading to financial losses. Counterparty risk includes the risk arising from credit value adjustment (CVA) and on revalued positions with the possibility of positive or negative fair value.

Operational risk

Operational risk corresponds to potential losses resulting from inadequate or failed internal processes, people and systems or from external events (spread over the other risks).
It includes the seven types of operational risk under Basel II: unauthorised activity and internal fraud risk; external fraud risk; employment practices and workplace safety risk; customer, product and business practice risk; damage to assets risk; business disruption and systems failures risk and execution, and delivery and process management risk. It also includes outsourcing risk, which is the risk arising from an arrangement of any form between a financial institution and a service provider by which the service provider compromises the continuity and the quality of a process, a service or an activity.

Market and ALM risk

Market and ALM risk refers to:

- Interest rate risk, which corresponds to the potential decrease of the Bank's value due to interest rate movements increasing the cost of interest rate liabilities or decreasing the value of interest rate assets.
- Price risk, which corresponds to the potential reduction in value of assets such as equity and real estate, funds, and derivatives pertaining to such assets.
- Currency risk, which is the potential decrease of the Bank's value due to currency exchange rate movements changing the cost of currency-denominated liabilities or the value of such assets.
- Commodity risk, which is the risk of losses caused by changes in commodity prices.
- Inflation risk, which is the risk of losses on assets and liabilities caused by an adverse inflation rate.
- Spread risk, which is the potential decrease of the value of a portfolio due to the general fluctuations of the spread between the portfolio's yield and the risk free rate, when the portfolio's risk profile is unchanged.
- Liquidity risk, which is the risk that the Bank will not be able to meet both expected and unexpected current and future cash flow and collateral needs.
- Funding risk, which is the risk that the refinancing cost for BIL increases.
- Basis risk, which is the risk arising from an imperfect hedging strategy and/or a difference of reference on financial instruments.
- Market risk is described in more detail in part 4.

Enterprise risk

Enterprise risk includes:

- Business and strategic risk, which refers to the decrease of profitability resulting from various endogenous or exogenous factors relating to the Bank (adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment, economic downturn, etc.). This risk excludes financial risks for which the impact on profitability is independently assessed.
- Pension risk, which is the risk of losses resulting from an inadequate funding of pension obligations.
- Model risk, which refers to potential risk assessment errors resulting from an inadequate methodology and model, and/or data uncertainty or inappropriate use of models.
- Remuneration risk, which is the risk arising from bad practices which may gave staff incentives to pursue unduly risky practices, for example by undertaking higher risk investments or activities that provide higher income in the short run despite exposing the institution to higher potential losses in the longer run.
- Human resources risk, which can come from three main sources: human resources operating risk results from inadequate recruitment procedures for screening employees, inadequate training and change management programmes or poor succession planning policies; key-man risk measures the over-reliance on the skills of one or a few individuals which could affect the overall sustainability of the activity; people risk is the risk associated with inadequacies in human capital and the management of human resources, policies and processes, resulting in the inability to attract, manage, motivate, develop and retain competent employees, with a concomitant negative impact on the achievement of strategic group objectives.

- Legal and compliance risk, which is the risk arising from the necessity that the group conducts its activities in conformity with the business and legal principles applicable in each of the jurisdictions where the group conducts its business. It is the possibility that a failure to meet these legal requirements may result in unenforceable contracts, litigation, fines, penalties or claims for damages or other adverse consequences. It also includes tax risk, which is risk associated with changes in tax law and/or in the interpretation of tax law.
- Reputation risk, which is the potential decrease in the value of BIL arising from the adverse perception of the image of the financial institution on the part of customers, counterparties, shareholders, investors, regulators and other stakeholders.
- Social and environmental risk, which are the risks that are due to the real or perceived negative impact of group business practices on a broad range of social matters related to employment, labour/management relations; occupational health and safety; training and education; diversity and equal opportunities and equal remuneration for women and men.
- Environmental risks, which are the risks that are due to the real or perceived negative impact of group business practices on a broad range of environmental matters related to energy and water consumption, emissions, production systems, biodiversity that could lead to climate change, resource scarcity and biodiversity loss.

Other risks

Behavioural risk (prepayment and outflow risks) refer to the potential change in exposure to interest rate and funding risks due to the uncertain behaviour of customers.

Banque Internationale à Luxembourg SA

69, route d'Esch
L-2953 Luxembourg
RCS Luxembourg B-6307
T: (+352) 4590 -1
F: (+352) 4590-2010

www.bil.com

BIL
1856
BANQUE
INTERNATIONALE
À LUXEMBOURG