Credit and Country Risk Management

Credit risk

Credit risk is defined as the potential loss arising from any failure by a borrower or a counterparty to fulfill its financial obligations, as and when they fall due. Credit risk is inherent in lending, trade financing, investment, treasury activities and other credit-related activities undertaken by the Group.

The Credit Committee, comprising the CEO and other senior and experienced officers of the bank, under delegated authority from the Board of Directors, oversees all credit, country and concentration risk matters. These include the monitoring and review of portfolio risk concentrations, approval of country and counterparty limits as well as the formulation of credit policies. The decisions of the Credit Committee and its credit risk management reports are reviewed by the Executive Committee and the Board of Directors.

To maintain independence and integrity of credit decision-making, the Group has established a Group Credit unit to segregate the credit approval function from loan origination. Credit approval authority is delegated within an established credit discretionary limit (CDL) structure that is risk-sensitive to ensure that the CDL is tiered according to the borrower's rating. The Bank has in place a very stringent process for the delegation of CDL based on the experience, seniority, product/business sector and track record of the officer. All officers with the authority to approve credits are guided by credit policies and guidelines with distinction made for institutional and individual borrowers. These credit policies and guidelines, which cover key risk parameters associated with credit structuring and approval, are periodically reviewed to ensure their continued relevance.

An internal credit rating system, which incorporates both statistical models and expert-judgement scorecards, has been developed, implemented and used as part of the credit approval process. Statistical models were built for portfolios with sufficient default data, and expert judgement scorecards were developed for low default portfolios.

Generally, a borrower is assigned a Customer Risk Rating (CRR) and a Facility Risk Rating (FRR). The CRR is a borrower's stand-alone credit rating and is derived after a comprehensive assessment of its financial condition, the quality of its management, business risks and the industry it operates in. The FRR incorporates transaction-specific dimensions such as availability and types of collateral, seniority of the exposures, facility structures, etc.

Consumer exposures are managed on a portfolio basis. The Bank has scorecards and stringent product programmes for credit underwriting purposes.

For the timely recognition of asset impairment, recovery action and the avoidance of undue concentration, a disciplined process is in place to regularly monitor, review and report the Group's portfolio risks. These include large credit exposures by obligor groups, sectors, security types, internal credit ratings, industries, countries as well as level of non-performing loans, appropriateness of classification and adequacy of provisioning.

Risk concentrations by industry are monitored closely to avoid undue concentration in any particular industry. Industry risk refers to the likelihood of groups of customers being adversely affected by economic developments impacting a particular industry in which such customers operate. Exposure concentrations and non-performing loans by industry type are analysed and significant trends reported to the Credit Committee as well as to the Executive Committee and the Board of Directors.

In particular, exposures arising from property-related loans are closely monitored to ensure compliance with regulatory and internal guidelines. The trends of such property-related loans are closely monitored by top borrowing groups, business sectors and geographical locations.

The Bank has in place a rigorous monitoring process that includes monthly reviews of all non-performing and special mention loans. In addition, credit reviews and audits are performed regularly to proactively manage any delinquencies, minimise undesirable concentrations, maximise recoveries, and check that credit policies and procedures are complied with. Past dues and credit limit excesses are tracked by business lines and product types, and significant trends are analysed and reported regularly to the Credit Committee and the Executive Committee.

To assess the resultant potential losses arising from the impact of possible adverse events on the Group's credit portfolio, credit stress tests are periodically conducted. The extent of the plausible credit impairments is analysed to determine if the potential losses are within the Group's risk tolerance.

In line with the Bank's drive to adopt best practices in risk management, the Bank has intensified its preparations for the New Basel Capital Accord. The Bank is targeting to adopt the Internal Rating Based Approach for Credit Risk and the Standardised Approach for Operational Risk.

The Bank remains committed and will continue to strengthen and invest in its risk management systems, processes and practices.

Customer loans

Loans and advances are made to customers in various industry segments and business lines. The top 20 obligor group borrowers and top 100 group borrowers made up 32.6% and 65.9% of its total loans and advances respectively.

Obligor groups are defined in accordance with Notice to Banks, MAS 623, to comply with Section 29 (1)(a) of the Banking Act. Where the parent company is a borrower, exposures to the parent company and companies that it has 20% or more shareholding or power to control are aggregated into a single obligor group.

The Personal Financial Services portfolio, which mainly comprises housing loans and other mortgage loans, accounted for 57.3% of the Bank's exposure as at 31 December 2005.

The composition of loans and advances to customers, contingent liabilities and corresponding non-performing portions were as follows:

	Loans & advances		Contingent liabilities		Non-performing loans	
By industry type (%)	**2005**	2004	**2005**	2004	**2005**	2004
Manufacturing	**7.5**	5.9	**3.8**	6.8	**–**	–
Building and construction	**4.0**	3.6	**12.6**	5.4	**–**	1.0
Housing loans	**36.8**	37.6	**–**	–	**18.6**	18.5
General commerce	**24.8**	26.3	**37.9**	37.9	**50.8**	47.7
Transport, storage and communication	**1.2**	0.9	**10.3**	10.5	**–**	–
Non-bank financial institutions	**3.8**	3.6	**24.2**	21.4	**22.6**	9.3
Professionals and private individuals	**20.5**	20.0	**7.7**	8.0	**8.0**	18.6
Others	**1.4**	2.1	**3.5**	10.0	**–**	4.9
Total (%)	**100.0**	100.0	**100.0**	100.0	**100.0**	100.0
Total gross loans (S$ million)	**270.4**	310.1	**15.6**	17.8	**7.8**	22.1

Classification and impairment charges on loans

The Bank classifies its loan portfolios according to the borrower's ability to repay the loan from its normal source of income. All loans and advances to customers are classified into the categories of 'Pass', 'Special Mention' or 'Non-Performing'. Non-Performing Loans are further classified as 'Substandard', 'Doubtful' or 'Loss' in accordance with Notice to Banks, MAS 612 (March 2005).

The Group has, since January 2005, largely adopted the methodology of Financial Reporting Standard (FRS) 39 for loan loss impairment. Under the new methodology of FRS 39, individual impairment losses are calculated based on the net present values of expected future cash flows and tangible collaterals.

Loan interest

The classification of a loan as non-performing does not disqualify the Group of its entitlement to interest income. It merely registers the uncertainty faced by the Group in the collection of such interest income. The Group has adopted the approach that once a loan is classified as non-performing, interest will be suspended and will cease to accrue, irrespective of whether any collateral would be adequate to cover such payments.

Write-off and charge-off policy

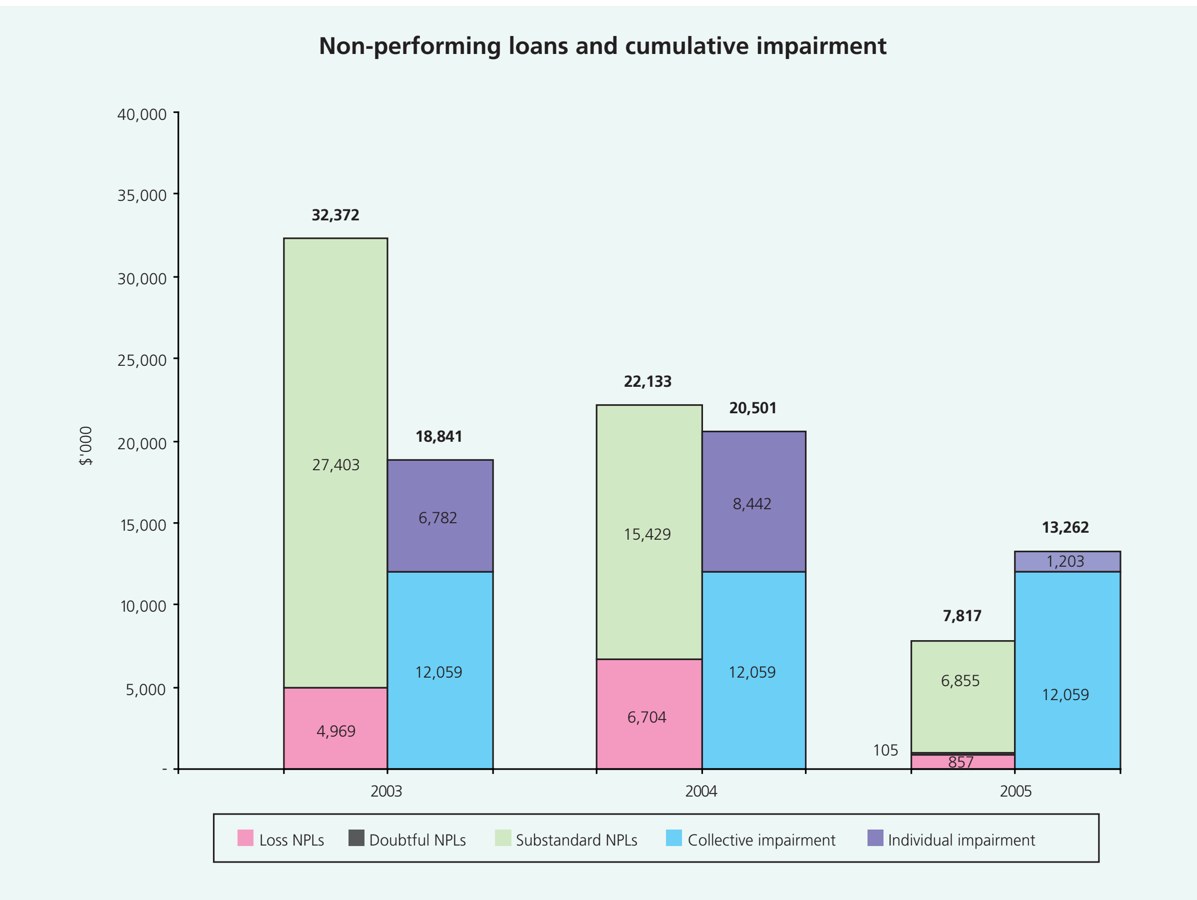
A classified account is written-off if it is deemed irrecoverable when there is no realisable tangible collateral securing the account and all feasible avenues of recovery have been exhausted.

Non-performing loans (NPLs) and cumulative impairment of the Bank

The Bank's non-performing loans (NPLs) improved dramatically by $14.3 million or 64.7% to $7.8 million as at 31 December 2005, compared to $22.1 million as at 31 December 2004. Correspondingly, NPLs as a percentage of gross customer loans dropped to 2.9%, from 7.1% as at 31 December 2004.

Individual impairment declined by $7.2 million or 85.7% to $1.2 million as at 31 December 2005, compared to $8.4 million as at 31 December 2004. Collective impairment remained unchanged at $12.1 million or 90.9% of the total cumulative impairment as at 31 December 2005. The cumulative impairment provided 169.7% cover against the Bank's NPLs.

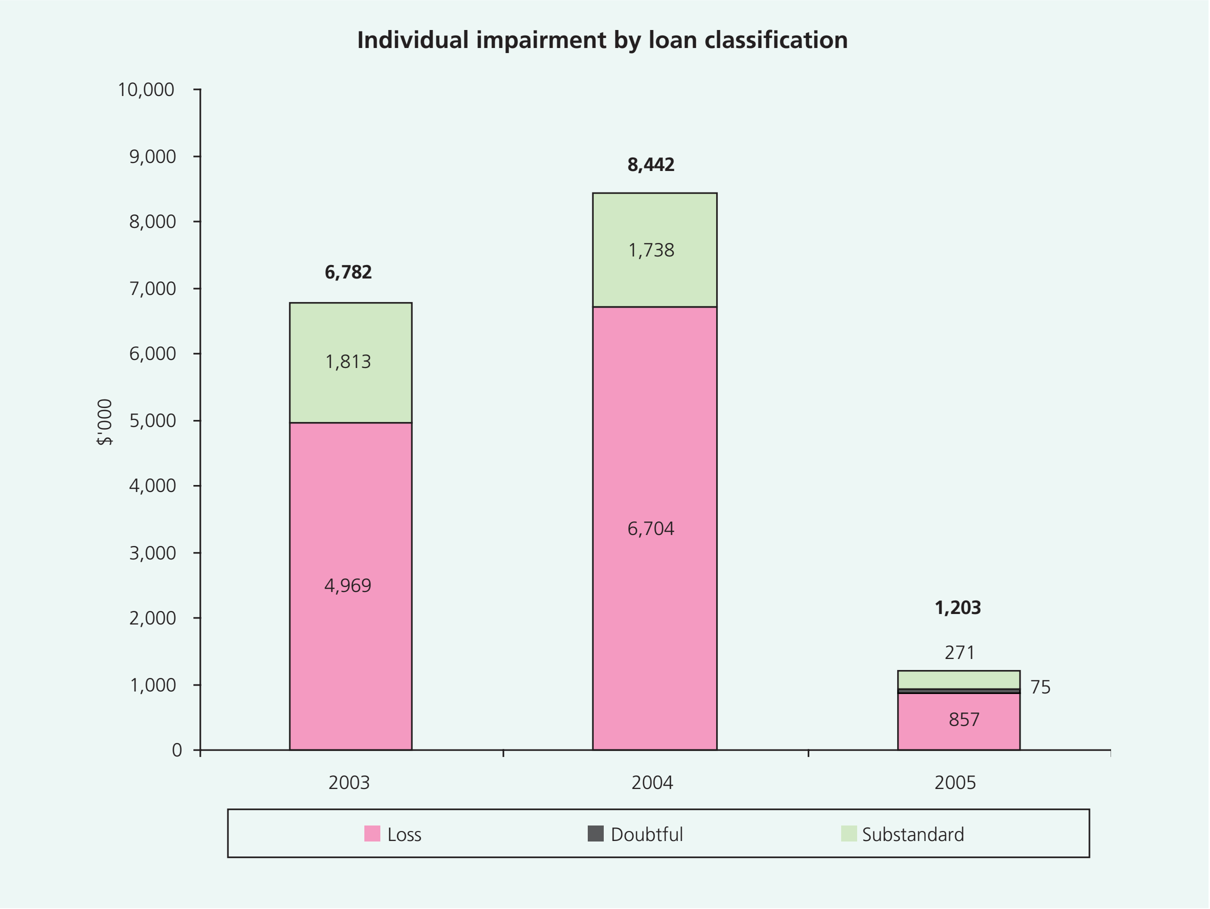
NPLs by loan classification and cumulative impairment as at 31 December 2005 were as follows:



Ratios (%)	2005	2004	2003
NPLs /Gross customer loans	**2.9**	7.1	10.1
NPLs/Total assets	**0.9**	2.7	4.0
Cumulative impairment/NPLs	**169.7**	92.6	58.2
Cumulative impairment/Unsecured NPLs	**388.0**	300.8	312.6
Cumulative impairment/Gross customer loans	**4.9**	6.6	5.9
Collective impairment/Gross customer loans (net of individual impairment for loans)	**4.5**	4.0	3.8

Individual impairment by loan classification

As at 31 December 2005, about 71.2% of individual impairment made for expected loan losses was for 'Loss' accounts. The individual impairment for each classified loan grade is shown in the following chart:



Ageing of NPLs

The full outstanding balance of an account is deemed non-current and aged when there are arrears in interest servicing or principal repayment. The ageing of NPLs at 31 December 2005 was as follows:

Ageing (Days)	2005 Amount ($'000)	2005 % of total NPLs	2004 Amount ($'000)	2004 % of total NPLs
Current	**2,081**	**26.6**	1,396	6.3
≤ 90	**904**	**11.6**	2,137	9.6
91 to 180	**570**	**7.3**	2,626	11.9
≥ 181	**4,262**	**54.5**	15,974	72.2
Total	**7,817**	**100.0**	22,133	100.0

Accounts that have payment records that are current or ≤ 90 days past due and/or in excess may be classified as 'Non-Performing' if the borrowers are deemed to be financially weak.

Collateral Types

The majority of the classified loans is secured by properties. Properties securing classified loans are revalued semi-annually. As at 31 December 2005, 56.3% of NPLs was secured by collateral, compared to 69.2% as at 31 December 2004.

The secured NPLs of the Bank by collateral type were as follows:

	2005	2004
	$'000	$'000
Property	**4,398**	15,040
Cash & Deposits	–	278
Total	**4,398**	15,318

Balance Sheet Risk Management

Balance sheet risk management is about managing interest rate and liquidity risks that arise out of business activities.

The UOB Group Asset Liability Committee (ALCO), under its delegated authority from the Board of Directors, approves the policies and limits for balance sheet risk. This risk is monitored and managed through the framework of approved policies and limits and reported regularly to ALCO, the Executive Committee of the Board and the Board of Directors.

In carrying out its business activities the Group strives to meet customers' demands and preferences for products with various interest rate structures and maturities. Sensitivity to interest rate movements arises from mismatches in the repricing dates, cash flows and other characteristics of assets and liabilities. As interest rates and yield curves change over time, the size and nature of these mismatches may result in a gain or loss in earnings. In managing structural interest rate risk, the primary objective, therefore, is to manage the volatility in Net Interest Income (NII) and Economic Value of Equity (EVE).

The balance sheet interest rate risk exposure is calculated using a combination of dynamic simulation modelling techniques and static analysis tools, such as maturity/repricing schedules. The schedules provide a static indication of the potential impact on interest earnings through gap analysis of the mismatches of interest rate sensitive assets, liabilities and off-balance sheet items by time bands, according to their maturity (for fixed rate items) or remaining period to their next repricing (for floating rate items).

The table in Note 33(c) of Notes to the Financial Statements represents the Group's interest rate risk sensitivity based on repricing mismatches as at 31 December 2005. Interest rate risk will arise when more assets/liabilities than liabilities/assets are repriced in a given time band. A positive interest rate sensitivity gap exists when more interest sensitive assets than interest sensitive liabilities reprice during a given time period. This tends to benefit NII when interest rates are rising. Conversely, a negative interest rate sensitivity gap exists when more interest sensitive liabilities than interest sensitive assets reprice during a given time period. This tends to benefit NII when interest rates are falling. Interest rate sensitivity may also vary during repricing periods and among the currencies in which the Group has positions. As at 31 December 2005, the Group had an overall positive interest rate sensitivity gap of $252.4 million, excluding non-interest sensitive items. The actual effect on NII will depend on a number of factors, including variations in interest rates within the repricing periods, variations among currencies, and the extent to which repayments are made earlier or later than the contracted dates. The interest rate repricing profile, which includes lending, funding and liquidity activities, typically leads to a negative interest rate sensitivity gap in the shorter term.

Complementing the static analysis is the dynamic simulation modelling process. In this process, the Group applies both the earnings and the EVE approaches to measuring interest rate risk. The potential effects of changes in interest rates on NII are estimated by simulating the future course of interest rates, expected changes in the Group's business activities over time, as well as the effect of embedded options in the form of loans subject to pre-payment and of deposits subject to pre-upliftment. The changes in interest rates include the simulation of changes in the shape of the yield curve, high and low rates, and implied forward interest rates.

EVE is simply the present value of the Group's assets less the present value of the Group's liabilities, currently held by the Group. In EVE sensitivity simulation modelling, the present values for all the Group's cash flows are computed, with the focus on changes in EVE under various interest rate environments. This economic perspective measures interest rate risk across the entire time spectrum of the balance sheet.

Stress testing is also performed regularly on balance sheet risk to determine the sensitivity of the Group's capital to the impact of more extreme interest rate movements. This stress testing is to show that even under more extreme market movements, for example the Asian financial crisis, its capital will not deteriorate beyond its approved risk tolerance. Such tests are also performed to provide early warning of potential worst-case losses so as to facilitate proactive management of these risks in the rapidly changing financial markets. The results of these stress testing are presented to ALCO, the Executive Committee and the Board of Directors.

Liquidity Risk Management

Liquidity risk is defined as the potential loss arising from the Group's inability to meet its contractual obligations when due. Liquidity risk arises in the general funding of the Group's activities and in the management of its assets. The Group maintains sufficient liquidity to fund its day-to-day operations, meet customer deposit withdrawals either on demand or at contractual maturity, meet customers' demand for new loans, participate in new investments when opportunities arise, and repay borrowings as they mature. Hence liquidity is managed to meet known as well as unanticipated cash funding needs.

Liquidity risk is managed in accordance with a framework of liquidity policies, controls and limits approved by ALCO. These policies, controls and limits ensure that the Group maintains well diversified sources of funding, as well as sufficient liquidity to meet all its contractual obligations when due. This distribution of sources and maturities of deposits is managed actively in order to ensure cost effectiveness and continued access to funds and to avoid a concentration of funding needs from any one source. Important factors in assuring liquidity are competitive pricing in interest rates and the maintenance if customers' confidence. Such confidence is founded on the Bank's good reputation, the strength of its earnings, and its strong financial position and credit rating.

The management of liquidity risk is carried out throughout the year by a combination of cash flow management, maintenance of high quality marketable securities and other short-term investments that can be readily converted to cash, diversification of the funding base, and proactive management of the Group's 'core deposits'. 'Core deposits' is a major source of liquidity for the Group. These 'core deposits' are generally stable non-bank deposits, like current accounts, savings accounts and fixed deposits. The Group monitors the stability of its 'core deposits' by analysing their volatility over time.

In accordance with the regulatory liquidity risk management framework, liquidity risk is measured and managed on a projected cash flow basis. The Group is required to monitor liquidity under "business as usual", "bank-specific crisis" and "general market crisis" scenarios. Liquidity cash flow mismatch limits have been established to limit the Group's liquidity exposure. The Group has also identified certain early warning indicators and established the trigger points for possible contingency situations. These early warning indicators are monitored closely so that immediate action can be taken. On a tactical daily liquidity management level, Global Treasury – Asset Liability Management is responsible for effectively managing the overall liquidity cash flows in accordance with the Group's approved liquidity risk management policies and limits.

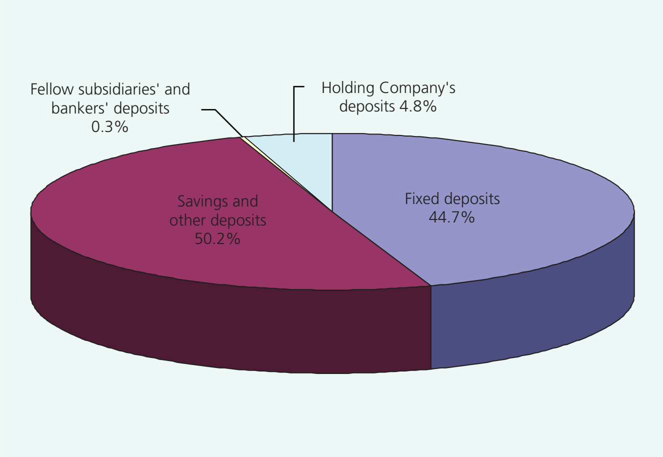
Liquidity contingency funding plans have been drawn up to ensure that alternative funding strategies are in place and can be implemented on a timely basis to minimise the liquidity risks that may arise upon the occurrence of a dramatic change in market conditions. Under the plans, a team comprising senior management and representatives from all relevant units will direct the business units to take certain specified actions to create liquidity and continuous funding for the Group's operations.

The table in Note 33(d) of Notes to the Financial Statements shows the maturity mismatch analysis of the Bank's nearer and longer-term time bands relating to the cash inflows and outflows based on contractual classifications arising from business activities.

Sources of deposits

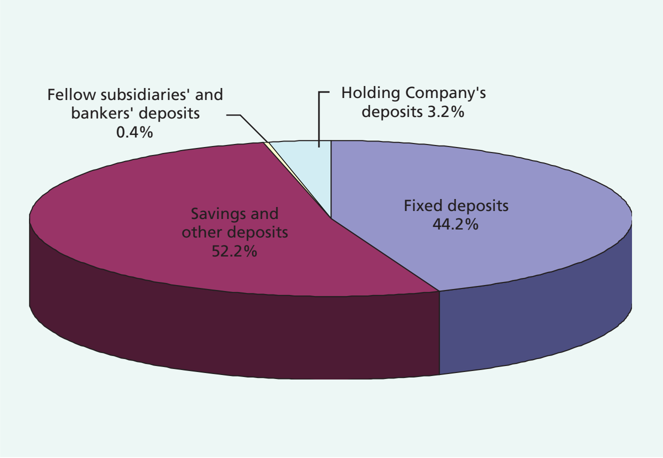
The Group has access to diverse funding sources. Liquidity is provided by a variety of both short-term and long-term instruments. The diversity of funding sources enhances funding flexibility, limits dependence on any one source of funds, and generally lowers the overall cost of funds. In making funding decisions, management considers market conditions, prevailing interest rates, liquidity needs, and the desired maturity profile of its liabilities.

Non-bank customers' fixed deposits, savings and other deposits continued to form a significant part of the Group's overall funding base in the year under review. As at 31 December 2005, customer deposits amounted to $647.7 million and accounted for 94.9% of total Group deposits. Fellow subsidiaries', bankers' and holding company's deposits on the other hand amounted to only $35 million and formed the remaining 5.1% of total Group deposits. In terms of deposits' mix, savings and other deposits comprised the majority of the funding base at 50.2% followed by fixed deposits at 44.7%.



Sources of deposits – 2005

	$'000	%
Customer deposits		
Fixed deposits	304,823	44.7
Savings and other deposits	342,867	50.2
Fellow subsidiaries'		
and bankers' deposits	1,833	0.3
Holding Company's deposits	33,134	4.8
Total Deposits	682,657	100



Sources of deposits – 2004

	$'000	%
Customer deposits		
Fixed deposits	292,362	44.2
Savings and other deposits	344,810	52.2
Fellow subsidiaries'		
and bankers' deposits	2,463	0.4
Holding Company's deposits	21,310	3.2
Total Deposits	660,945	100

Operational Risk Management

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Potential loss may be in the form of financial loss or other damages, for example, loss of reputation and public confidence that will impact the Group's credibility and ability to transact, maintain liquidity and obtain new business.

Operational risk is managed through a framework of policies, techniques and procedures by which operational risks inherent in the Bank's business are identified, assessed/measured, monitored, controlled/mitigated and reported to the UOB Group Management Committee, the Executive Committee of the Board and the Board of Directors.

The UOB Group Management Committee, under its delegated authority from the Board of Directors, oversees the establishment of a sound operational risk management framework and monitors the operational risk profile of the Group.

The Group has an independent Operational Risk Management Division to develop and maintain the operational risk management framework, policies, and techniques; support and guide business units in the implementation of operational risk management programmes; and provide oversight over the management of operational risk in the Group.

The framework of techniques and procedures encompasses the following:

- building of Operational Risk Profiles (ORPs);
- conduct of Operational Risk Self Assessments (ORSA) based on the ORPs;
- development of an Operational Risk Action Plan (ORAP);
- monitoring of Key Operational Risk Indicators (KORIs);
- collection and analysis of operational risk events/loss data;
- monitoring and reporting of operational risk issues.

The building of ORPs involves risk identification, the assessment of inherent or absolute risks, as well as the identification of controls to address the identified operational risks. As part of the continual assessment, ORSA provides the business/support heads with an analytical tool to assess the adequacy of controls over these risks and to identify control deficiencies at an early stage so that timely action can be taken. Where actions need to be taken, these are documented in the form of an ORAP for monitoring and reporting to management. The ORSA program consists of a control self assessment covering the general control environment, and a process-based risk & control self assessment for core business processes.

KORIs are statistical data collected and monitored by business and support units on an ongoing basis for the early detection of potential areas of operational control weakness. Trend analysis is carried out to determine whether there are systemic issues to be addressed.

A database for collection of operational risk events and losses has been established to enable the future use of advanced approaches for quantification of operational risks. Additionally, the analysis of operational risk events and sharing of lessons learnt help to further strengthen the operational risk management capability of the business units.

Included in the overall framework of operational risk is the new product/service programme process. This process aims to ensure that risks associated with each new product/service are identified, analysed and managed before launch.

For the implementation of all online products and services, extra care and precautionary measures are taken to address and protect customers' confidentiality and interests. Clear instructions are also posted on the Group's website to advise and educate customers on the proper use and safekeeping of their access identification and passwords.

In line with the increasing need to outsource internal operations in order to achieve cost efficiency, a Group Outsourcing Policy has been established to ensure that outsourcing risks are identified and managed prior to entering into the arrangements as well as on an ongoing basis.

The Group has developed effective Business Continuity Management and Crisis Management strategies and plans to mitigate the potential impact of major business and/or system disruptions.

In addition, risk transfer mechanisms, such as effective use of insurance to mitigate the risk of high impact loss events also form part of the operational risk management framework.

Legal risk is part of operational risk. Legal risk arises from inadequate documentation, legal or regulatory incapacity or insufficient authority of customers and uncertainty in the enforcement of contracts. This is managed through consultation with the Group's legal counsel and external counsel to ensure that legal advice is appropriately taken where necessary.

As part of our ongoing promotion of an operational risk management culture, an operational risk management training programme has been established and will be implemented progressively in the Group.

As part of preparations to comply with Basel II, the Group has mapped all its business activities to the eight Business Lines as defined by the Basel Committee on Banking Supervision.