Aresbank

اريسبنك

BASEL II - PILLAR III DISCLOSURES 2012

ARESBANK PILAR III DISCLOSURES (December 31st, 2012)

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1 INTRODUCTION

The Basel II Accord is built on three pillars:

- Pillar I defines the regulatory minimum capital requirements by providing rules and regulations for measurement of credit risk, market risk and operational risk. The requirement of capital has to be covered by own regulatory funds.
- Pilar II addresses the bank´s internal processes for assessing overall capital adequacy in relation to risks (ICAAP). Pillar II also introduces the Supervisory Review and Evaluation Process, which assesses the internal capital adequacy.
- Pilar III complements the other two pillars and focuses on enhanced transparency in information disclosure, covering risk and capital management, including capital adequacy.

This document gathers main aspects of the disclosure required under Pillar III. Materiality and relative worth are also taken into account.

This document is organized as follows:

Firstly, it gives an overview of internal governance structure and risk governance functions.

Secondly it provides the detail of capital structure and the capital charge with an overview of the approach taken by Aresbank to Pilar I and provides the profile of risk assets according to rules defined by Bank of Spain.

Finally, an overview of risk management current situation and measurement practices are presented, with emphasis in credit risks, and it sets out the related monitoring procedures.

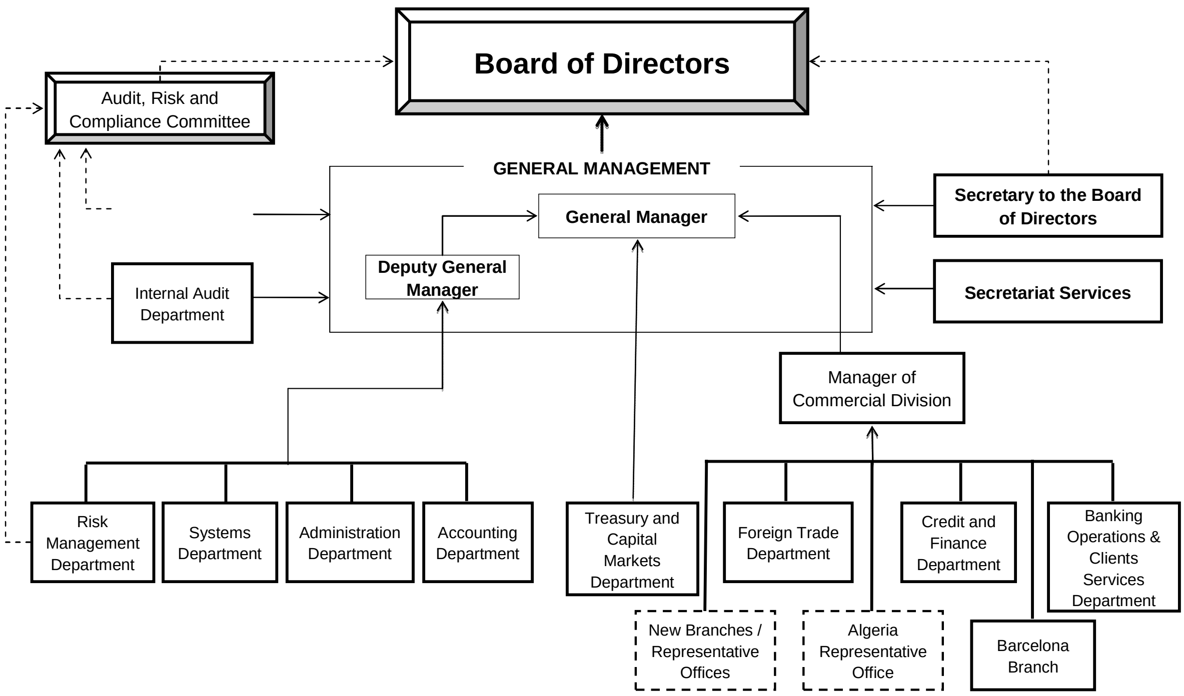
2 INTERNAL GOVERNANCE STRUCTURE

Aresbank's internal governance structure has been set up primarily to serve the business needs of its Head Office located in Madrid, and its branch located in Barcelona. Most of the business transactions are carried out centrally at the Head Office and are closely monitored by the General Management.

The assumed risks are to be managed and controlled in such a manner as to guarantee at all times the fulfillment of the following two concrete conditions which form the business objective of the Bank:

- That the risks, once assumed, are subject to regular supervision to check their progress and to take when necessary the appropriate rectifying action as mandated by the Bank.
- That all the Bank's risks are authorized and controlled from the headquarters; maintaining at all times a prudent profile adequate to the experience and the available resources in Aresbank.

The purpose of the Bank's organizational structure is to guarantee an adequate level of control that assures a suitable segregation of functions while at the same time aiming to achieve its business objective. The current Aresbank's organizational structures is as follows:



The Bank understands that the control functions need to maintain independence from business operations. As a result, the Internal Audit department, as well as, the Risk Management Unit report functionally to the Audit, Risk and Compliance Committee and administratively to the Bank's General Management.

As part of its overall management the Bank has also put in place the following committees:

1. Credit Committee
2. Asset Liability Committee
3. Administration Committee
4. Internal Control Committee

3 RISK GOVERNANCE

The following guidelines underpin the Risk and Capital Management function at Aresbank:

- The Board of Directors provides overall risk and capital management supervision for the bank.
- The Audit, Risk and Compliance Committee informs the Board of Directors about outstanding risks and operational performance.
- The ongoing management of risk is supported by control procedures to ensure compliance with specified limits, defined responsibilities, and the monitoring of indicators.
- The main goal is the management of credit, market, liquidity, operational, business and reputation risks as well as the capital in a coordinated manner at all relevant levels within the organization.
- The risk management function is made independent of other departments

Aresbank has restructured its organization to move towards the globally followed best practices of separation of Risk Management from the day to day business operations. The bank’s Risk Management Department is responsible for the design and application of the bank’s risk management framework. This risk management framework includes:

- Risks identification: The Bank endeavors to identify all material risks that may affect it. Identification is a continuous and pro-active process and it covers all the current activities of the Bank as well as new products and initiatives.
- Risk policies: The Bank establishes policies in order to ensure that the Bank's business units comply with the designed risk management framework.
- Measuring and handling risks: The Bank continually monitors models and validates risk parameters to ensure that risk measurement gives a fair presentation of the underlying portfolios and transactions.
- Risk controls: The Bank has established an independent control environment to monitor and enforce approved policies and limits.
- Risk reporting: The Bank applies periodically risk reporting at all levels of the organization with openness in the reporting of risk factors to the Bank's Board of Directors.

4 CAPITAL STRUCTURE AND SOLVENCY

On 31st December 2012 the capital base of Aresbank comprises of (a) Tier I capital which includes share capital of the bank 292,917 thousand of Euros, and reserves that amounted to a total of (97,502) thousand of Euros, and a profit of current period of 7,530 thousand of Euros, and (b) Tier 2 capital which consists only of generic provisions 1,668 thousand of Euros.

Aresbank reports its banking solvency calculated according to the relevant guidelines issued by the Spanish regulator. Aresbank´s Capital Adequacy ratio is 71.90%.

(EUR '000)

Breakdown of Capital Base	**Tier I**	**Tier II**	**Total**
Share Capital	292,917	--	292,917
Profit – (Losses)	7,530	--	7,530
Reserve	(97,502)	--	(97,502)
Generic Provision	--	1,668	1,668
Tier I and Tier II	**202,945**	**1,668**	**204,613**
Risk weighted assets (RWA)			
Credit Risk			263,216
Market Risk			--
Operational Risk			21,337
Total RWA			**284,553**
Capital Adequacy Ratio			71.90%
Of TIER I ratio			71.32%

Solvency information

4.1 Capital Requirements under Pilar I and Pilar II

The following table provides an aggregation of risks and the capital required for each of them, according to Pilar I and Pilar II of Basel II.

(EUR '000)

RISKS	Pillar I Capital Charge	Pillar II Capital Charge
Credit Risk (1)	21,058	--
Market Risk (2)	--	--
Operational Risk (3)	1,707	341
Interest Rate Risk in Banking Book (4)	--	--
Credit Concentration Risk (5)	--	5,012
Liquidity Risk (6)	--	1
Other Risks (7)	--	1,138
Total Capital Requirements (1+2+3+4+5+6+7)	**22,765**	**6,492**

Capital charges for Pilar I and Pilar II

5. PROFILE OF RISK WEIGHTED ASSETS AND CAPITAL CHARGE

For the risks covered under the Pillar I, the Bank adopted the following approaches as at 31st December 2012:

- Credit Risk – Standardized Approach.
- Market Risk – Standardized Method.
- Operational Risk – Basic Indicator Approach.

5.1 Credit Risk Weighted Assets

The exposures are classified as mentioned under the Basel II capital adequacy framework covering the standardized approach for credit risk. Aresbank calculates risk weighted assets as product of the exposure and relevant risk weight determined by its supervisor. Risk weights are determined by the category of borrower and depend upon external credit assessments by ECAIs (Standard & Poors, Moodys and Fitch) and also on the type of product.

(EUR '000)

Asset Class	Gross Exposure	Value of Credit Exposure (after CRM and CCF adjustments)	Risk Weighted Assets	Capital Charge
Central Governments & Central Banks	885	885	0	0
Financial Institutions	307,126	222,464	64,224	5,138
Corporate	219,240	186,258	159,148	12,733
Retail	903	766	477	38
Mortgages	--	--	--	--
Past Due	131,560	9	9	1
Other Assets	40,044	40,044	39,358	3,148
Total			**263,216**	**21,058**

Credit risk weighted asset and capital charge by asset class

5.2. Market Risk Weighted Assets

The bank does not have a material trading book. There is no risk linked to movements in prices in trading book, and consequently there is no capital requirement subject to market risk.

5.3. Operational Risk Weighted Assets

The Operational Risk capital charge, 1,707 thousands of Euros, is based on the average of positive gross income of previous three years multiplied by 15%. The total Operational Risk Weighted Assets amounts to a total 21,337 thousand of Euros.

(EUR '000)

	2012	2011	2010
Gross Income	11,370	12,265	10,508

Gross income for latest three years

6. RISK MANAGEMENT PRACTICES

6.1. Credit Risk Thresholds

Credit exposure to individual customers or customer groups is controlled through a tiered hierarchy of delegated approval authorities based on the risk of the customer. Where unsecured facilities sought are considered to be beyond prudential limits, Aresbank credit risk policies require collateral to mitigate credit risk in form of cash, or legal charges over third party guarantees. On the other hand, credit risk policy includes specific guidelines to set counterparty or group of counterparty limits to diversify its portfolio according to credit risk.

6.2. Credit Risk Concentration

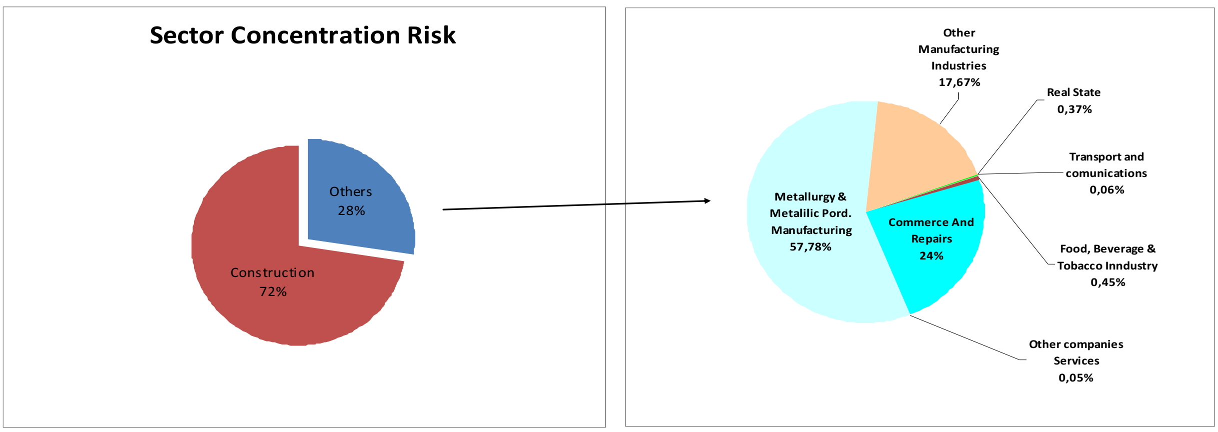
Concentrations arise when a number of counterparties are engaged in similar business activities, or/and activities in the same geographic region, that cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Risk concentrations are identified accordingly.

The key component of total lending was "Loans and Advances to Credit Institutions", mirroring around 45% of the total assets of the Bank's balance sheet, followed by "Loans and advances to other debtors", representing 46% o the total assets. Regarding the "Loans and Advances to Credit Institutions", the interbank deposits represented 78% of the latter. Approximately 88% of those deposits were placed in Spanish financial institutions, and the rest, with banks located in the MENA region.

6.2.1 Sector concentration Risk

As can be seen in the pie chart below regarding the sector concentration, the bank concentrates part of its portfolio in construction and public work sector. This is primarily because the bank facilitates trade transactions between construction companies and the MENA region.

The following graph is a detail of sector concentration risks in E.U. excluded interbank risks, as 31st December 2012:



Sector concentration risk

6.3. Credit Risk Mitigation

The amount and type of collateral depend on an assessment of credit risk of counterparty. Collaterals are monitored, and additional collateral is requested in accordance with the underlying agreement if necessary.

The following table breaks down the eligible Credit Risk Mitigation (CRM) used by the Bank as 31st December 2012:

Type of CRM	Amount *(EUR '000)*	Asset Class of Counterparty
Real Guarantees	22,356	Financial Institutions
Real Guarantees	4,032	Corporate
Real Guarantees	258	Retail
Guarantees Received	3,528	Financial Institutions
Guarantees Received	123,813	CESCE

Credit Risk Mitigation by Asset Class

6.4. Impairment of assets

An assessment is made periodically by Aresbank to determine whether there is objective evidence that a specific financial asset or group of financial assets may be impaired. If such evidence exists, an impairment loss is recognized.

Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, default or the probability that they will enter bankruptcy.

6.4.1 Doubtful assets, specific and country risk provisions

Below there is a classification by type of doubtful exposure, both on balance sheet and contingent exposures, and by type of provision, both specific and country risk provisions held as of 31st of December 2012.

(EUR '000)

Classification Type	Exposures	Provisions
Balance sheet	131,095	131,095
Contingent exposures	455	437
Total	**131,550**	**131,532**
Country risk on balance sheet	972	812
Country risk on contingent exposures	50	11
Total	**1,022**	**823**

Doubtful assets, specific and country risk provisions

Additionally the bank allocates generic provision for an amount of 1,424 Thousand Euro (for debt exposure) and 244 thousand Euro (for contingent exposure).

6.5. Interest rate Risk Management

Interest rate risk arises from the possibility that changes in interest rates will affect future profitability or the fair values of financial instruments. The bank is exposed to interest rate risk as a result of mismatches of interest rate re-pricing of assets and liabilities.

Assessment of IRRBB

Interest Rate Risk in Banking Book (IRRBB) refers to the risk of loss in earnings or economic value of the Bank's Banking Book as a consequence of movement in interest rates.

Capital Charge for IRRBB is worked out using Economic Value Approach. The Bank does not experience significant gap between the duration of assets and duration of liabilities indicating a low impact on Economic Value of Equity (EVE). This is specifically conceptualized through the methodology 'Duration Gap'.

In order to calculate the change in the economic value of Equity interest rate risk in banking book, the Bank assumes a 200 basis point positive shift as the extreme interest rate scenario.

Modified Duration (Assets) (DA)	0,142
Modified Duration(Liabilities) (DL)	0,053
Weight (RSA / RSL)	0,335
Modified Duration Gap (Balance Sheet), Years (DGAP)	0,124
Modified Duration of Equity	0,196
For a 200 bps Rate shock the drop in equity value	0,39%

Rate Shock	2,00%

Economic Value of Equity	**166.980,50**
Change in Economic Value of Equity	**(786,27)**

Change in Economic Value of Equity under a shift of 200 basic points

The ratio (Capital Held – Change in EVE) / Capital Required under Pillar I , after applying the shock stands greater than 350% and hence no capital is required to be kept for Pillar II.

6.6. Liquidity Risk Management

Liquidity risk is the risk that maturing assets may not cover cash flow obligations (or liabilities). The bank is generally in a position of comfortably off liquidity.

Assessment of Liquidity Risk

All assets and liabilities are mapped to respective time buckets as per their residual maturities. Liquidity statement and positive gaps (both absolute and cumulative mismatch) across all the time buckets on 31st December 2012, are presented in the following table: ***(EUR '000)***

Time Buckets	Assets	Liabilities	Gap	Cumulative Gap
Up to 1 Month	201,991	152,129	49,862	49,862
1 Month to 3 Months	10,842	2,737	8,105	54,967
3 Months to 6 Months	7,762	146	7,616	65,583
6 Months to 12 Months	23,235	1,777	21,458	87,041
1 Year to 5 Years	61,314	32	61,282	148,323
Over 5 Years	151,417	0	151,417	299,740

Liquidity Position & Mismatches

Liquidity capital charge for Pilar II is calculated with a combined assessment of both quantitative and qualitative approaches. Liquidity quantitative analysis is worked out using the standard models like maturity based gap analysis and cost of funding in short term. Qualitative assessment uses liquidity ratios and self assessments to evaluate liquidity management. A summary of internal assessment scores of both quantitative and qualitative approaches used for calculation of liquidity charge for Pilar II are presented below:

In EUR'000

LIQUIDITY RISK CAPITAL CHARGE

Key Risk Factors	Fixed Weight (a)	Score
Stock Approach (cuantitative ratios)	40%	52.83%
Flow Approach	30%	66.67%
Asset Liability Management	20%	50.00%
Adherence to Reserve Ratios	10%	100.00%
Qualitative Score		61.13%

Cost of Funding Short Tem Liquidity Gap (LIBOR1M)	0.11%

Impact on Economic Capital		
Quantitative Assessment based Charge		1.02
Adjustment based on Qualitative Assessment Score		0.40
Liquidity Risk Capital Charge		1.42

Liquidity Capital Charge

6.7. Operational Risk Management

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes or systems, or from external events. The bank intends to develop in short an operational risk framework, which includes identification, measurement, management, and monitoring and risk control elements. Risk and control assessments, Key Risk Indicators, event management, new product review and approval processes and business contingency plans. As this operational framework is still pending to be implemented, it has been decided to add a residual operational risk charge for Pilar II of 341 thousands of Euros.

6.8. Capital Management

The bank aims to maintain an optimum level of capital to enable it to pursue strategies that build long-term shareholder value. Its key principle is to have an adequate capital that is maintained as buffer for unexpected losses.

The bank has an approach to risk and business strategy which analyses current and future capital needed according to its business planning.

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