Bank of China (Canada)

BASEL PILLAR III DISCLOSURES

AS AT DECEMBER 31, 2016

Bank of China (Canada)

Basel Pillar 3 Disclosures

December 31, 2016

Table of contents

1. Scope of Application

In this document, the Bank of China (Canada) (the "Bank") provides its Basel Pillar III disclosures, as required by the office of the Superintendent of Financial Institutions Canada (OSFI).

The Bank is licensed to operate in Canada as a foreign bank subsidiary with full banking powers under the Bank Act. The Bank is a wholly owned subsidiary of Bank of China Limited (the "parent bank"). The Bank is domiciled in Canada and its registered office is located at 50 Minthorn Boulevard, Suite 600, Markham, Ontario, L3T 7X8, Canada.

(All figures are in thousands of Canadian dollar, unless otherwise stated)

2. Capital Management

The Bank's objectives when managing capital are as follows:

- To comply with the capital requirements set by OSFI;
- To safeguard the Bank's ability to continue as a going concern and at the same time provide reasonable return to the sole shareholder; and
- To maintain a strong capital base to support future business development.

The Bank has established a policy on capital management. The Board of Directors and Management regularly review the Bank's capital structure and its capital adequacy ratio. The process of allocating capital to specific operations and activities is undertaken by the Bank's Asset and Liability Management Committee.

The capital adequacy of the Bank is measured pursuant to the guidelines issued by OSFI, based on standards established by the Bank for International Settlements. OSFI establishes risk based capital targets for financial institutions. These targets are currently a tier 1 capital ratio of 7% and a total capital ratio of 10.5%.

(a) Capital structure

<u>Tier 1 and total capital</u>

Tier 1 capital represents the permanent form of capital and primarily includes common shares and retained earnings of the Bank. Total capital includes Tier 1 and Tier 2 capital, net of certain deductions. Tier 2 capital primarily consists of subordinated liabilities.

	December 31, 2016	December 31, 2015
	$	$
Paid up common share capital	**455,230**	115,230
Retained earnings	**71,502**	55,696
Accumulated other comprehensive income	**(482)**	315
Tier 1 Capital	**526,250**	171,241
Subordinated liabilities	**40,000**	40,000
Tier 2 Capital	**40,000**	40,000
Total Capital	**566,250**	211,241

(b) Capital adequacy ratio

	December 31, 2016	December 31, 2015
	%	%
Tier 1 Capital adequacy ratio	**21.76**	11.46
Tier 2 Capital adequacy ratio	**1.66**	2.68
Total Capital adequacy ratio	**23.42**	14.14

(All figures are in thousands of Canadian dollar, unless otherwise stated)

2. Capital Management (continued)

The capital adequacy ratio as at December 31, 2016 was compiled in accordance with the Guideline – Capital Adequacy Requirement issued by OSFI in December 2014. The Bank has adopted the Standardized Approach for the calculation of the risk weighted assets for credit risk and the Basic Indicator Approach for the calculation of operational risk.

(c) Minimum capital requirement for principal risks:

	December 31, 2016	December 31, 2015
	$	$
Credit risk		
Bank	**13,044**	6,727
Corporate	**196,559**	123,148
Residential mortgages	**18,395**	9,252
Other retail	**3,610**	1,189
Operational risk	**8,427**	7,285

(d) Leverage ratio

The leverage ratio is defined as the capital measure divided by the exposure measure, with this ratio expressed as a percentage. It can be summarized as a measure of Tier 1 capital as a proportion of total adjusted assets.

Beginning in Q1 2015, institutions are expected to maintain a leverage ratio that meets or exceeds 3% at all times. OSFI has prescribed an authorized leverage ratio of 4% to the Bank. To ensure that the reported leverage ratio remains above 4% throughout the normal course of business, the Bank has set up an internal target leverage ratio at 5% including an appropriate operating buffer.

	December 31, 2016	December 31, 2015
	%	%
Total on-balance sheet exposure	**3,124,571**	1,878,254
Total derivative exposures	**22**	1,310
Other off-B/S exposures	**384,620**	260,676
Total exposures for the calculation of leverage ratio	**3,509,213**	2,140,240
Tier 1 Capital	**526,250**	171,241
Leverage Ratio	**14.99**	8.01

3. Risk management framework

The Board of Directors of the Bank has established a risk management system and policies to identify, analyze, monitor and control various types of risk that the Bank faces in its operations. The risk management policies covering credit risk, market risk, operational risk, and liquidity and funding risk of the Bank are reviewed regularly by the Risk Management Committee, the Asset and Liability Management Committee, the Risk Policy Committee and the Audit Committee.

(a) Credit risk

Credit risk arises from the possibility that a customer or counterparty in a transaction may default. Such risk may arise from customer risks from loans and advances, issuer risks from securities purchased and counterparty risks from inter-bank deposit placements.

The Risk Policy Committee reviews and the Board of Directors approves credit risk management policy to establish delegated lending authorities, portfolio quality, credit extension criteria, credit monitoring process, concentration limit, risk rating system, credit recovery and provisioning, and account officer responsibilities. Management ensures that credit risk is managed and controlled within the policy to permit sound and prudent management and control of existing and potential credit risk exposure. The policy is reviewed and enhanced on an on-going basis to cater for market changes, statutory requirements and best practice credit risk management processes.

In evaluating the credit risk associated with an individual customer or counterparty, financial strength and repayment ability are always the primary considerations. Credit risk may be mitigated by obtaining collateral, such as cash deposits, properties and guarantees, from the customers or counterparties. During the year ended December 31, 2016, the Bank had not used any credit derivatives to mitigate credit or concentration risks.

The Bank undertakes on-going credit analysis and monitoring at several levels and establishes a system to promote early detection of customer, industry, or product exposures that require special monitoring. The overall portfolio risk, individual impaired loans and potential impaired loans are monitored on a regular basis.

The Risk Policy Committee of the Board of Directors and Management meet regularly to review and deal with significant issues relating to credit risk exposures.

Based on the Bank's internal risk rating system, the credit exposure can be classified as "Performing", ""Special Mention", "Substandard", "Doubtful" and "Loss". "Performing" means the borrowers can honor the terms of the credit agreements, and there is no reason to doubt their ability to repay principal and interest on loans in full and on a timely basis. "Special Mention" means the borrowers have the capability to meet its financial commitment, but adverse business, financial, or economic condition will likely impair their capacity or willingness. "Substandard", "Doubtful" and "Loss" means the borrowers cannot repay loan principal and interest in full and significant losses will be incurred.

The Bank classifies loans and advances as impaired when, in the opinion of Management, the Bank no longer has reasonable assurance of timely collection of the full amount of principal and interest. Loans and advances where principal or interest is contractually past due 90 days are automatically classified as impaired, unless the Bank determines that they are fully secured, in the process of collection, and the collection efforts are reasonably expected to result in either full repayment of the loans and advances or restoring it to a performing status within 180 days from the date the payment has become in arrears.

(All figures are in thousands of Canadian dollar, unless otherwise stated)

3. Risk management framework (continued)

(a) Credit Risk (continued)

When loans and advances is classified as impaired, their carrying amount is reduced to its present value of estimated future cash flows discounted at the original effective interest rate inherent in the loans and advances. If the original interest rate is contracted at a variable interest rate, the discount rate for measuring the present value of estimated future cash flows will be the current effective interest rate determined under the loan agreement. The reduction in carrying amount of the impaired loan is recognized as a change in the impairment allowances and will be charged to the statement of income and comprehensive income in the period in which impairment is identified.

As at the following reporting dates, the Bank's exposure to credit risk is as follows:

	December 31, 2016	December 31, 2015
	$	$
Commercial loans		
Neither past due nor impaired	**1,169,500**	871,014
Past due but not impaired	**-**	-
Impaired	**-**	-
	1,169,500	871,014
Mortgages		
Neither past due nor impaired	**1,074,425**	546,474
Past due but not impaired	**-**	2,529
Impaired	**-**	-
	1,074,425	549,003
Other loans		
Neither past due nor impaired	**27,603**	23,737
Past due but not impaired	**-**	-
Impaired	**11**	-
	27,614	23,737

The credit quality of the portfolio of loans and advances that were neither past due nor impaired as assessed by reference to the Bank's internal credit risk rating system is as follows:

				December 31, 2016	December 31, 2015
	Performing	**Special Mention**	**Impaired**	**Total**	Total
	$	**$**	**$**	**$**	$
Commercial loans	**1,106,164**	**63,336**	**-**	**1,169,500**	871,014
Mortgages	**1,071,074**	**3,351**	**-**	**1,074,425**	546,474
Other loans	**27,528**	**75**	**11**	**27,614**	23,737
	2,204,766	**66,762**	**11**	**2,271,539**	1,441,225

(All figures are in thousands of Canadian dollar, unless otherwise stated)

3. Risk management framework (continued)

(a) Credit Risk (continued)

Loans and advances to customers by industry are as follows:

	December 31, 2016	December 31, 2015
	$	$
Commercial and other loans		
Financial institutions	283,254	204,180
Mining	38,708	122,816
Manufacturing	131,201	34,053
Service	76,872	59,968
Transportation	218,232	91,616
Trading	60,999	25,793
Real estate	293,339	214,987
Energy	53,756	116,874
Agriculture	87	96
Other	40,666	24,368
	1,197,114	894,751
Mortgages	1,074,425	549,003
	2,271,539	1,443,754
Less: allowance for impairment	(15,818)	(9,264)
Total, net of allowance for loan impairment	2,255,721	1,434,490

Loans and advances to customers by geographic location are as follows:

						December 31, 2016
	Gross portfolio	Net portfolio (1)	Gross impaired loans	Specific allowance	Collective allowance	Total allowance
	$	$	$	$	$	$
Canada						
Commercial loans	745,931	741,093	-	-	(4,838)	(4,838)
Commercial mortgages	549,843	545,047	-	-	(4,796)	(4,796)
Residential mortgages	524,582	522,251	-	-	(2,331)	(2,331)
Other loans	26,499	26,405	-	-	(94)	(94)
	1,846,855	1,834,796	-	-	(12,059)	(12,059)
International						
Commercial loans	423,569	419,815	-	-	(3,754)	(3,754)
Other loans	1,115	1,110	-	-	(5)	(5)
	424,684	420,925	-	-	(3,759)	(3,759)
Total	2,271,539	2,255,721	-	-	(15,818)	(15,818)

(All figures are in thousands of Canadian dollar, unless otherwise stated)

3. Risk Management Framework (continued)

(b) Market risk

Market risk is the potential for adverse changes in the value of the Bank's assets and liabilities resulting from changes in market variables such as interest rates, foreign exchange rates, equity and commodity prices and their implied volatilities. The two primary types of market risk applicable to the Bank are: (i) interest rate risk and (ii) foreign exchange risk.

The Risk Policy Committee reviews, and the Board of Directors approves, the Bank's policy on market risk management to monitor and control its market risk exposures within acceptable parameters, while optimizing the return on risk. The Asset and Liability Management Committee, which is responsible for the ongoing general market risk management, meets regularly to review and deal with issues in response to the changing market conditions.

(i) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Bank is exposed to interest rate risk when asset and liability principal and interest cash flows have different interest payment or maturity dates. These are called mismatched positions. An interest sensitive asset or liability is re-priced when interest rate changes or when there is cash flow from final maturity, normal amortization and when customers exercise prepayment. The Bank's exposure to interest rate risk depends on the size and direction of interest rate changes, and on the size and maturity of the mismatched positions.

Interest rate risk is measured using various interest rate shock scenarios to estimate the impact of changes in interest rates on the Bank's annual Earnings at Risk ("EaR"). EaR is defined as the change in the Bank's annual net interest income from 200-basis-point unfavorable interest-rate shock due to mismatched cash flows. The Bank establishes a risk-acceptable level in terms of a percentage to EaR to monitor this exposure and adjust any mismatch position whenever the policy limit is exceeded.

As at the following reporting date, the before-tax impact on the net interest income over the next 12 months due to an immediate 200 basis point change in interest rates is as follows:

	December 31, 2016	December 31, 2015
200 basis points increase in interest rates:	**816**	2,195
200 basis points decrease in interest rates:	**(816)**	(2,195)

(All figures are in thousands of Canadian dollar, unless otherwise stated)

3. Risk Management Framework (continued)

(b) Market risk (continued)

(i) Interest rate risk (continued)

As at December 31, 2016 and 2015, the financial assets and liabilities of the Bank based on the earlier of their contractual re-pricing or maturity date are presented below.

	Floating rate	Within 3 months	Over 3 months to 1 year	Over 1 year to 5 years	Over 5 years Total	Non-rate sensitive	Total
Assets							
Cash & cash equivalents	113,893	428,747	-	-	-	35,060	577,700
Securities	-	29,985	239,142	-	-	-	269,127
Loans and advances	968,671	678,720	192,529	431,619	-	-	2,271,539
Allowance for impairment	-	-	-	-	-	(15,818)	(15,818)
Other assets (1)	-	-	-	-	-	22,095	22,095
Total assets	1,082,564	1,137,452	431,671	431,619	-	41,337	3,124,643
Liabilities and equity							
Deposits from customers							
Demand and notice	599,583	-	-	-	-	59	599,642
Fixed term	-	490,385	581,307	18,835	-	-	1,090,527
Deposits from banks	437,839	67,195	279,766	49,724	-	-	834,524
Other liabilities (2)	-	-	-	-	-	33,700	33,700
Subordinated liabilities	-	40,000	-	-	-	-	40,000
Equity	-	-	-	-	-	526,250	526,250
Total liabilities and equity	1,037,422	597,580	861,073	68,559	-	560,009	3,124,643
Total gap - 2016	45,142	539,872	(429,402)	363,060	-	(518,672)	
Total gap - 2015	87,119	126,004	(210,373)	113,475	32,003	(148,228)	

(1) Other assets include customer liabilities under acceptances, property and equipment, deferred tax assets and other assets.

(2) Other liabilities include bank's liabilities under acceptances, cheques and other items in transit, income taxes payable and other liabilities.

(ii) Foreign exchange risk

Foreign exchange risk is the risk of loss due to the changes in the foreign exchange rates. The Bank's foreign exchange market activities are to cover customers' needs and foreign currency positions in the non-trading book. During the years ended December 31, 2016 and 2015, the Bank did not speculate on foreign exchange movements or maintain large open positions in foreign currencies.

The Bank does not have significant risk in foreign exchange as it is not involved in speculative trading activities. The Bank covers or hedges its currency exposure using foreign currency forward contracts. There is no significant foreign exchange exposure incurred in foreign currency deposit and loan transactions.

3. Risk Management Framework (continued)

(c) Operational risk

Operational risk is the potential for loss resulting from inadequate or failed internal control process or systems, human interactions or external events.

The Audit Committee reviews and the Board of Directors approves the policy for operational risk management. Management establishes various operational and control procedures to identify, manage and monitor inherent control weaknesses. The Audit Committee has oversight responsibility for operational risk strategy and governance. The Bank's Operational Risk Management Committee provides advice and guidance to the business units on operational risk assessments, measurement, mitigation and monitoring initiatives. A report on the status of the operational risk management is submitted to the Audit Committee quarterly.

(d) Liquidity and funding risk

Liquidity and funding risk arises when the Bank encounters difficulty in meeting obligations from its financial liabilities.

The Risk Policy Committee reviews and the Board of Directors approves the policies for liquidity and funding risk management. The Asset and Liability Management Committee of the Bank meets regularly to review and deal with liquidity management issues in response to changing market conditions.

The Bank's liquidity risk management policy and control procedures are designed to ensure that an effective liquidity contingency planning and liquefiable assets exist at all times to permit uninterrupted daily operations. The Bank's liquidity position is monitored daily and liquidity stress testing is conducted regularly under a variety of scenarios covering both normal and more severe market conditions.

The key measure used by the Bank for managing liquidity risk is the Liquidity Coverage Ratio ("LCR"). LCR is a standard that aims to ensure that an institution has an adequate stock of unencumbered high-quality liquid assets ("HQLA") that consists of cash or assets that can be converted into cash at little or no loss of value in private markets, to meet its liquidity needs for a 30 calendar day liquidity stress scenario. OSFI requires that, absent a situation of financial stress, the value of the LCR be no lower than 100%.

(e) Counterparty credit risk

Counterparty credit risk is the risk that the counterparty to a derivative transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value to the Bank at the time of default. In the normal course of business, the Bank has foreign exchange transactions with positive values and there is a risk that the counterparties might default. The Bank has established limits governing its foreign exchange activities with banks and customers; and, most importantly, it does not speculate on foreign exchange trading. To quantify settlement and counterparty risk, the Bank has adopted the 'current exposure method' to measure it and calculate the capital requirement for it.

As at December 31, 2016, the capital requirement for counterparty credit risk calculated by using the current exposure method is presented in the table following:

				December 31, 2016	
	Notional amounts	Positive (negative) replacement cost		Credit equivalent amount	Risk weighted balance
	$	$	$	$	$
Foreign exchange contracts					
Forward contracts	**2,269**	**-**	**(1)**	**23**	**5**
Total	**2,269**	**-**	**(1)**	**23**	**5**

4. Remuneration Policy

The Bank's remuneration policy applies to all its employees in Canada. The primary objectives of the Bank's remuneration policy are to compensate its employees in such a manner that it can attract, retain and motivate them, while at the same time enable the Bank implement and achieve its business targets and strategies.

The Bank has implemented a fair and balanced remuneration package that reflects the values of the business units and each individual employee. The package is comprised of the following components:

- Base salary
- Incentive pay
- Other benefits
- Severance payment

The base salary, which is a fixed remuneration, represents 80% to 90% of the total remuneration. The Bank aims at being competitive in determining the base salary of different positions.

The incentive pay is applied to motivate employees and increase their productivity. Employees with satisfactory performance are generally eligible. The amount of incentive pay is determined according to the performance of each individual employee measured by a number of criteria that are communicated to the employees in advance. The Bank has established certain risk control measures to prevent employees from taking excessive risks in attempting to achieve targets; and, the Bank can at its sole discretion adjust the incentive pay structure from time to time in order to minimize risk taking.

Other benefits are non-cash rewards to employees and include some special awards to employees who have demonstrated outstanding performance either at work or in internal competitions organized by the Bank.

The Bank may provide severance payment to terminate the employment relationship with unsatisfactory employees after all efforts to help them are unsuccessful.

The Bank conducts annual review on the remuneration package to ensure its competitiveness and that it matches with the Bank's overall business strategy.

Key Management Compensation

Key management refers to the members of the Board of Directors and Management of the Bank. Their compensation is determined and overseen by the parent bank in accordance with the Bank of China Group remuneration policy. For the year 2016, their remuneration was approximately C$2.67 million (2015 - C$2.36 million).