# BANK SADERAT PLC

## BASEL II PILLAR 3 DISCLOSURES

## As At 31st December 2010

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## Introduction

Financial institutions within the scope of Basel II are required to disclose information about their risk exposures and the risk assessment processes they have used together with explanations of their risk objectives and risk management. These disclosures form Pillar 3 of the Basel II framework.

Basel II is implemented in the European Union (EU) via the Capital Requirements Directive (CRD). The CRD brings together two existing EU directives, the Banking Consolidation Directive and the Capital Adequacy Directive. The CRD directly affects banks and building societies and certain types of investment firms.

The CRD consists of three "pillars". Pillar 1 sets out the minimum capital requirements banks will be required to meet based on their credit, market and operational risk exposure. Under Pillar 2, banks and their supervisors at the Financial Services Authority (FSA) have to assess whether additional capital is required to cover risks not covered in Pillar 1.

Pillar 3 complements the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2) with the aim of developing a set of disclosure requirements which enable market participants to assess information on a bank's risks, capital and risk management procedures.

In the following pages, Bank Saderat PLC ("the Bank") explains the risks inherent in its business and the structure and procedures that its Board of Directors have established to manage those risks. It also explains the Bank's capital structure and how capital adequacy is managed.

The information contained in this disclosure has not been audited by the Bank's external auditors.

## Activities of the Bank

The principal activity of the Bank is the business of banking.

Despite having been regulated by the Financial Services Authority of the United Kingdom (FSA) and prior to the formation of the FSA, by the Banking Supervision Division of the Bank of England, financial sanctions were imposed upon the Bank on 27th July 2010 by the Council of the European Union. There is no allegation that the Bank has broken any UK or EC laws or regulations and the notice states the reason for the sanctions being that Bank Saderat PLC is a 100% owned subsidiary of Bank Saderat Iran.

One of the effects of the imposition of sanctions is that Bank Saderat PLC is subject to an asset freeze. This includes a prohibition on the Bank or any other person dealing with the Bank's funds and economic resources and a prohibition on any person making funds or economic resources available, directly or indirectly, to or for the benefit of the Bank without a licence from HM Treasury in the United Kingdom.

## Risk management objectives

The objectives of the risk management regime within the Bank are firstly, to identify and measure all risks that the Bank is subject to and secondly, to ensure that control structures are in place to limit risks to levels that are commensurate with the level of capital held and thirdly, to identify, where appropriate, methods of mitigating risk.

Where the risk management process identifies a risk that is unacceptable to the Directors and cannot be mitigated satisfactorily, the risk is avoided if possible. If a risk cannot be avoided as it is inherent in the operations of the Bank, the Directors allocate capital to cover the risk.

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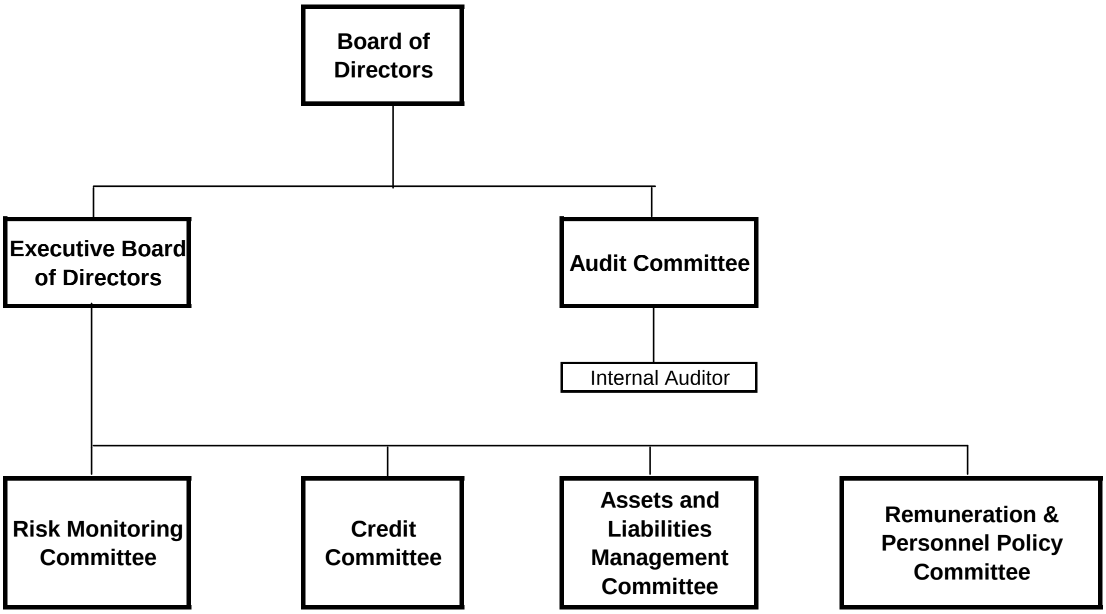
## Risk Management Structure




Despite having suffered an asset freeze as a result of the imposition of sanctions on 27th July 2010, the Bank remains subject to certain risks in relation to its outstanding business entered into prior to the imposition of sanctions. These risks are measured and reported on to Senior Management even though the Bank's ability to reduce risk positions is severely curtailed by the effect of sanctions.

The principal risks facing the Bank remain liquidity risk, interest rate risk, credit risk, foreign exchange risk and operational risk. Strategic risk, including political risk and economic risk, are considered to be types of operational risk. Operational risk also includes the risk of non-compliance with regulatory and legal requirements.

The Bank's risk management focuses on these major areas of risk.

Liquidity risk is the risk that the Bank will encounter difficulty in meeting its obligations from its financial liabilities as they become due.

Interest rate risk is the risk of variability of the fair value of future cash flows arising from financial instruments due to changes in interest rates and is measured by analysing assets and liabilities into time bands according to their maturity or next interest repricing date, whichever is the earlier.

Credit risk is the risk that companies, financial institutions and other counterparties will be unable to meet their obligations to the Bank which may result in financial loss. Credit risk arises principally from the Bank's lending book and from discounting of letters of credit; also to a lesser extent, from its holdings of investment securities and from the settlement of derivative contracts. Over the past twenty years discounting letters of credit issued by Iranian banks to finance trade between Iran and the rest of the world, the Bank, and its predecessors in London, Bank Saderat Iran London Branch and Iran Overseas Investment Bank PLC, have not suffered a loss due to non-payment of a discounted letter of credit.

Foreign exchange risk arises from the change in value expressed in reporting currency, of assets and liabilities held in currencies other than the reporting currency, due to fluctuations in spot or forward exchange rates. The Bank does not take speculative positions in currencies and any net open positions arise in the ordinary course of business. Since the imposition of sanctions on the Bank by the EU on 26th July 2010, the Bank is prohibited from entering into foreign exchange transactions without a specific licence from HM Treasury.

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

Authority flows from the Board of Directors and the above diagram shows the risk management structure. The main elements of risk governance are as follows:

## The Board of Directors

This is the primary governing body of the Bank. It approves the level of risk which the Bank is exposed to and the framework for reporting and managing those risks. The Board comprises the non-executive Chairman, an Iran based non-executive Director representing the principal shareholder, two UK based independent non-executive Directors and the Managing Director. The Board of Directors meets four times a year.

The Board of Directors delegates authority for many of the ongoing operational decisions to:

## The Executive Board of Directors

The Executive Board of Directors comprises the two UK based independent non-executive Directors and the Managing Director.

The Risk Monitoring Committee, the Credit Committee, the Assets and Liabilities Management Committee and the Remuneration and Personnel Policy Committee report to the Executive Board of Directors. The Executive Board meets monthly, unless a full Board meeting is being held.

## The Audit Committee

The Audit Committee comprises the non-executive Chairman, the Iran-based non-executive Director representing the principal shareholder and the two UK based independent non-executive Directors. It is chaired by an independent non-executive Director. It may be attended by the Managing Director, the Treasurer, the Assistant Managing Director, the Financial Controller, the Internal Auditor and the External Auditor. The Committee meets four times a year and reports directly to the Board of Directors. There is an opportunity at each meeting for members to discuss any matter without members of the executive being present.

The Committee is responsible for the assessment of the effectiveness of controls that are in place to mitigate risk and determines the risks to be assessed. It also oversees the Internal Audit function, receives internal audit reports and is responsible for approving the detailed audit plan and timetable.

## The Risk Monitoring Committee

The Risk Monitoring Committee comprises the two UK based independent non-executive Directors, the Managing Director, the Assistant Managing Director, the Treasurer, the Manager of loans and trade finance and the Financial Controller. It reports to the Executive Board of Directors.

The Risk Monitoring Committee is charged with the responsibility of advising the Executive or full Board of Directors, as appropriate, on the nature and relative scale of the risks confronting the Bank, the appropriateness of the controls intended to manage those risks and whether the residual risk is within the parameters approved by the Board.

The Risk Monitoring Committee oversees the production of a Risk Register whereby each department of the Bank analyses the risks to which it is subject, the mitigants and how the residual risk is managed. These departmental Risk Registers are then consolidated into a Bank Risk Register. The Risk Committee also ensures that contingency plans are in place to achieve business continuity in the event of serious disruption to business operations.

## The Remuneration and Personnel Policy Committee

The Remuneration and Personnel Policy Committee comprises the two UK based independent Non-executive Directors, the Managing Director, the Assistant Managing Director and up to two departmental managers. It is charged with the responsibility of advising the Board of Directors on matters related to remuneration, including the Bank's bonus and salary review policy. It also considers matters related to employment legislation, terms and conditions of employment, the staff handbook, disciplinary matters, staff complaints and the appeals process.

## The Credit Committee

The Credit Committee comprises the Managing Director, the Assistant Managing Director, the Manager, Loans and Trade Finance, the Financial Controller, the Manager, Documentary Credits and the Operations Manager. Meetings are held as and when necessary. The Committee reports to the Executive Board of Directors.
The Credit Committee receives annual reviews of outstanding borrowers.

### The Internal Credit Rating System

The Board of Directors has approved an in-house developed internal credit rating system which is used to determine whether or not the Credit Committee may approve a loan or advance, or whether higher level approval should be sought from either the Executive Board or full Board of Directors. The system is also used in conducting annual reviews of borrowers to assess their on-going credit standing and to consider whether a loan or advance should be placed on a "watch list" due to a deteriorating assessment of the borrower. The system is based upon a points scoring method with points awarded against various criteria from an analysis of accounts provided by borrowers. The sum of the points awarded determines the classification of each borrower from A (the highest rating) to D (the lowest). It is likely that any D rated borrowers would be in default resulting in the raising of a provision against the debt.

## The Assets and Liabilities Management Committee

The Assets and Liabilities Management Committee comprises the Managing Director, The Assistant Managing Director, The Treasurer, The Manager, Loans and Trade Finance and the Financial Controller. It meets once a month and reports to the Executive Board of Directors.

The Assets and Liabilities Committee monitors best practice management of the Bank's financial resources operating within the Bank's policy guidelines and the applicable regulatory framework.

The committee receives financial and statistical reports presented by the Treasurer, the Manager of Loans and Trade Finance and the Financial Controller related to exposures, liquidity, capital adequacy and limit utilisation.

# Capital Adequacy

The Bank's capital resources comprise share capital and retained earnings (Tier 1 Capital) together with subordinated loan notes and a general banking risk reserve (Tier 2 Capital). The Bank does not hold any Tier 3 Capital.

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At 31st December 2010, Tier 1 Capital comprised:

| | € 000s |
|---|---|
| **Share Capital** | |
| 162,392,300 Ordinary shares of €1 each | 162,392 |
| **total share capital** | 162,392 |
| **General Banking Risk Reserve** | 5,000 |
| **Retained Earnings** | 6,413 |
| **Total Tier 1 Capital** | **173,806** |

and Tier 2 Capital comprised:

| | |
|---|---|
| **Shareholder's subordinated term loan notes** | 60,290 |
| **Total Tier 2 Capital** | **60,290** |
| **Total Capital** | **234,096** |

Interim dividends of €12,004,850 were paid during 2010 and payment of a further dividend of € 6,000,395 related to the earnings of 2010 will be proposed at the Annual General Meeting of the Bank to be held on 10th March 2011. After payment of the dividend, the total Capital base will be €228,085,132.

The majority of Tier 1 Capital is issued and fully paid-up ordinary shares of €1 each. Audited retained earnings to 31st December 2010 and a general banking risk reserve, which was raised to maintain the regulatory capital base and is not available for distribution, are also included in Tier 1 capital.

Tier 2 capital consists of capital instruments that combine the features of debt and equity in that they are structured as debt instruments, but exhibit some of the loss absorption and funding flexibility features of equity. Capital instruments must satisfy the criteria contained in GENPRU 2.2.159 R in order for them to be included in Tier 2 capital, one being that the claims of these creditors must rank behind those of all unsubordinated creditors.

Tier 2 capital comprises:

- Shareholders subordinated term loan notes maturing in 2022. The notes are repayable on notice of five years and one day. No notice has currently been given.

## Capital Requirement

The Bank's capital requirement at 31st December 2010, under the Basel II convention was:-

| | **€'000** |
|---|---|
| Pillar 1 Credit risk capital requirement | 22,299 |
| Pillar 1 Foreign Exchange risk requirement | 168 |
| Pillar 1 Operational risk requirement | 4,870 |
| **Total Pillar 1 Capital** | **27,337** |
| Pillar 2 Additional Credit risk capital requirement | 3,484 |
| Pillar 2 Concentration risk requirement | 2,642 |
| Pillar 2 Residual risk requirement | 589 |
| Pillar 2 Market risk requirement | 6,148 |
| **Total Pillar 2 Capital** | **12,864** |
| **Total Capital Requirement** | **40,201** |
| **Total Capital held at 31.12.10 under Basel II** | **234,096** |
| **Total Capital held after payment of proposed** | **228,096** |
| **Capital cover under Basel II at 31.12.10** | **582.32%** |
| **Capital cover after payment of proposed dividend** | **567.39%** |

# Market Risk

Market risk is the risk that changes in interest rates, foreign exchange rates or other prices and volatilities will have an adverse effect on the Bank's financial conditions or results. The Bank does not have a trading book, however any currency risk arising from the Bank's commercial banking and lending activities in the banking book is treated as though it was a trading book item and managed accordingly.

It is the objective of the Bank to manage and control market risk exposures in order to optimise risk and return.

Market risk is reported to the Asset and Liability committee, which in turn reports to the Executive Board of Directors and through them, to the full Board of Directors.

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## Interest Rate Risk

Interest rate risk is the risk of variability of the fair value of future cash flows arising from financial instruments due to changes in interest rates.

The Bank is exposed to interest rate risk in the banking book due to mismatches between the repricing dates of assets and liabilities. This risk is monitored by the Assets and Liabilities Management Committee, reporting to the Executive Board of Directors and through them, to the full Board of Directors.

### Pillar 2 Capital

Residual interest rate mismatches at 31st December 2010 exist in Euros, Sterling, US Dollars and United Arab Emirates Dirhams for periods up to one year. Consolidated interest rate mismatches at 31st December 2010 were:

| | Less than three months | More than three months but less than six months | More than six months but less than one year | Undated - Non-interest bearing | Total |
|---|---|---|---|---|---|
| | €'000 | €'000 | €'000 | €'000 | €'000 |
| **Assets** | | | | | |
| Cash, loans and advances to banks | 215,489 | 40,880 | 744 | - | 257,113 |
| Debt securities | - | 20,000 | 10,450 | - | 30,450 |
| Tangible fixed assets | - | - | - | 13,485 | 13,485 |
| | - | - | - | - | - |
| | - | - | - | - | - |
| Other assets | - | - | - | 3,326 | 3,326 |
| Prepayments and accrued income | - | - | - | 962 | 962 |
| **Total assets** | **215,489** | **60,880** | **11,194** | **17,773** | **305,336** |
| **Liabilities** | | | | | |
| Deposits by banks & customer | 62,095 | 1,159 | - | - | 63,254 |
| | - | - | - | - | - |
| Other liabilities | - | - | - | 7,986 | 7,986 |
| Shareholders' funds | - | - | - | 173,806 | 173,806 |
| Subordinated loan | - | 60,290 | - | - | 60,290 |
| **Total liabilities** | **62,095** | **61,448** | **-** | **181,792** | **305,336** |
| **Off balance sheet items** | | | | | |
| **Interest rate sensitivity gap** | **153,394** | **(568)** | **11,194** | **(164,019)** | **-** |

The Bank does not have interest rate gaps in excess of one year since all interest earning assets and interest bearing liabilities, have their interest rates re-set within one year. Non-interest earning assets and non-interest bearing liabilities are included in the "More than six months but less than one year" time band as they either contribute to the funding of, or are funded by assets and liabilities which, themselves are repriced within this period.

The effect of a 2% movement in interest rates across all currencies and all dates at 31st December 2010 was € 6,148,368 (31st December 2009: € 7,183,888). This calculation assumes that all interest rate gaps were closed in the market by taking deposits or placing amounts at interest rates 2% above or below the actual rate applied to each gap in each currency.

The Bank's exposure to interest rate risk is not expected to change significantly during the course of 2011.

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## Foreign Exchange Risk

Foreign exchange risk arises from the change in value expressed in reporting currency, of assets and liabilities held in currencies other than the reporting currency, due to fluctuations in spot or forward exchange rates. The exposure is measured and monitored daily considering the position in terms of net exposure.

The foreign exchange position risk requirement in Pillar 1 is calculated by:

- calculating the net open position in each currency
- converting each such net position into base currency equivalent at spot rates of exchange
- calculating the total of all net short positions and the total of all net long positions
- selecting the larger of the two totals
- multiplying by 8% in accordance with BIPRU 3.1.5R.

The Bank's foreign exchange position risk requirement at 31st December 2010 was **€ 168,228**

| | US Dollar | United Arab Emirates Dirhams | Euros | Other Currencies | Sterling | Total |
|---|---|---|---|---|---|---|
| | €'000 | €'000 | €'000 | €'000 | €'000 | €'000 |
| **Assets** | | | | | | |
| Cash, loans and advances to banks | 4,633 | 3,084 | 148,620 | 142 | 17,437 | 173,916 |
| Loans and advances to customers | 21,110 | - | 60,182 | - | 1,905 | 83,197 |
| Debt securities | - | - | 30,305 | 145 | - | 30,450 |
| Tangible fixed assets | - | - | 13,485 | - | - | 13,485 |
| Other assets | 748 | - | 2,138 | 94 | 346 | 3,326 |
| Prepayments and accrued income | - | - | 238 | - | 724 | 962 |
| **Total assets** | **26,491** | **3,084** | **254,968** | **382** | **20,412** | **305,336** |
| **Liabilities** | | | | | | |
| Deposits by banks | 23,337 | 2,489 | 10,704 | 219 | 12,965 | 49,714 |
| Customer accounts | 2,616 | 16 | 5,344 | 3 | 5,561 | 13,540 |
| Other liabilities | 552 | 285 | 3,565 | - | 3,585 | 7,986 |
| Shareholders' funds | - | - | 173,806 | - | - | 173,806 |
| Subordinated loan | - | - | 60,290 | - | - | 60,290 |
| **Total liabilities** | **26,505** | **2,791** | **253,709** | **222** | **22,111** | **305,336** |
| **Net position** | **(14)** | **293** | **1,260** | **160** | **(1,699)** | **-** |
| **Off-balance sheet items** | | | | | | |
| Foreign exchange contracts | - | - | - | - | - | - |
| Undrawn commitments | - | - | 180 | - | - | 180 |
| Guarantees and other obligations | - | - | - | - | - | - |

**Pillar 2 Capital**

As foreign exchange positions are deemed to be insignificant and they will remain so for the foreseeable future, it is not considered necessary to hold additional capital to cover these positions, in excess of the position risk requirement included under Pillar 1.

## Credit Risk

Credit risk is the risk that companies, financial institutions and other counterparties will be unable to meet their obligations to the Bank which may result in financial loss. Credit risk arises principally from the Bank's lending book and from discounting of letters of credit; also, to a lesser extent, from its holdings of investment securities and from the settlement of derivative contracts. The Bank uses the Simplified Method of calculating its credit risk capital requirement using the standard risk weighting table published in BIPRU 3.5.

**Credit risk exposures at 31st December 2010**

| € 000 | Carrying Value | Weighted Under Basel II | 8% of Basel II Weighted Asset |
|---|---|---|---|
| Cash | 950 | 0 | 0 |
| Lending to Bank Saderat Group companies | 33,351 | 33,351 | 2,668 |
| Lending to Other Banks | 170,064 | 138,084 | 11,047 |
| Lending to Other Non-Banks | 83,198 | 89,725 | 7,178 |
| Direct Credit Substitutes | 0 | 0 | 0 |
| Trade Related Contingents | 0 | 0 | 0 |
| Undrawn Commitments | 180 | 180 | 14 |
| Other Assets | 17,396 | 17,396 | 1,392 |
| | **305,140** | **278,736** | **22,299** |

Under Basel II, the Pillar 1 capital required to support € 278,735,750 of weighted exposures at 31st December 2010 amounted to € 22,298,940.

**Non-bank credit exposures by industrial sector at 31st December 2010.**

| € 000 | Outstanding | Limit | Capacity |
|---|---|---|---|
| Automotive | 3,000 | 45,000 | 42,000 |
| Transport | 14,000 | 59,000 | 45,000 |
| Shipping | 0 | 0 | 0 |
| Utilities | 0 | 0 | 0 |
| Metals | 1,000 | 47,000 | 46,000 |
| Construction | 32,000 | 40,000 | 8,000 |
| Food | 0 | 48,000 | 48,000 |
| Oil/gas/petroleum | 18,000 | 128,000 | 110,000 |
| Investment companies | 16,000 | 81,000 | 65,000 |
| | **84,000** | **448,000** | **364,000** |

**Pillar 2 Capital**

From the various risks attributed to credit, one has been identified as high risk to the Bank - that of a fall in the price of shares quoted on the Tehran Stock Exchange which are held as security for loans. The mitigant for this risk is that the Bank normally demands 200% cover for secured lending.

Medium risks relate to the deterioration of a counterparty's financial position, an illiquid market in the Tehran Stock Exchange, the inability to convert Iranian Rials into hard currency, a beneficiary being insolvent at the time of discounting a bill of exchange and the incorrect handling of a documentary credit.

Low risks include the inability of Iranian banks to pay; the insolvency of the borrower; the inability to enforce security claims due to defective documentation and a series of risks relating to internal procedural failures.

The Bank believes that sufficient mitigants are in place to cover the high and low credit risks but considers it to be prudent to hold additional Pillar 2 capital of 1.25% of risk weighted assets to cover the medium risk in this category. At 31st December 2010, this amounted to € 3,484,209 (2009: € 7,280,189.)

### Concentration of credit risk

Concentration risk is a measure of the Bank's exposure to an individual counterparty, group of connected counterparties, industry sector or country. The Bank does not hold any significant concentrations of exposure to counterparties or industry sectors but does have a significantly concentrated exposure to Iran.

The table below shows the Bank's geographic concentrations of credit risk as at 31st December 2010.

| € 000 | Iran | Germany | United Kingdom | Other | Total |
|---|---|---|---|---|---|
| Cash and balances at banks | 70,432 | 19,700 | 2,436 | 22,303 | 114,871 |
| Loans and advances to banks | 27,491 | 0 | 31,554 | 0 | 59,045 |
| Loans and advances to customers | 83,198 | 0 | 0 | 0 | 83,198 |
| Debt securities | 30,450 | 0 | 0 | 0 | 30,450 |
| Undrawn commitments | 180 | 0 | 0 | 0 | 180 |
| | **211,751** | **19,699** | **33,988** | **22,303** | **287,743** |

### Pillar 2 Capital

For prudence, additional capital of 1.25% of Iranian exposures has been allocated to compensate for the high concentration of assets in Iran. At 31st December 2010, this amounts to € 2,642,286 (2009: € 5,910,436.)

### Average exposure to credit risk by credit class

| € 000 | Outstanding at 31.12.10 | Average outstanding during 2010 |
|---|---|---|
| Cash and balances at banks | 114,871 | 75,865 |
| Loans and advances to banks | 59,045 | 114,714 |
| Loans and advances to customers | 83,198 | 155,298 |
| Debt securities | 30,450 | 22,649 |
| | **287,564** | **368,526** |

### Residual risk

All the identified residual risks are common to the credit risk items with the exception of a borrower failing to adhere to covenants and the inability to realise security should the borrower be unable to repay.

The Bank has a share secured portfolio of loans of € 47 million at 31st December 2010. The security margin of these facilities is normally 200% of the drawn amount, although replacement to that level, should the share price fall, normally only takes place when the cover has fallen to 150%. Additional Pillar 2 capital of 1.25% of the share secured loan portfolio is deemed prudent to cover these risks and amounted to € 588,750 at 31st December 2010.

In addition to those loans secured by Tehran Stock Exchange shares, the Bank has € 16 million of loans to customers which are guaranteed by a parent company or bank and a further € 21 million of loans to customers which are secured by other collateral or take-down agreement. Where collateral is provided by a third party, the third party becomes subject to the same annual credit review as the primary borrower. The Bank has the right to call on its security in the event of customer default on principal or interest repayments.

**Residual maturity.**

The residual maturity breakdown of all the exposures analysed by class is as follows:

| € 000 | Less than three months | Between three and six months | Between six months and one year | Between one and five years | Over five years and undated | Total |
|---|---|---|---|---|---|---|
| Cash, loans and advances to banks | 145,669 | 27,500 | 748 | 0 | 0 | 173,917 |
| Loans and advances to customers | 10,702 | 3,962 | 15,741 | 52,791 | 0 | 83,197 |
| Debt securities | 0 | 20,305 | | 10,145 | 0 | 30,450 |
| | **156,370** | **51,767** | **16,490** | **62,937** | **-** | **287,564** |

**Past due and impaired.**

A financial asset is past due when the counterparty has failed to make a payment when contractually due. Past due does not mean that a counterparty will never pay, but it can trigger various actions such as renegotiation, enforcement of covenants or legal proceedings.

| | | Less than one month | | More than one month and less than three months | | Over three months | | |
|---|---|---|---|---|---|---|---|---|
| **By Industry Sector € 000s** | **Not Overdue** | **€ 000s Past Due Principal** | **€ 000s Past Due Interest** | **€ 000s Past Due Principal** | **€ 000s Past Due Interest** | **€ 000s Past Due Principal** | **€ 000s Past Due Interest** | **€ 000s Total** |
| Automotive | 2,078 | - | - | 693 | 250 | - | - | 3,021 |
| Construction | 13,750 | 2,750 | 383 | 3,750 | 699 | 3,000 | 497 | 24,829 |
| Oil/Gas/Petroleum | 2,000 | 667 | 66 | - | - | - | - | 2,733 |
| | **17,828** | **3,417** | **449** | **4,443** | **949** | **3,000** | **497** | **30,583** |

The carrying value of loans are secured as follows:

| | By Shares Listed on the TSE (Tehran Stock Exchange) | | By Guarantee | Total |
|---|---|---|---|---|
| | **150 to 199% cover** | **200% cover and greater** | | |
| Automotive | 3,021 | - | - | 3,021 |
| Construction | - | 16,673 | 8,156 | 24,829 |
| Oil/Gas/Petroleum | - | 2,733 | - | 2,733 |
| | **3,021** | **19,406** | **8,156** | **30,583** |

The Directors are of the opinion that should it be deemed necessary to realise the security, in all the above instances sufficient funds would be realised to repay the amounts outstanding.

On-going assessment is made to determine whether there is objective evidence that a specific financial asset or group of financial assets is impaired. Evidence of impairment may include past due amounts or other indications that the borrower has defaulted, is experiencing significant financial difficulty or where a debt has been restructured to reduce the burden to the counterparty.

If such evidence exists, the estimated recoverable amount of that asset is determined and any impairment loss is provided for.

The following impaired exposures and provisions against those exposures existed at 31st December 2010.

| € 000 | Impaired Exposure | Provisions |
|---|---|---|
| Non-performing loans and advances | | |
| - to customers | 0 | 0 |
| - to banks | 4 | (4) |
| Blocked funds | 2,066 | (1,318) |
| | **2,070** | **(1,322)** |

Amounts are written off when collection of the loan or advance is considered to be impossible, On secured loans, any write off would take place only after ultimate realisation of collateral value. All write offs are on a case by case basis, taking account of the exposure at the date of the write off.

**Reconciliation of movements in provisions**

| | 2010 |
|---|---|
| **At 1st January 2010** | **671,766** |
| Exchange adjustments | (5,496) |
| Increase in provision against blocked funds | 655,952 |
| Recoveries | - |
| **At 31st December 2010** | **1,322,222** |
| Impaired loans and advances | |
| - to banks | 3,938 |
| - to customers | 1 |
| Blocked funds | 2,066,282 |
| | **2,070,221** |

## Operational Risk

Operational risk is the risk of loss to the Bank resulting from deficiencies in processes, personnel, technology and infrastructure, and from external factors other than credit, market and liquidity risk.

The Bank's objective is to manage operational risk so as to balance the avoidance of financial loss through the implementation of controls, whilst avoiding procedures which inhibit efficiency and increase costs unjustifiably.

The Bank has elected to use the Basic Indicator Approach (BIA) which is considered to be the most appropriate basis given the disproportionate cost of establishing more sophisticated methods of capturing the requisite data and devising an acceptable method of calculating operational risk capital. Under this approach, the operational risk capital is calculated by mapping the Bank's three year average net interest income and net non-interest income and applying 15% thereto, as in the following table.

| € 000 | 2008 | 2009 | 2010 |
|---|---|---|---|
| Net interest income | 33,415 | 27,973 | 18,215 |
| Fees and commissions receivable | 1,312 | 1,114 | 4,334 |
| Dealing profits | 351 | 138 | 72 |
| Other operating income/(expense) | (514) | (41) | 0 |
| | **34,564** | **29,185** | **22,621** |
| **Average** | | **28,790** | |
| **15% thereof = capital requirement** | | **4,318** | |

Since its formation, Bank Saderat PLC has not suffered any material operating loss and the Directors consider that sufficiently robust operating procedures are in place to ensure that any operating loss that can reasonably be expected to occur in the foreseeable future would more than adequately be covered by the amount of capital allocated on this basis.

Operational risk is formally reviewed annually, when the Bank prepares its budget for the ensuing year. This review then encompasses the experience gained during the previous twelve months and also ensures that any risks associated with new areas of business, or changes in emphasis or scale of existing areas of business are incorporated in the risk review. The next formal review will take place in December 2011.

**Pillar 2 Capital**

The Bank has considered the following additional risks and the mitigants in place to ameliorate those risks in the context of providing additional Pillar 2 capital against Operational Risk.

Strategic risk
Liquidity risk
Transactional risk
Settlement risk
Regulatory risk
Reputational risk
Systemic risk
Pension risk

i) Strategic risk

The following four categories of strategic risk have been identified:-

a) Iran's inability to pay its debts due to low oil price or insufficient hard currency
b) Difficulty in enforcing security in the Iranian courts
c) Difficulty in keeping clearing facilities due to international pressure on other banks

In a worst case scenario, investment of the Bank's free capital, together with a sensible programme of cost reduction, would allow Bank Saderat PLC to remain solvent and profitable.

The Bank is of the view that the inability of Iran to pay its obligations due to lack of funds is not a risk for the foreseeable future. The current oil price of $91 per barrel and the strong continuing demand for oil and oil products from the BRIC economies (Brazil, Russia, India and China) means that it is deemed unlikely that demand or prices will decline to such an extent that the Iranian economy will significantly contract. Consequently, the Bank does not consider it necessary to allocate additional capital.

The risk of loss due to difficulty enforcing security in the Iranian courts is a type of credit risk, albeit a risk that could be triggered by political events and is therefore covered in the additional capital allocated for credit risk.

ii) Liquidity risk

Following the imposition of sanctions, the Bank is highly liquid as assets existing at the date of sanctions mature into cash. This highly liquid position will not change significantly until sanctions are removed and the Bank is able to operate normally. No additional capital is required, therefore, to support liquidity risk.

iii) Transactional risk

With the exception of the risk that a borrower may not adhere to covenants in their facility, all other transactional risks are common with credit risks. The single highest risk is that of a fall in the price of shares on the Tehran Stock Exchange when such shares are held as collateral. This risk has been dealt with as a credit risk.

iv) Settlement risk

Settlement risk may be divided into two elements: risks that relate to the failure of a payments system internally and risks of settlement failure due to sanctions, closure of correspondent accounts or the inability to access external payment system. The Bank has been living for many years with the risk that payments may be disrupted due to the efforts of the United States Treasury and is therefore confident that internal payment procedures and controls over systems are sufficiently robust to justify the conclusion that no additional capital is required to mitigate these risks beyond that already provided for operational risk.

The elements of settlement risk that relate to the political risk of sanctions are incorporated in the additional capital allocated for credit risk, as they arise, predominantly, from the concentration of the Bank's business in Iranian assets. In order to mitigate the effect of sanctions, the Bank has opened US Dollar accounts in non-US jurisdictions and arranges for the netting of payments and receipts whenever possible to restrict the necessity for the movement of funds.

v) Regulatory risk

Regulatory risk concerns the Bank failing to comply with its statutory obligation of adhering to the financial sanctions imposed upon it and the regulatory limits on its business and reporting timetables and are considered to be in the medium to low category of risk. The Bank has minimal retail business that could be subject to consumer protection legislation.

The Board of Directors of Bank Saderat PLC has adopted a series of policies designed to ensure that the Bank operates in accordance with its statutory obligations and has created a "culture of compliance" throughout the organisation to ensure that regulatory requirements are met. The Bank does not consider that the allocation of additional capital for regulatory risk is necessary.

vi) Reputational risk

These medium to low probability risks may be analysed into four areas reflecting the underlying reason from which reputational risk may arise:-

a) IT related risk such as data loss, internal or external hacking, defamatory e-mails or inappropriate web sites or theft of confidential data.

b) Poor procedures that result in the mishandling of letters of credit.

c) Internal failings with regard to staff matters, e.g. loss of personal data or failure to comply with employment legislation.

Reputational risk in respect of items a) to c) above, is intangible and considered to be mitigated by having in place appropriate and robust procedures together with a high degree of management overview of operations. It is not considered that the allocation of additional capital is necessary to mitigate these risks.

vii) Systemic risk

The principal systemic risk to which the Bank is vulnerable is that of changes to Iranian laws that would prevent the Bank enforcing a claim for security in the event of default by a borrower. If Iranian law was changed, for example, to disallow shares being offered as security for external borrowing or exchange controls were imposed that prevented the conversion of Rials into hard currency then the Bank could experience difficulty in recovering funds.

There are two mitigating factors in place. Firstly, regardless of any legislative changes in Iran, a primary obligation would remain on the borrower to repay its indebtedness and secondly, it is the Bank's policy to lend only to large, reputable, publicly owned companies.

If the Bank had recovered security in Iranian Rials but was unable to convert the Rials into hard currency, the Bank's shareholder, Bank Saderat Iran, has agreed to accept any dividend payments in Rials which could then be netted against the value of the security. The shareholder would also assist the Bank to recover Rial denominated security within Iran in any way possible.

It is not deemed necessary to allocate additional capital to cover systemic risk.

viii) Pension risk

The Bank is not vulnerable to pension risk.

With effect from 31st January 2002, the Bank's defined benefit pension scheme, the Iran Overseas Investment Bank PLC Retirement Benefits Scheme (the 'Scheme'), was closed and all active members became deferred pensioners.

As at 31st December 2009 the assets of the Scheme were nil having been used to settle the liabilities in respect of individual members' benefits by the purchase of deferred annuities from Legal & General Assurance Company, or by the payment of individual transfer values to another pension scheme or personal pension plan.

The final winding up of the Scheme is now complete, the liabilities have been discharged and final accounts have been prepared and to this extent, the financial statements contain adequate disclosure of the cost of providing retirement benefits and the related gains, losses, assets and liabilities.

As the scheme has been terminated, an indemnity has been given by the Bank to each trustee against any possible action by a scheme member. And the Bank has become the sole corporate trustee of the scheme.

The costs of providing pension benefits to staff under the defined contribution scheme are charged to the profit and loss account monthly.