Aresbank

Basel III Pillar III

DISCLOSURES REPORT

2016

Pillar III
Disclosures Report
December 31st 2016

ARESBANK PILAR III DISCLOSURES (December 31st, 2016)

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1 INTRODUCTION

On 26 June 2013 the Basel III legal framework was incorporated in the European legal order through Directive 2013/36 (CRD IV), and Regulation 575/2013 on prudential requirements for credit institutions and investment firms (CRR).

CRD IV was introduced into Spanish law through Law 10/2014 on the ordering, supervision and solvency of credit institutions. The CRR is directly applicable in Member States from 1 January 2014. The CRR provides for a phase-in period that will allow institutions to adapt gradually to the new requirements in the European Union. The phase-in arrangements have been introduced into Spanish law through Bank of Spain Circular 2/2014, with implementation starting in 2014 and ending, in some cases, in 2024. The phase-in affects both the new deductions from capital and the instruments and elements of capital that cease to be eligible as capital under the new regulations. The capital conservation buffers provided for in CRD IV will also be phased in gradually, starting in 2016 and reaching full implementation in 2019.

The regulatory framework is based 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.

- Pillar 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.

- Pillar 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 requirement with an overview of the approach taken by Aresbank to Pillar 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

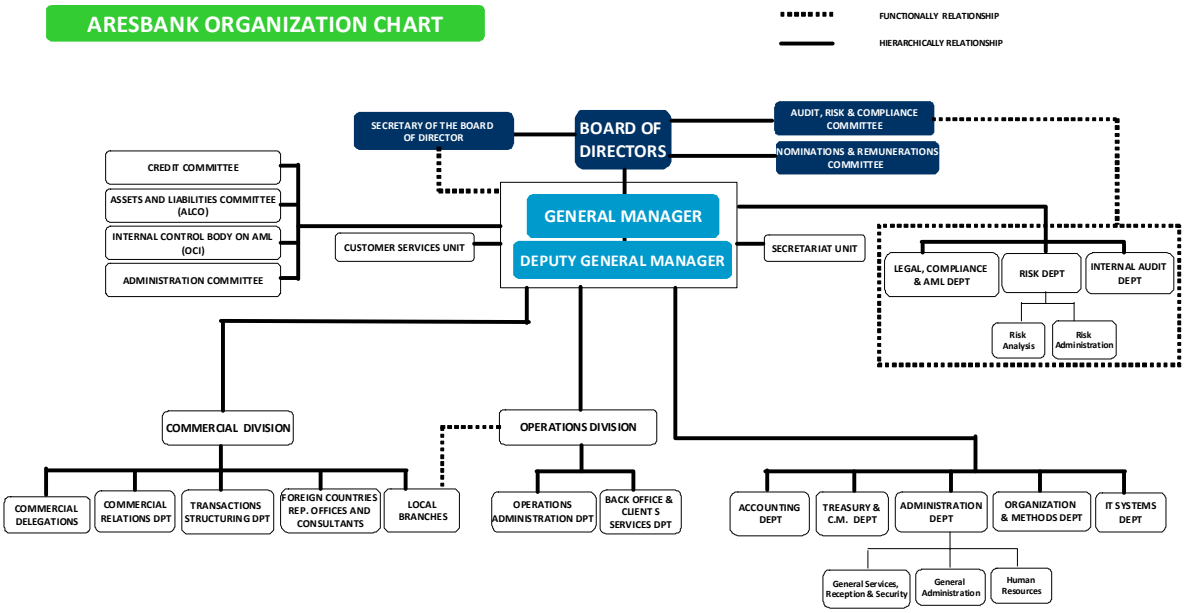
Aresbank's internal governance structure has been set up primarily to serve the business needs of its Head Office located in Madrid, and its branch located in Barcelona. Most of the business transactions are carried out centrally at the Head Office and are closely monitored by the General Management.

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 structure 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

Also, there is a Nominations and Remunerations Committee depending on the Board of Directors.

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 inform 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 2016 the capital base of Aresbank comprises of (a) Tier I capital which includes share capital of the bank 300,001 Thousand Euro, and reserves that amounted to a total of 14,444 Thousand Euro, a retained earnings of 23,790 Thousand Euro, and (b) Tier 2 capital which consists only of generic provisions 1,297 Thousand Euro.

Aresbank reports its banking solvency calculated according to the relevant guidelines issued by the Spanish regulator. Aresbank´s Capital Adequacy ratio is 52.82%.

(EUR '000)

Breakdown of Capital Base	**Tier I**	**Tier II**	**Total**
Share Capital	300,001	--	300,001
Retained Earnings	23,790	--	23,790
Reserves	14,444	--	14,444
Intangible Assets	-150		-150
Other transitory adjustments	-839		-839
Credit Risk Provision	--	1,297	1,297
Tier I and Tier II	**337,246**	**1,297**	**338,543**

Risk weighted assets (RWA)	
Credit Risk	595,613
Market Risk	12,938
Operational Risk	32,438
Total RWA	**640,987**
Capital Adequacy Ratio	**52.82%**
Of TIER I ratio	**52.61%**

(*considering Tier I without audited results)

Solvency information

4.1 Capital Requirements under Pillar I and Pillar II

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

(EUR '000)

RISKS	Pillar I Capital requirement	Pillar II Capital requirement
Credit Risk (1)	47,649	--
Market Risk (2)	1,035	--
Operational Risk (3)	2,595	516
Interest Rate Risk in Banking Book (4)	--	--
Credit Concentration Risk (5)	--	23,610
Liquidity Risk (6)	--	0
Other Risks (7)	--	2,564
Total Capital Requirements (1+2+3+4+5+6+7)	**51,279**	**26,690**

Capital requirements for Pillar I and Pillar II

5 PROFILE OF RISK WEIGHTED ASSETS AND CAPITAL REQUIREMENT

For the risks covered under the Pillar I, the Bank adopted the following approaches as at 31st December 2016:

- 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 requirement
Central Banks	83,235	83,235	0	0
Financial Institutions	1,264,956	1,253,230	377,042	30,163
Corporate	246,812	171,094	168,383	13,471
Retail	40,122	21,641	10,748	860
Mortgages	15,327	15,327	5,977	478
Past Due	4,709	2,473	83	7
Other Assets	38,499	38,499	33,380	2,670
Total			**595,613**	**47,649**

Credit risk weighted asset and capital requirement by asset class

5.2. Market Risk Weighted Assets

The bank does not have a material trading book; it recorded a capital requirement of 1,035 Thousand Euro for market risk due to a foreign exchange position.

5.3. Operational Risk Weighted Assets

The Operational Risk capital requirement, 2,595 Thousand Euro, is based on the average of positive gross income of previous three years multiplied by 15%. The total Operational Risk Weighted Assets amounts to 32,438 Thousand Euro.

(EUR '000)

	2016	2015	2014
Gross Income	12,049	14,245	25,611

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.

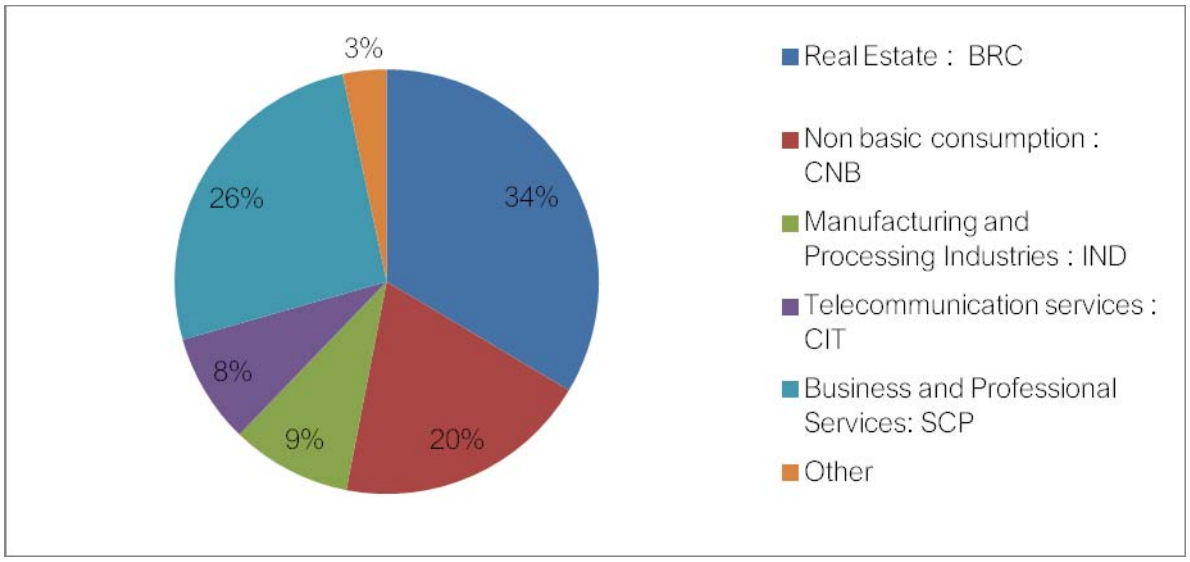
6.2. Credit Risk Concentration

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 total lending (gross) amounted as of December 31st, 2016 to 1,341 Million Euro. The key component of the total lending was "Loans and Advances to Credit Institutions", for an amount of 1,045 Million Euro. Around 69.3% of those investments regard to banks rated BBB- or above (investment grade). Money market transactions accounted for 360,278 Thousand Euro. Contingent exposures have increased from the previous year to a total amount of 234,895 Thousand Euro, compared to 182,175 Thousands Euro.

6.2.1 Sector concentration Risk

From the sector point of view, 34% of the Bank portfolio in E.U. (excluding interbank market) is related to real state sector, followed by business and professional services in a 26% and non basic consumption in a 20%.



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 2016:

Type of CRM	Amount *(EUR '000)*	Asset Class of Counterparty
Real Guarantees	14,062	Financial Institutions
Real Guarantees	17,647	Corporate
Guarantees Received	18,842	Financial Institutions
Guarantees Received	72,513	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 2016.

(EUR '000)

Classification Type	Exposures	Provisions
Balance sheet	2,473	2,390
Contingent exposures	412	395
Total	**2,885**	**2,785**
Country risk on balance sheet	16,540	3,771
Total	**16,540**	**3,771**

Doubtful assets, specific and country risk provisions

Additionally the bank allocates generic provision for an amount of 818 Thousand Euro (for debt exposure) and 451 Thousand Euro (for contingent exposure).

6.5. Interest rate Risk Management

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. Interest rate risk arises from holding assets / liabilities with different principal amount, maturity dates or reprising dates thereby creating exposure to changes in levels of interest rates.

a) Repricing gap approach

Under this approach, the assets and liabilities are grouped into the time intervals or buckets according to the time until Re-pricing. The Bank's GAP then equals to the difference between Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL), which is further used to identify the Bank's interest rate risk and to develop strategy to manage the same. This has been implemented in Regulatory Report RP52.

The revision gap report as of December 31, 2016 is presented below. The interest rate sensitive liability is subtracted from the interest rate sensitive asset, resulting in a gap for each time interval:

	Bucket 1	Bucket 2	Bucket 3	Bucket 4	Bucket 5	Bucket 6	Bucket 7
	<1M	1-3M	3-6M	6-12M	1-3Y	3-5Y	> 5 Y
Rate Sensitive Assets	597,696	334,828	79,577	971	0	0	356
Rate Sensitive Liabilities	596,431	231,477	48,383	949	0	0	2,383
Rate Sensitive Gap (Assets - Liabilities)	1,265	103,351	31,194	22	0	0	-2,027
Cumulative GAP	1,265	104,616	135,810	135,832	135,832	135,832	133,805

b) Economic Value Approach

This approach analyzes the dynamic behavior of economic value of equity (EVE) with response to varying interest rate scenarios. Broadly, the EVE is defined as the difference between the economic value of assets and economic value of liabilities in response to a change in the interest rate. The linkage between the two is established via modified duration of rate sensitive assets and liabilities.

To assess the capital requirements for structural interest rate risk Aresbank has decided to use the simplified option in which the entity uses the adverse impact on its economic value referred to in the hundredth sixth rule of Circular 3/2008 on determination And control of own resources of the entities and that is collected in column 2 of state RP51.

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 shift as the extreme interest rate scenario.

As stated in column 2 of state RP51, the impact on the economic value of the entity is as follows:

Currency	Impact on the Economic Value				
	Global			Breakdown by currencies	
	Amount	(%) of the Equity	(%) of the Economic Value	As a result of a raise of the interest rates	As a result of a drop of the interest rates
TOTAL	**-284**	**-0.08**	**-0.23**		
USD				331	-284
EUR				1,639	

c) Capital Requirement Calibration

Since for Aresbank the estimate of the impact of the interest rate risk on economic value as a percentage of equity is 0.08, it is not necessary for the entity to allocate capital to cover that risk.

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 of 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 2016 are presented in the following table:

(EUR 000)

Liquidity Position & Mismatches

Time Buckets	Assets	Liabilities	Gap	Cumulative Gap
Up to 1 Month	814,329	695,242	119,087	119,087
1 Month to 3 Months	251,885	231,477	20,408	139,495
3 Months to 6 Months	55,456	48,957	6,499	145,994
6 Months to 12 Months	47,062	1,028	46,034	192,028
1 Year to 5 Years	109,114	528	108,586	300,614
Greater than 5 Years	34,630	10,256	24,374	324,988

Liquidity capital requirement for Pillar 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 requirement for Pilar II are presented below:

Key Risk Factors	Fixed Weight (a)	Score
Stock Approach (quantitative ratios)	40%	43.75%
Flow Approach	30%	63.33%
Asset Liability Management	20%	83.33%
Adherence to Reserve Ratios	10%	100.00%
Qualitative Score		**63.17%**
Cost of Funding Short Tem Liquidity Gap (LIBOR1M)		**0.00%**
Impact on Economic Capital		
Quantitative Assessment based Requirement		**0**
Adjustment based on Qualitative Assessment Score		**0**
Liquidity Risk Capital Requirement		**0**

Liquidity Capital Requirement

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 is developing an operational risk framework, which includes identification, measurement, management, monitoring and risk control elements. Meanwhile, the bank continues applying the basic regulatory method, following EBA guidelines

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. In this sense, Aresbank assesses its accomplishment with capital guidelines as stated in Basel III and, in addition, with the prudential requirements issued for Aresbank by Bank of Spain that for the coming year are established in the 13.03%; as it can be seen in the coming chart, Aresbank is far away above this ratio, indeed.

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

The computable own funds of the Bank as of December 31, 2016 (without the profit of the year) are as follows:

	Thousand Euro 2016	Thousand Euro 2015
Total Equity (computable)	338,543	337,344
CET 1	**337,246**	**335,399**
Paid-in capital	300,001	300,001
Retained earnings	23,790	21,939
Reserves	14,444	13,905
Intangible Assets (-)	(150)	(446)
Other transitory adjustments (-)	(839)	---
Tier 2	**1,297**	**1,945**
Credit risk adjustments (standard approach)	1,297	1,945
Common Equity Tier 1 Ratio	52.61%	65.31%
Surplus (+) / Deficit (-) on CET 1 Ratio	308,402	312,288
Solvency Ratio	52.82%	65.68%
Surplus (+) / Deficit (-) on Solvency Ratio	287,264	296,257

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