Aresbank

RISK GOVERNANCE

Table of Contents

RISK GOVERNANCE

A. GOVERNANCE

Aresbank is well aware of the multiple risks that may affect our day to day activities and implements strict controls to manage those risks. In terms of Governance, the ultimate responsibility lies on the Board of Directors which is assisted by the Audit, Risk and Compliance Committee ("The Audit Committee" or "ARCC"). The Audit Committee reviews and assesses the risk management activities of the institution and ensures an effective risk management governance structure. The Audit Committee meets as and when required and at least five times a year. The Committee performs an oversight review of the accuracy and integrity of the financial statements, the financial reporting process, the compliance with legal and regulatory requirements and the selection and independence of the external public auditors. The Internal Audit, Risk and Compliance Departments report and assist the ARCC. They assist the Bank to evaluate and improve the effectiveness of our own risk management processes.

B. PRINCIPAL TYPES OF RISK

All bank activities present a large variety of risks. For the purpose of this analysis we have selected the following key risks, as we consider they could cause a significant impact if they were to materialize:

- **Credit Risk:** The possible loss Aresbank would suffer if any of our borrowers or counterparties were to default on their obligations to us. Credit Risk is inherent to all our activities and in particular to lending activities, lending commitments, foreign trade transactions, foreign exchange and guarantees issued.

- **Operational Risk**: The risk of loss resulting from inadequate or failed internal processes, human factors and systems, breaches of technology and information systems, or from external events.

- **Market Risk:** The risk of loss due to adverse changes in the financial markets. Our Market Risks are primarily interest rate and foreign exchange risks.

- **Liquidity Risk:** The risk resulting from the inability to raise cash at a reasonable cost in the local or international markets. Liquidity risk can arise from cash flow mismatches, market constraints, deposit run-off, or contingent liquidity events.

- **Legal Risk:** The risk of loss that may occur for incorrect or inadequate loan or facility documentation. The risk of legal procedures from a counterparty who considers that the bank has acted incorrectly and causing damage to his interests or failed to meet non-contractual obligations.

- **Information Technology Risk:** The risk of financial loss resulting from the malfunctioning, partial or total disruption of the IT Infrastructure of the Bank.

- **Risk of Fraud:** The risk of financial loss as a result of criminal conduct that involves the use of dishonest or deceitful means in order to obtain some unjust advantage or gain over the Bank.

- **Money Laundering Risk:** The risk of financial loss as a result of inadequate internal controls or human errors to prevent financial transactions with the aim of laundering money.

- **Reputational Risk:** This risk of loss resulting from damages to a firm's reputation due to an adverse or potentially criminal event. There are a very large range of events that can tarnish a company's reputation such as safety, ethics, accounting, pollution, labor conditions, discrimination, etc.

- **Fiscal Risk:** The risk of loss resulting from errors and inadequate controls at the time of preparing our Financial Information and Profit and Loss Accounts resulting in incorrect taxes paid to the authorities.

- **Compliance Risk:** Is the risk of failing to comply with all the rules and regulations established by law, governments and international and local supervisory authorities and failing to implement effective measures to meet the specific requirements.

C. RISK OVERVIEW

1. **Credit Risk:** Credit Risk is intrinsic to much of the banking business and is probably the most relevant risk affecting the day to day operations of the Bank. In essence Credit Risk derives from the probability that a client might fail to comply with its contractual obligations and may cause the Bank a financial loss. The Bank has a strong culture of risk which is embedded across all levels of the organization. This risk culture is essential in order to prevent or minimize losses from our credit portfolio.

   Aresbank follows a strict process for the approval of new operations which is complemented with internal controls and regular supervision for the entire portfolio. All commercial executives must be well familiarized with the objectives of the Business Strategy of the bank, which can be translated as the Risk Appetite that the Bank has for different countries and corporate sectors.

   Risk Control Model

   Aresbank implements a strict system for approving the size, terms and maturity of all credit exposures as well as the ongoing monitoring of the creditworthiness of the counterparty. Our credit risk approval model entails the following procedures:

   - **Board of Directors**: The Board of Directors have the ultimate decision-making authority and is responsible and empowered for establishing the Bank's strategy, short and long term objectives and the general policy and direction of the institution. All geographical country limits must be approved by the Board. Facilities which exceed a certain threshold (see Annex I) need to be presented and approved by the Board. It is the Board of Directors, who in setting up the business strategy, provide a clear indication of the Risk Appetite that the Bank has for different geographical regions of the world as well as different corporate sectors and short and long term policies.

- **General Management:** The Board has delegated on the General Manager and the Deputy General Manager a certain level of authority (see Annex I) for the approval of new transactions. It is the responsibility of the General Management to implement and execute the Business Plan in order to achieve the established goals while maintaining the highest credit risk parameters across all business sectors.

- **Commercial Division:** Day to day transactions may be approved (within established parameters indicated in Annex I) by the Manager of Commercial Division and a member of the General Management.

- **Credit Committee**: The Credit Committee is formed by the Manager of Commercial Division (who is the Chairman), the Manager of Treasury, the Manager of Operations Division and the Manager of Risk Department. The Manager of Audit Department sits at the Committee but without vote. The risk Committee may approve new operations to a certain level of exposure as established in Annex I.

- **Internal Facility Proposal (IFP):** All clients that have credit facilities must have an Internal Facility Proposal (IFP) prepared by the Commercial Executive responsible for the relationship. In addition and with total independence from the Commercial Division, Risk Department analyses the Client's financial creditworthiness and provides support or otherwise to the proposed transaction. Once these two documents (the IFP and Risk Department Report) have been prepared, the transaction goes for "Approval" at the right level. The level of Authority is established in the Credit Approval Manual, allocating different levels of authority to (A) The Credit Committee; (B) The Commercial Division; (C) The General Management and (D) The Board of Directors. The Credit Approval Manual describes in detail the specific responsibilities for the various areas involved in the approval process.

- **Risk Department** prepares a number of documents which help to assess and monitor, on a regular basis, the risks undertaken by the Bank. Some of these documents are: **Country Risk Report** which establishes the risk limit approved for each country where the Bank has credit facilities; **Bank and Corporate Risk Report** which analyses the creditworthiness of counterparty banks and Corporates; the **Credit Risk Concentration Report** which provides an analysis of risk concentration on a group of companies, on an industry sector or on a country and **Monthly Risk Report** which provides a monthly review of the Bank's portfolio and its evolution. At the same time it monitors that approved limits are not exceeded.

- **Ratings:** Aresbank uses Fitch, Moody's and S&P as independent external rating agencies for banks and corporate companies that have been rated. In addition, the Bank uses an internal score system that evaluates: (A) Quality and quantity of the information obtained; (B) Track record; (C) Profitability, (D) Financial Structure; (E) Leverage and (F) Cash Flow.

Internal Audit

The control of facilities, so that approved limits are no exceeded, is the prime responsibility of the commercial executive who should maintain regular contact with the clients to assess their needs, monitor and control the relationship and ensure that facilities are at all times within the approved limits. The Risk Department provides monthly reports of all facilities outstanding and generates an alert if a given limit is exceeded.

Additionally the Internal Audit Department provides an independent review, analyzing the compliance with all internal policies and in particular that all credits outstanding are in strict adherence with the approved limits. It is also the responsibility of the Internal Audit Department to implement “Snap Inspections” as well as regular portfolio reviews to assess the quality of our assets and that they are in compliance with the approved terms and conditions.

Aresbank is committed to comply at all times with directives and regulations from Basel and Bank of Spain and regularly estimates the capital required to support the overall credit risk portfolio. The credit-related capital calculation also serves for profitability analysis and concentration limits of capital at risk with anyone borrower, industry or country.

2. **Operational Risk**: Like any company or financial institution Aresbank is exposed to operational risks that may result on financial loss, litigation and in the final analysis tarnish the good name of the institution. Operational risk may originate from a large variety of areas, namely from errors related to transaction processing; breaches of the internal control system and compliance requirements; fraud by employees or people outside the Bank; from natural disasters and other external events as general strikes, terrorists attacks and social unrest that may produce business disruptions. Operational risk also includes non-compliance with applicable laws, regulatory requirements or contracts which could result in the imposition of fines and payment of damages. Aresbank regularly monitors its operational risks and has a business recovery planning, including on-line backup information technology system and additional facilities.

3. **Market Risk:** Changes in the financial market happen, and it tends to happen in an abrupt manner and without prior advice. Those changes occur from a very large variety of unexpected events that causes a rapid disruption in the market place. The main alterations tend to take place in the following areas: Interest rates; Foreign exchange markets, Stock Exchanges; Interbank Liquidity and a general volatility of spreads and other financial instruments. As a general strategy, Aresbank maintains a very prudent policy and we do not maintain speculative “open” positions in foreign exchange or in our loan book and therefore unexpected changes in interest rates or foreign exchange markets should not affect our business.

4. **Liquidity Risk:** Aresbank maintains a very strong liquidity position due to a very robust capital and a very prudent leverage policy. We ensure that sources of liquidity are sufficient, in amount and diversity, to fund our requirements without causing any adverse impact on our earnings, our day to day operations or our financial condition. The Board of Directors is ultimately responsible for the liquidity risk of the institution and approves the liquidity risk tolerance. The Asset and Liability Committee (ALCO) is the senior management committee responsible for the oversight of liquidity management. ALCO meets on a monthly basis and is responsible to ensure that Board approved strategies, policies and procedures for managing liquidity are appropriately executed.

5. **Legal Risk:** All financial institutions are exposed to the risk that clients or other counterparties may sue them, claiming that the bank has failed to perform under a contract or otherwise failed to carry out a duty perceived to be owned to them. Aresbank has a strong internal Legal Department and uses external legal experts as and when required.

6. **Information Technology Risk:** All our communications' and operations' systems run on very sophisticated infrastructures of information technology. Any disruption to our IT systems can have severe consequences to our internal operations and our capacity to communicate on an accurate and timely basis with our clients, our regulator and any other counterparty in the market place. In spite of very strict controls and sophisticated alarm systems to protect our IT platforms it is possible that we may not be able to anticipate or to implement effective preventive measures against all cyber threats. There are nowadays attacks that have been perpetrated to banks, industrial firms and even governments by organized crime groups, people linked to terrorist organizations and even hostile foreign governments. A breach to our IT systems could produce severe disruptions to our Operations and damage the reputation and good name of our institution.

7. **Risk of Fraud:** All financial institutions, like all companies in the market place, are exposed to the risk of fraud. In essence fraud can originate from internal sources though more frequently comes from external origins. Untrained staff or recently recruited employees who have not yet acquired the culture of the organization or who are leading a life style well above their salary capabilities may be exposed to the temptations of committing a fraudulent transaction. But it is the external sources that present unquantifiable mechanisms to perpetrate fraudulent transactions against banks. A short sample of fraudulent transactions are: Account opening documentation with false identifications; counterfeit checks; false credit/debit cards; false financial statements; false collateral given in order to obtain a loan; etc. As fraud occurs in so many different ways, there is no standard recipe for fraud prevention. Nonetheless the following elements can help the prevention of fraud: (A) Carefully recruited and well trained staff; (B) Internal culture of integrity and loss prevention; (C) Strict adherence to internal rules and procedures and (D) Regular auditing of transactions by Internal Auditing Department.

8. **Money Laundering risk:** Money laundering is the generic term used to describe the process by which criminals disguise the original ownership and control of the proceeds of criminal conduct by making such proceeds appear to have derived from a legitimate source. Typically, it involves three steps: placement, layering and integration. First, the illegitimate funds are furtively introduced into the legitimate financial system. Then, the money is moved around to create confusion, sometimes by wiring or transferring through numerous accounts. Finally, it is integrated into the financial system through additional transactions until the "dirty money" appears "clean". As a result, governments and international organizations have undertaken efforts to deter prevent and apprehend money launderers. New regulations have been enacted imposing obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing and to verify the identity of their customers.

   Aresbank implements strict "Know Your Customer" controls and maintains updated the lists of people and entities sanctioned by the Spanish and International Regulators in order to avoid business with these clients. At the same time we exert strict controls in order to avoid any financial transaction with sanctioned countries. We also ensure that all our counterparty banks have in their web an updated signed copy of their Patriot Act and that all our clients provide us with all the legal documentation required in order to demonstrate their identity, including the documentation to show the Ultimate Beneficiary Owner of the companies. The OCI (Internal Body Control on Prevention of Money Laundering), the Representative of Aresbank before the Sepblac (Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences) and ultimately the Board of Directors are responsible for the Prevention of Money laundering in the bank. Failure to prevent money laundering transactions can have severe consequences including fines and damage the Bank´s reputation.

9. **Reputational Risk:** Any failure or circumvention of our controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, reputation, results of operations and financial condition. Reputational Risk is a hidden danger that can pose a threat to the good name or standing of a business or entity including a threat to the survival of the biggest and best-run companies (Accenture, Enron, BP, Merck, etc.). The biggest problem with reputational risk is that it can literally erupt out of nowhere. The list of the most important events that may affect a company's reputation is practically "unlimited" but we could highlight the following issues: fraud, bribery, corruption, cyber breaches, safety, health, labor conditions, and nowadays at the top of the list, the environment.

10. **Fiscal Risk:** Recent changes in the law governing publicly owned companies introduced by the Spanish Government (Law 31/2014) has reinforced the responsibilities of the Board of Directors as well as the Audit Committee. There is in particular the responsibility to supervise the efficient management of the fiscal risks of the company. Fiscal errors or inadequate internal controls can result in direct legal responsibilities over the members of the Audit Committee and the Board of Directors. Unfortunately changes over corporate taxation and income tax retention have experienced substantial modifications every time that a new government has been elected and even during the four year term that they are in government.

11. **Compliance Risk:** During the last two decades there have been a great deal of financial and accounting scandals that resulted in unprecedented bankruptcies and even the closure of well known companies. Many countries and supranational organizations saw the need to introduce new regulations with the aim to guarantee transparency, improve internal controls and strengthen internal corporate governance to achieve a strict adherence to the law. All of a sudden the financial industry was exposed to a dramatic increase in new controls and regulations. Regulations which needed to be understood implemented and embedded into the day to day operational and business practices of all banks. The complexities of the new norms created the need of a new role: the Compliance Officer, a person responsible for overlooking and managing all matters related with the strict adherence to all norms and regulations.

    Analysts have established that there are three pillars that are essential for a well managed company to perform and meet its objectives: *Governance*, *Risk Management* and *Compliance (GRC)*. **Governance** is the combination of processes established and executed by the Board of Directors that are reflected in the organization's structure and how it is managed and led toward achieving goals. **Risk Management** is predicting and managing risks that could hinder the organization to achieve its objectives. **Compliance** is a strong culture and attitude to implement at all times the company's best practices, policies and procedures, to respect and obey laws and regulations and maintain a strong and efficient governance in all areas of our business activities. Compliance takes a proactive approach by anticipating evolving regulatory standards and remaining aware of industry best practices, legislative initiatives, competitive issues and public expectations and perceptions. Compliance is one of the most "actual" risks affecting the financial industry. A great number of banks have been fined, both in the US and in Europe for gross breach of internal compliance procedures. The cases of Madoff's Ponzy fraud, the fixing of the LIBOR rate in Europe and the problems related with the extension of Mortgages in the US are some clear examples of incidents happened during the last few years.

D. MANAGING RISK

It has been said that banking is the art of managing risk with the aim of obtaining a financial return. The risks in the financial industry are practically endless and the above comments have only tried to highlight those risks that we consider can have a more significant impact on our day to day operations. There is not a one single solution to all the potential difficulties that can arise on our normal business activities.

There are however three Lines of Defense that can help Aresbank to minimize the effects of risk in our operations.

- First Line: **Business lines** have primary responsibility for risk decisions. They are required to manage, monitor and control effectively the risks for their business, and to act within Bank risk appetite and approved limits, set by the Board.
- Second Line: **Risk Division** is a centralized function providing oversight and independent view to the risk decisions submitted by business management. They are also responsible for assessing, monitoring and reporting the risks undertaken by the Bank, to ensure they are being managed in accordance to the risk appetite defined.
- Third Line: **Internal Audit** provides independent, objective assurance that the policies, procedures and controls are adequate and that they are effectively embedded in the organization. It provides a disciplined approach to evaluate and improve the effectiveness of risk management, control framework and governance processes.

Additionally we should all implement the following principles and practices:

- Good knowledge of our customers and their business activities
- Knowledge of the financial support provided by other banks
- Good knowledge of the complexities of all proposed operations
- Audited financial information well studied and analyzed
- Strong guarantees and collateral, whenever possible
- Strong credit culture in the organization
- Well trained executives and aware of the company’s credit culture
- Good knowledge of market conditions and market information
- Strict analysis of Risk – Return on all our operations
- Regular follow-up of all operations during their life time
- Strong internal controls to ensure proper application of internal procedures
- Strong credit approval process.

Annex 1
Delegation Matrixes

1. CORPORATES

1.1 TRADE TRANSACTIONS

(Transactions with maturity above 5 years should be authorized by the Board of Directors).

- Trade Transactions: All facilities which are backed by trade commitments will be classified as Trade Transaction. Such facilities include both on and off balance sheet exposures. Some of the credit facilities which will be classified as trade facilities are: issuance of letters of credit, Discounting against letters of credit, Letters of guarantee, Pre / Post Shipment Financing.

(In Million Euros)

Level of Authority	Credit Powers based on Transaction Type			
	Unsecured	Partially Secured	Secured	Remarks
Board of Directors	> 4	> 8	> 10	
General Management (at least two members)	≤ 4	≤ 8	≤ 10	Can authorize adhoc facilities
One member of General Management + Manager of the Commercial Division	≤ 1	≤ 2	≤ 3	
Credit Committee	≤ 0.25	≤ 0.5	≤ 1	

1.2 PURE LENDING TRANSACTIONS

(Transactions with maturity above 5 years should be authorized by the Board of Directors).

(In Million Euros)

Level of Authority	Credit Powers based on Transaction Type			
	Unsecured	Partially Secured	Secured	Remarks
Board of Directors	> 1	> 2	> 4	
General Management (at least two members)	≤ 1	≤ 2	≤ 4	Can authorize adhoc facilities
One member of General Management + Manager of the Commercial Division	≤ 0.15	≤ 0.5	≤ 1	Can authorize adhoc CA overdrafts
Credit Committee	≤ 0.1	≤ 0.2	≤ 0.5	

2. BANKS

2.1 TRADE AND MONEY MARKET TRANSACTIONS

(Transactions with maturity above 5 years should be authorized by the Board of Directors).

- Trade finance facilities to correspondent banks. Tenure up to 1 year.
- Trade Transactions: All facilities which are backed by trade commitments will be classified as Trade Transaction. Such as confirmation of letters of credit, issuance of letters of guarantees, silent participation in syndicated transactions.
- Financing L/C's and SBLC up to one year
- Money Market transactions.

(In Million Euros)

Level of Authority	Credit Powers based on Transaction Type			
	Unsecured	Partially Secured	Secured	Remarks
Board of Directors	> 8	> 10	> 15	
General Management (at least two members)	≤ 8	≤ 10	≤ 15	• Term of guarantees ≤ 4 years • Can authorize adhoc facilities
One member of General Management + Manager of the Commercial Division	≤ 4	≤ 5	≤ 7	• Term of guarantees ≤ 4 years Can authorize adhoc facilities
Credit Committee	≤ 0.5	≤ 1	≤ 1.5	Term of guarantees ≤ 1 year

Note:

1. With regards to open positions which arise out from foreign currency transactions, the bank intends to put in place a limit of EUR **20 Million (*).**
2. All Trading Portfolio positions need approval from the Board of Directors.
3. The Bank currently has limited activity in Foreign Exchange transactions (viz. Spot, Forwards, Swaps etc.). Although there are no limits currently in place for Foreign exchange, unutilized limits approved for placements may be used for foreign exchange transactions.

(*) **the Open Currency Position in non-convertible currencies of Aresbank (ISK) is not considered to comply with the limit approved for the open position.**