The **co-operative** bank
good with money

Pillar 3 disclosures 2008

Part of The **co-operative** financial services

Contents

Overview and context

For the year ended 10 January 2009
All amounts are stated in £m unless otherwise indicated

Introduction

The Capital Requirements Directive (Basel ll) introduced on 1 January 2007 set out the new disclosure requirements for firms operating under the framework. The disclosure requirements (Pillar 3) aim to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2) and aim to encourage market discipline by allowing market participants to assess key pieces of information on risk exposures and the risk assessment processes of the firm.

Frequency

This report will be published on an annual basis based on the financial year end date in line with the financial statements announcement. All amounts are reported in £ millions unless otherwise indicated.

These disclosures are based on the financial year covering the reporting period 52 weeks to end 10 January 2009. Since the accounting date is virtually coterminous with the calendar year 2008, figures for the financial year are headed 2008 and the corresponding amounts for the 52 weeks to 12 January 2008 are headed 2007.

Media and location

The report will be published on the CFS (Co-operative Financial Services) website, www.cfs.co.uk.

Verification

Disclosures will only be externally verified to the extent they are equivalent to those made under accounting requirements.

Scope of Application of Disclosure Requirements

The disclosure requirements of Pillar 3 as defined by BIPRU 11 are based on The Co-operative Bank Group. All subsidiaries of The Co-operative Bank are fully consolidated. The creation of a covered bond LLP was the only change to The Co-operative Bank Group during 2008. In August 2008 the Bank launched a 3 year £1 billion covered bond programme in order to qualify for the Bank of England Special Liquidity Scheme (SLS) which allows banks to swap high quality mortgage book assets and other securities for UK Treasury Bills. With the exception of the capital held within the LLP there is no material, practical or legal impediment to prompt transfer of capital resources or repayment of liabilities amongst the parent undertaking and its subsidiaries.

The Bank also reports on a solo-consolidated basis. The subsidiaries excluded from the solo-consolidation are Unity Trust Bank p.l.c. and its subsidiaries, Co-operative Bank Financial Advisers Limited, Co-operative Commercial Limited and the Covered Bond LLP.

Scope of Internal Ratings Based Coverage

The FSA has granted approval for the use of IRB approach, effective from 1st January 2008. The scope of (Internal Ratings Based) IRB permission is identified in the table on the following page. The specialised lending portfolios are analysed using a slotting model. A number of portfolios are on a 3 year rollout to Foundation IRB approach; these include Corporates with total assets less than £350k, public sector entities (PSEs), housing associations, charities/not for profit organisations, and leveraged finance. The areas falling outside the scope of the IRB permission and remaining on standardised approach under immaterial portfolios include Unity Trust Bank p.l.c., asset finance and equity shares.

The standardised approach (TSA) is used to calculate the operational risk capital requirement.

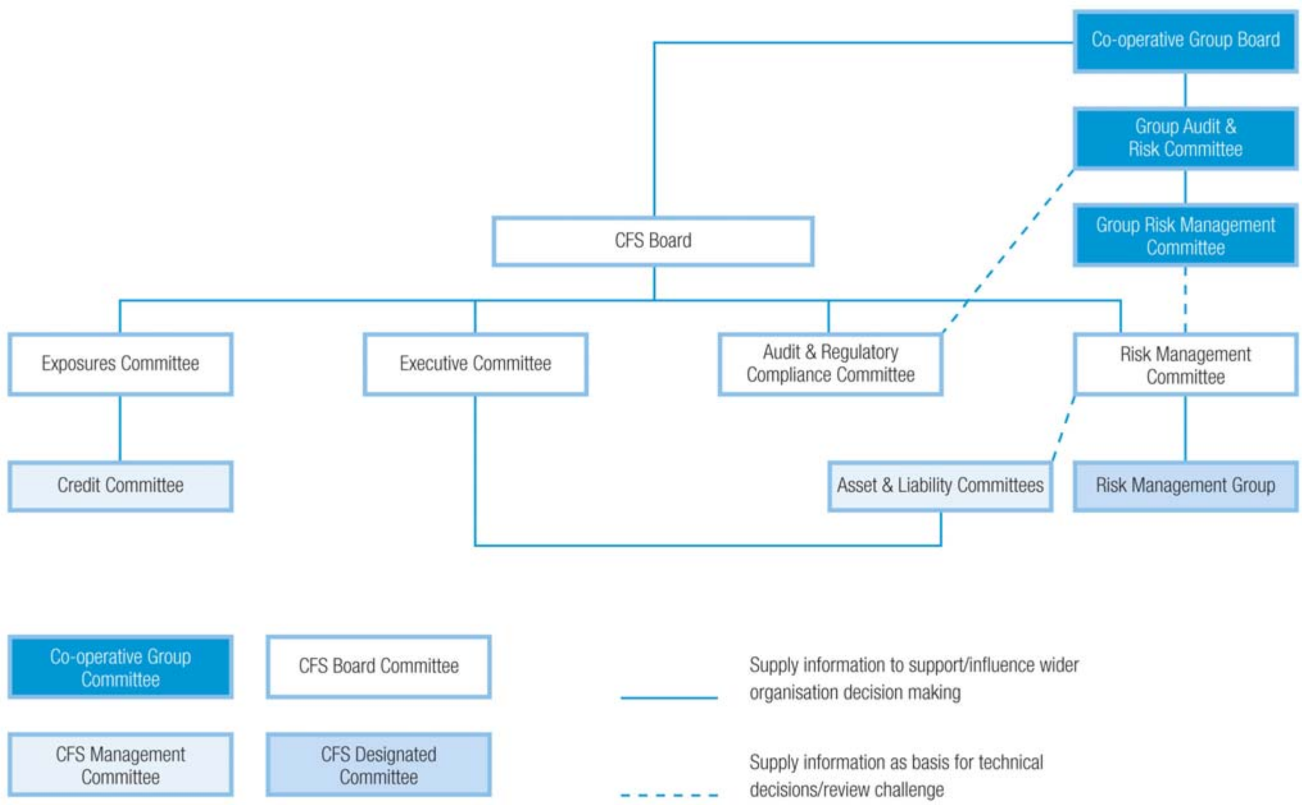
Coverage of IRB Recognition Granted and Approaches by Business Area/ Portfolio.

Business area	Portfolio	IRB exposure classes	CRD approach
Retail	Mortgages	Retail – residential mortgages	Retail IRB
	Loans	Retail - other	Retail IRB
	Credit cards, overdrafts	Retail – qualifying revolving retail exposures	Retail IRB
Corporate	Corporate (Total assets >£350k)	Corporates	Foundation IRB
	Corporate (Total assets <£350k)	Corporates/Retail SME	3 year rollout to Foundation IRB
	Public sector entities	Central governments and central banks	3 year rollout to Foundation IRB
	Housing associations	Corporates	3 year rollout to Foundation IRB
	Leveraged finance	Corporates	3 year rollout to Foundation IRB
	Specialised lending	Corporates	Foundation IRB (slotting approach)
	Asset Finance	Corporates	Standardised (immaterial portfolio)
Treasury	Central governments and central banks	Central governments and central banks	Foundation IRB
	Financial institutions	Institutions	Foundation IRB
	Structured investments/ Credit trading funds	Corporates	Foundation IRB (Securitisation ratings based Approach)
Other	Equity shares	Equity shares	Standardised (immaterial Portfolio)
UnityTrust Bank		Institutions	Standardised (immaterial portfolio)
		Corporates	Standardised (immaterial portfolio)

IRB Approach

Following the FSA approval of the Bank's Waiver application in December 2007, the Bank has been since the start of 2008, operating fully on an internal rating basis (IRB). The Bank has developed a range of internal ratings systems dependent on approach, asset class and product type to produce risk factors for the range of Bank products.

The CFS group of companies including Co-operative Financial Services Limited, Co-operative Insurance Society Limited (Life & Savings business), CIS General Insurance Limited, and The Co-operative Bank p.l.c. have a common Board composition. The Board sub-committees work on a CFS-wide basis, with the same committee structure supporting each Board within the CFS group. The CFS Board has ultimate responsibility for the management of all risks across CFS.



The Board is responsible for approving the Bank's strategy, its principal markets and the level of acceptable risks articulated through its statement of risk appetite. It is also responsible for overall corporate governance which includes ensuring that there is an adequate system of risk management and that the level of capital held is consistent with the risk profile of the business.

The Board has established Board Committees and Senior Management Committees to administer, oversee and challenge the risk management process, identifying the key risks facing the business and assessing the effectiveness of planned management actions. Specific Board authority has been delegated to Board Committees and the Chief Executive who may, in turn, delegate elements of his discretions to appropriate Executive Directors and their senior line managers.

CFS Board Committees

The CFS Board delegates authority to the CFS Risk Management Committee (RMC) (Senior Board Committee) for monitoring compliance with the Board-approved risk appetite statements. This includes:

- setting limits for individual types of risk; and
- approving (at least annually) and monitoring compliance with risk policies and delegated levels of authority.

CFS Risk Management Committee (RMC): this committee is responsible for review and challenge of the adequacy of capital for all risks (including operational risk); and for technical risk management activities and portfolio exposures across CFS including:

- operation of mandates and limits;
- technical risk management policy approval;
- risk management information reporting and integrity of relevant data;
- risks adequately identified and measured;
- risk and portfolio exposure management strategy;
- adequacy of the risk mitigation process; and
- review and discussion of technical risk issues identified as a result of internal audit work.

CFS Audit & Regulatory Compliance Committee (ARCC): this committee provides independent oversight in relation to financial reporting; internal control and risk management; regulatory compliance; external and internal audit. It is responsible for approval of policies and review of adequacy of risk management activities in relation to operational risk.

CFS Exposures Committee: this committee ensures that Non-Executive Directors are actively involved in major credit decisions (including sanctioning large counterparty transactions), monitor large exposures and problem loans and review the adequacy of individual credit provisions.

CFS Executive Committee: this committee manages the business in line with the Board Risk Appetite Statement. It also maintains oversight of risk management processes and management information.

CFS risk and capital management sub-committees

CFS Asset & Liability Committees (ALCO): these committees are management committees of the Board which are chaired by the Chief Executive. They are primarily responsible for overseeing the management of interest rate, market, liquidity and funding risks and to advise on capital utilisation, in addition to, the composition and sourcing of adequate capital.

CFS Risk Management Group (RMG): this committee is a designated committee reporting to RMC and chaired by the Chief Financial Officer. Its purpose is to provide a mechanism to ensure that CFS-wide technical risk management requirements, developments and processes are approved, (with escalation to RMC where required) and embedded within and across CFS. The Committee also monitors all significant and emerging risks, and oversees the development and implementation of stress testing and risk appetite across CFS.

CFS Credit Committee: this committee is chaired by the Director of Banking Risk and Capital Management. The Chair has delegated authority for approving credit facilities within approved strategies and delegated authorities.

CFS Operational Risk Committee: this committee interfaces with both the Executive Committee and ARCC and is chaired by the Head of Operational Risk. It monitors significant operational risks and controls as well as the management actions taken to mitigate them to an acceptable level and/or transfer them. This includes business continuity arrangements and insurance cover to protect the CFS business. Each division within CFS is represented on the committee. The committee is not shown on the previous diagram as it is an information sharing committee, to increase understanding and transparency of significant operational risks and reporting is via the Operational Risk department.

There is also a framework of sector specific management committees supporting risk and capital management, and implementing changes in business strategy, optimising performance, adherence to and setting of policy, and development of management information and training.

Risk Management Framework

A robust qualitative and quantitative risk and governance framework has been developed, embedded and implemented enterprise-wide. This framework:

- includes processes for the quantification, management and mitigation of all risks across the Bank;
- has built on the work undertaken in developing the Bank's Basel II IRB Permission Application Pack (PAP); and
- enabled much stronger links between risk, capital and business management, increasing confidence in the capital calculations and accurately reflecting the risk profile and risk appetite of the business.

The CFS Risk Management Policy sets out the above in detail including:

- risk management vision, strategy, and principles;
- risk governance structure, model and target operating model (TOM);
- risk roles, accountabilities and responsibilities;
- risk categorisations and definitions;
- risk appetite (definition and application);
- risk identification, evaluation, monitoring, assessment and control;
- significant risk reporting; and
- risk quantification methods and processes.

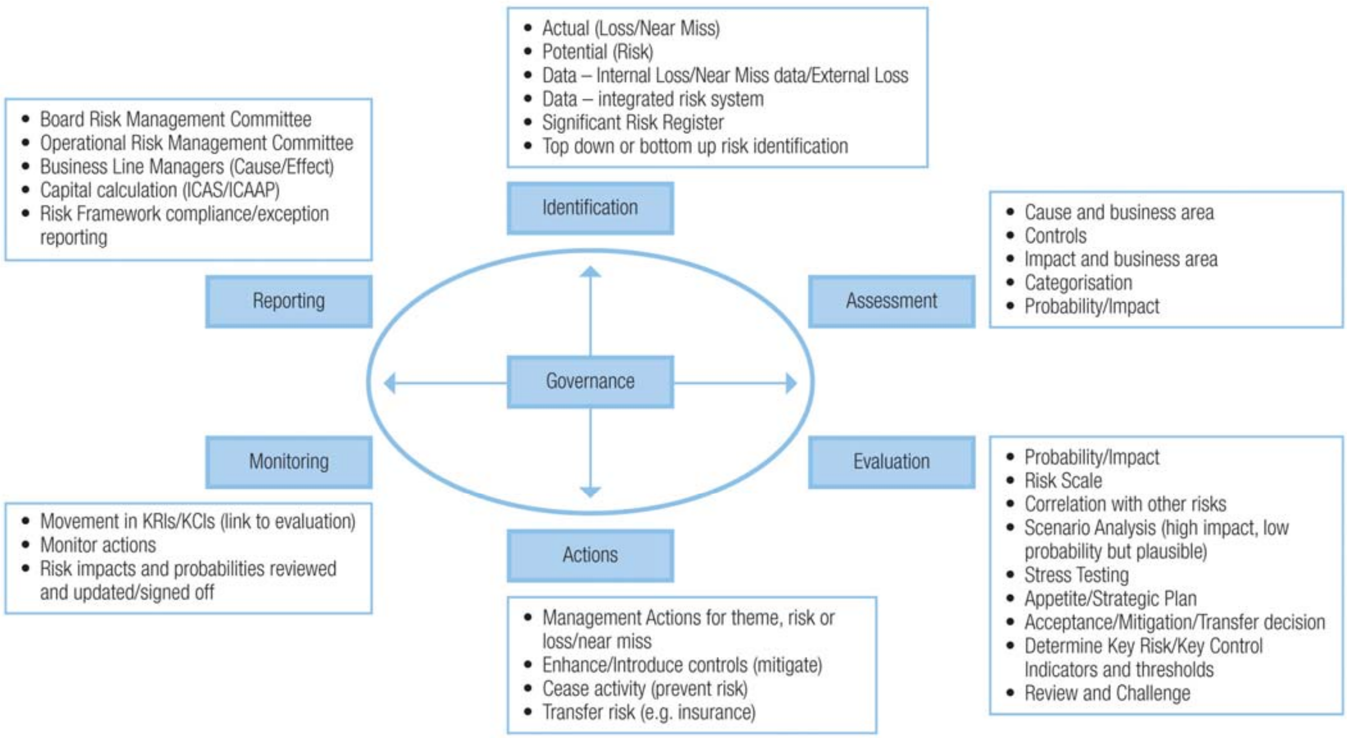
In addition, for all material risks within the Banks risk profile, the approach to risk management is documented within a set of detailed risk management policies which are owned and approved by the relevant mandated Board Committee.

A significant amount of risk initiatives have been completed to date including:

- embedding and approving roles and responsibilities;
- continuous enhancements to the Integrated Risk System (IRS) to capture and monitor all CFS risks;
- mapping of core processes and controls to ensure adequate management of efficiency and operation;
- development and implementation of a process ownership model with clear accountability for managing processes and controls;
- improved tools to identify and quantify emerging and actual risk losses; and
- key risk indicators (KRIs) and key control indicators (KCIs) to assess the adequacy of risk adjusted capital to meet risk appetite and strategic planning targets.

Risk Management Monitoring and Reporting:
To ensure full understanding of the current and projected risk position:

- Monitoring of all technical and operational risks, the adequacy of controls and of the capital required for these risks is undertaken on a regular basis.
- The Bank monitors its liquidity position on a daily basis against a Board approved liquidity risk appetite and stress scenario. It also closely monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed, and regularly assesses its funding position.
- Technical risks are managed through appropriate tools and committees and are reported upon regularly.
- Actual operational losses and near-misses are reported and considered monthly by the CFS Executive and CFS has, during 2008, introduced a control self-assessment process which will be fully rolled-out by May 2009.
- On a regular basis, risk and risk appetite management information, liquidity monitoring, stress testing, and quarterly significant risk reporting are undertaken.



Risk categorisation

For the year ended 10 January 2009
All amounts are stated in £m unless otherwise indicated

CFS uses the following risk categories to define and group significant risks under common headings:

- Credit risk;
- Market risk;
- Liquidity risk; and
- Operational risk.

Credit risk

Credit risk is the current or prospective risk to earnings and capital arising from an obligor's failure to meet the terms of any contract with the institution or its failure to perform as agreed.

Credit risk is an integral part of many of our business activities and is inherent in traditional banking products (loans, commitments to lend and contingent liabilities, such as letters of credit) and in "traded products" (derivative contracts such as forwards, swaps and options, repurchase agreements, and securities borrowing and lending transactions).

The Credit Risk Management Policies are approved by the RMC (delegated authority from the Board) annually and are the responsibility of the Director of Banking Risk and Capital Management. The policies determine the criteria for the management of retail, corporate and wholesale market exposures and credit management standards, including country, sector and counterparty limits, along with risk appetites and delegated authorities.

All authority to take credit risk derives from the CFS Board. This is delegated through authorities to individuals or committees via the Chief Executive. The level of credit risk authority delegated depends on seniority and experience, varying according to the quality of the counterparty and any associated security or collateral held.

Market risk

Market risk arises from the effect of changes in market prices of financial instruments, on income derived from the structure of the balance sheet, execution of customer and inter-bank business and proprietary trading. The majority of the risk arises from changes in interest rates[1].

Interest Rate Risk Policy Statements, approved by the CFS Risk Management Committee on behalf of the Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. The policy is executed by the Bank's ALCO, which meets monthly and its prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Bank's assets and liabilities. It sets limits within which Treasury and CFS' Corporate Finance department manage the effect of interest rate changes on the Bank's overall net interest income. Treasury is responsible for interest rate risk management for Treasury and CFS' Corporate Finance department manages interest rate risk within the rest of the Bank. The principal analytical techniques involve assessing the impact of different interest rate scenarios and changes in balances over various time periods.

The Board receives quarterly reports on the management of balance sheet risk and, each month, ALCO reviews the balance sheet risk position and the utilisation of wholesale market risk limits.

Treasury interest rate risk

Treasury executes short term funding and hedging transactions with the wholesale markets on behalf of the Bank and its customers. It also generates incremental income from proprietary trading within strict risk limits. There are two prime measures of risk supplemented by additional controls such as maturity and stop loss limits. Risk units express the various re-pricing and maturity mismatches as a common unit of measurement. Value at Risk (VaR) measures the daily maximum potential gain or loss due to recent market volatility to a statistical confidence level of 95% and a one day holding period. The VaR methodology has inherent limitations in that market volatility in the past, may not be a reliable predictor of the future, and may not reflect the time required to hedge or dispose of the position, hence VaR is not used as the sole measure of risk.

[1] The Bank does not trade in equities or commodities and has limited foreign currency activities.

All amounts are stated in £m unless otherwise indicated

Trading value at risk: At 10 January 2009, total Treasury VaR of £1.1 million (2007: £0.5 million) represents the maximum potential daily gain or loss in market rates within a confidence level of 95% based on recent market performance. The average, highest and lowest VaR, as calculated on a daily basis, for the accounting year ended 10 January 2009 were £0.7 million (2007: £0.7 million), £1.5 million (2007: £1.4 million) and £0.2 million (2007: £0.4 million).

The Bank does not have FSA VaR model permission and VaR is not used in regulatory reporting. The maturity method is used for reporting general interest rate risk for prudential reporting purposes.

PV01 is used as an additional risk measure to supplement VaR and is calculated on a daily basis and measured against limits for the Treasury Portfolio[2].

PV100 - Instruments are decomposed into applicable term cash flows and the present value of each position is derived using zero coupon discount factors[3].

The table below illustrates the change in valuation on a fixed income portfolio experienced given a 1% increase and decrease in interest rates for Treasury (Banking Book and Trading Book combined).

	1% increase in interest rates		1% decrease in interest rates	
	2008	2007	2008	2007
At reporting date	(3.1)	(4.4)	3.1	4.4
Average in the period	(5.0)	(11.8)	5.8	14.1
Maximum	(9.9)	(16.9)	12.4	21.4
Minimum	(1.3)	(4.4)	1.3	4.4

PV100 is the effect on the net present value (NPV) of the Treasury portfolio to a parallel shift of 100 basis points upon the base yield curve. PV100 is calculated daily, the average for the period is the average over 252 business days, maximum and minimum represent the high and low points during the year.

Analysed by currency the year end position for Treasury Banking Book is represented in the table below:

	1% increase in interest rates		1% decrease in interest rates	
	2008	2007	2008	2007
Treasury Banking Book	(3.0)	(4.4)	3.0	4.4
By Currency				
- GBP	(2.8)	(5.2)	2.8	5.2
- US dollars	(0.1)	0.4	0.1	(0.4)
- Euros	(0.1)	0.4	0.1	(0.4)
Treasury Trading Book	(0.1)	-	0.1	-
Total Treasury	(3.1)	(4.4)	3.1	4.4

[2] This risk measure is based upon a full revaluation and indicates the change in value of a fixed income product, or portfolio, given a 1 basis point movement in interest rates. A number of different scenarios including +/- 10bp and 100bp are also calculated.

[3] A further full revaluation is performed following a 100 basis point parallel shift across the entire yield curve. The sensitivity result is calculated as the movement between the base and 100 basis point shift valuations.

Currency risk

The Bank's Treasury foreign exchange activities are primarily:

- providing a service in meeting the foreign exchange requirements of customers;
- maintaining liquidity in euros and US dollars by raising funds and investing these to generate a return; and
- performing limited intra-day trading and overnight positioning in major currencies to generate incremental income.

At 10 January 2009 the Group's open position was £0.7 million (2007: £2.9 million) representing a potential loss of £nil million (2007: loss of £0.1 million) given a 3% depreciation in sterling. The Group's open position is monitored against limits in addition to limits in place on individual currencies.

Non Treasury interest rate risk

The Bank (excluding Treasury) uses an earnings approach to managing interest rate risk, focusing in detail on the sensitivity of assumed changes in interest rates on net interest income for one year. Higher level analysis is performed for subsequent years.

ALCO monitors the non-trading interest rate risk which is split between certain Treasury portfolios, banking and investment books, and the rest of the Bank. The following describes the Bank non-trading portfolios excluding these certain Treasury portfolios. These positions are managed by Corporate Finance. All interest rate risk is centralised into Corporate Finance using appropriate transfer pricing rates.

The management of interest rate risk is supplemented by the use of gap reports, which are based on defined time periods. ALCO set guidance limits around the gap, principally that the sum of positions maturing in greater than twelve months and non-sensitive balances (includes non-maturity deposits) is no more than £350m.

Risk limits are formally calculated at each month end. Interest rate risk and effectiveness of hedging is monitored daily using gap positions, incorporating new business requirements. Draw down risk, in particular for fixed rate mortgages, is managed through weekly balance sheet meetings. Corporate Finance undertake hedges for interest rate risk using derivative instruments and investment securities which are executed via Treasury to wholesale markets, and loans and deposits which are executed internally with Treasury.

Interest rate risk in the non-trading book

For Basel II, the exposure to interest rate risk in the retail non-trading book is measured using the Bank's extreme rate scenario (used for the stress of Pillar I) across all yield curve rates. The calculation for interest rate risk assumes external rates on variable rate retail products and new fixed rate business changes by varying amounts based on the Bank's future view of pricing and margins. Balances are based on expected balance sheet growth over the next 3 years. As existing fixed rate business matures, marginal business is added based on balance sheet growth, pricing and behavioural maturity assumptions.

Prepayment risk for fixed rate personal lending is modelled based on past behaviour observed by the Bank. Those non-maturity deposits which are non-interest bearing are separated into a stable 'core' element, based on a long run average, and the residual balance, which can fluctuate. In the gap report, the residual balance and interest bearing non-maturity deposits are deemed to re-price or mature within 1 month. The 'core' non-maturity deposits are within the non-sensitive balance on the gap report, along with non-dated capital and other non-sensitive balances. ALCO sets guidance around the treatment of non-sensitive balances, to reinvest evenly in fixed rate assets in periods up to 5 years. In a low base rate environment the amounts of deposits which can no longer reprice increases leading to an increase in interest rate risk in the 'core' bank.

All amounts are stated in £m unless otherwise indicated

The Bank's balances excluding Treasury are wholly GBP sterling and the table below shows the estimated change in net interest income over the next 12 month period to a 1% shock in interest rates across the yield curve. The percentage change in forecast net interest income (NII) as a proportion of cumulative net interest income for the next 12 months is shown below:

	100bp parallel increase	100bp parallel decrease
2008		
At 10 January 2009	4.9%	(5.0%)
Average during the year	0.1%	(0.7%)
Maximum during the year	5.0%	(5.1%)
Minimum during the year	0.4%	0.2%
2007		
At 12 January 2008	(0.6%)	0.5%
Average during the year	(0.9%)	0.9%
Maximum during the year	(1.3%)	1.4%
Minimum during the year	(0.6%)	0.5%

The shock results are driven by product pricing and product mix. The extent of rate movements and the low rate environment have impacted the repricing of liability products resulting in larger exposure to rate shocks.

Liquidity risk

Liquidity risk arises from the timing of cash flows generated from the Group's assets, liabilities and off-balance sheet instruments. The Group's liquidity management policies are reviewed and approved annually by the Risk Management Committee and compliance reviewed monthly by ALCO.

Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed to policies developed by ALCO. Liquidity risk is defined as the Board approved survival period under stress scenarios. The Bank undertakes the following stress tests on a weekly basis:

- A severe stress which uses double the worst gross outflows experienced over the last 3 years.
- A double stress scenario which models a combination of a Bank specific event (run on the Bank) and market wide disruption.
- A Treasury stress test which assumes restricted access to wholesale market funding.

The Bank's liquidity management framework is designed in line with industry guidelines, including Institute of International Finance (IIF) and Bank for International Settlements (BIS) recommendations, and is being developed in response to emerging FSA requirements.

The Bank manages liquidity risk by applying:

- A rigorous control process embedded in the Bank's operations;
- Robust liquidity management with:
  - Net outflows monitored to ensure they are within FSA limits;
  - Maintenance of a well diversified deposit base;
  - Management of stocks: high quality primary liquidity including cash, and secondary liquidity including certificates of deposit; and
  - Target funding ratio and funding ratios translated into Retail and Corporate targets.

Day-to-day cash flow (tactical liquidity) is managed by Treasury within guidelines laid down by ALCO and in accordance with the standards established for all banks by banking regulators.

The Bank currently funds in excess of 100% of retail assets by retail deposits, ensuring there is no over reliance on wholesale funding, in line and within the Board approved target funding ratio. The Group's structural liquidity risk management is therefore retail based and is dependent on behavioural analysis of both customer demand deposit and loan drawdown profiles by product category based on experience over the last 10 years. The behaviour of retail products is reviewed by ALCO on a quarterly basis. In addition the Group has maturity mismatch limits to control the exposure to longer term mismatches.

The Bank's liquidity position is monitored on a daily basis and reported to ALCO each month. Treasury holds a pool of liquid assets of £775m on behalf of the Bank, and actionable management actions are in place to provide an additional £775m of liquidity. These sources of liquidity totalling £1.5bn are held in order to be available to meet unexpected outflows.

Marketable assets are maintained as a liquidity pool against potential retail outflows; the asset quality of these is controlled via credit limits. Concentration limits are set by issuer name and holding per bond to ensure diversity of assets.

A Covered Bond Programme has been developed to provide access to the Bank of England Special Liquidity Scheme and the Bank has issued a £1bn Covered Bond from its £3bn Programme, which was bought back on to the Bank's balance sheet to enable it to be used as collateral for funding if required in a stress event. Until access to other government schemes is secured the Bank of England Special Liquidity Scheme has been drawn to ensure continuing access to this scheme.

The Bank is eligible for the Government Guarantee Scheme[4], which would enable the Bank to issue debt with maturities up to 3 years under a government guarantee.

Operational risk

Operational risk is defined within CFS as the risk of loss resulting from inadequate or failed internal processes, people and systems or external events. This encompasses the effectiveness of risk management techniques and controls to minimise these losses.

Objectives

As part of the CFS governance model (which deploys 3 lines of defence), the key objectives are as follows:

- The 1st line of defence (incorporating all areas of the business) is responsible for the identification and management of operational risks within their respective areas / processes, in line with policy[5].
- CFS has a dedicated central operational risk team who are responsible for provision of a consistent operational risk framework and policy across CFS in line with best practice and regulatory expectations. The team operates as a second line of defence, alongside other areas including Compliance Monitoring, Legal & Regulatory Advice and Financial Crime Management.
- Internal Audit act as the 3rd line of defence, and have independent oversight of the appropriateness and effectiveness of the operational risk framework.

Operational risk framework

The CFS operational risk framework is compliant with the Basel Standardised Approach for operational risk.

Operational risks are identified, managed and mitigated through ongoing risk management practices including risk assessments; formal internal control procedures; training; segregation of duties; delegated authorities; and contingency planning.

Operational risks are formally reviewed, with significant operational risks regularly reported to Executive Directors, a management Operational Risk Committee, and the Audit and Regulatory Compliance Committee (a formal Board sub-committee). These meet regularly to monitor the suitability of the risk management framework and management of significant risks within CFS. Capital requirements in relation to operational risk are monitored by the Risk Management Committee.

2008 has seen continued refinement and embedding of the framework including development of an operational risk appetite statement, and reporting enhancements.

The framework is subject to regular Internal Audit review in line with CFS' rolling risk-based audit plan.

[4] The scheme will only be used if cost effective when viewed against other sources of funding.

[5] The objective is to improve efficiency, minimise unexpected losses, ensure effective controls, and manage the relationship between risk and reward.

Business Continuity Framework

The Business Continuity Framework is included within the operational risk framework and consists of a number of components. These are summarised as follows:

- crisis management and incident response capability – through formally established and trained teams.
- business continuity capability – identification of critical areas and business priorities, and the structured development, implementation and testing of continuity planning.

Corporate insurance programme

CFS has a structured insurance programme designed to transfer the impact of specific operational risks and provide a level of protection in line with the appetite of the organisation and industry best practice. For example:

- insurance of CFS' buildings and assets.
- protection of revenue in the event of business interruption.
- protection against impacts of financial crime.
- motor, employer and public liability insurance.

Responsibilities

Whilst the Board is ultimately responsible for operational risks across the Bank and the wider CFS organisation, this is delegated to the Chief Executive and Executive Directors within CFS who are responsible for controlling the operational risks in their direct areas of accountability and for compliance with CFS policies.

Each Executive has a nominated Divisional Risk Co-ordinator who is a member of the Operational Risk Committee and is responsible for ensuring the consistent application of the operational risk framework in their division. Divisional Risk Co-ordinators are supported from within their business division. The central operational risk team facilitate the identification, management and reporting of operational risks across CFS in line with regulatory and business requirements; manage the CFS corporate insurance programme and support development and testing of business continuity arrangements.

Operational risk themes

CFS categorises operational risk into a number of distinct themes for internal management, monitoring and reporting. Key operational risks managed by CFS are:

Financial crime

This relates to the effectiveness of controls to minimise financial losses arising from the fraudulent activities of employees, customers and third parties[6].

Data security and confidentiality

CFS has introduced a new theme during 2008 in respect of the potential loss or theft of confidential customer information. This enables the organisation to manage and monitor exposures in this area as a specific theme, recognising the increasing concerns of customers, regulatory authorities and the media in this area, as well as reflecting CFS' risk management culture.

[6] Specific risks arise from external fraud, including but not limited to computer fraud (computer viruses, key logging tools, Trojan attacks, phishing), anti money laundering (including but not limited to failure to comply with FSA money laundering regulations and to prevent organised crime) and internal fraud.

Compliance (with regulatory and legal requirements)
As a regulated business, CFS places great emphasis on maintaining compliance with our regulatory and legal obligations by:

- regulatory - supporting CFS' business objectives through the provision of advice, and the recommendation of solutions where appropriate, in respect of the regulatory implications of business developments, and assisting the business in assessing and addressing new and enhanced regulatory expectations. This is supported by appropriate and effective monitoring, aimed at influencing the business to mitigate or eliminate regulatory risk and demonstrate that we are meeting our regulatory obligations.
- legal - seeking to pro-actively manage legal issues in relation to commercial, contractual, employment and litigation activities.

Employee practices/workplace safety
It is acknowledged that our people are a key asset. The financial services sector as an industry is reliant on its people and the skills, knowledge and experience that they provide. The risk of failure to maintain employee relations, or provide a safe environment in line with legislative requirements and with the ethical, diversity and discrimination rules is managed with support from our Human Resources division.

Property & facilities
The risk of unforeseen operational disruption caused through the denial of access to major occupancies or other interruptions to business operations is managed through our business continuity framework and corporate insurance programme.

Customer service
As a financial services business, providing fair and high-quality customer service is a must. Controls to manage customer service risks occurring are regularly assessed and monitored. These include customer service levels, getting things right first time, availability of customer facing systems, together with trained and skilled resource to service customer demand.

Suppliers
CFS looks to source cost-effective and quality services, both internal and external to the Co-operative Group. Given the reliance on our business partners who provide services and products, a major or prolonged disruption to the supply of their services and products would impact on CFS. Risks are monitored relating to the effectiveness of contracts and relationship management to ensure that performance levels reach our expectations.

Major IT systems/major payments systems failure
Financial service providers have a heavy reliance on the availability and performance of underlying systems and applications, and the processes and frameworks which underpin these. Consequently the effectiveness of controls over the IT systems and infrastructure supporting IT processes and controls, major payment systems and clearing and business processes are monitored on a regular basis.

Change management
CFS continues to invest in major change programmes through developing and improving its products, systems and processes. To manage delivery of these change programmes, manage risks, prioritise resources and realise benefits CFS has developed and implemented a Change Management Framework. This is regularly reviewed to maintain its effectiveness.

Additional risks
In addition to the significant risks covered above, the following risks are also reported and managed in the CFS Risk Management Framework:

- Group wide risks, to include pensions, reputational and contagion risk
- Business risk

Pensions risk: the risk of the firm being unable to meet Pension Fund commitments. Risks are identified at the Co-operative Group level, with the impact of any potential changes to contribution assessed under the Bank Risk Management Framework.

Reputational risk: failure to proactively develop, protect and optimise the value of the brands of the CFS group of companies through inappropriate strategic decisions, poor business performance, or operational failure. Reputational risks are identified at the Bank entity level. As part of the assessment of this risk, we consider the impact of other CFS entities and Co-operative Group entities to the Bank.

Contagion risk: risks originating from elsewhere in the group impacting upon the Bank.

Business risk: arises from changes to the Bank's business, specifically the risk of not being able to carry out the Bank's business plan and desired strategy.

Capital resources

For the year ended 10 January 2009
All amounts are stated in £m unless otherwise indicated

The following table shows the capital resources of the Bank Group as at 10 January 2009.

	2008 £'m	2007 £'m
Core tier one capital[7]		
Permanent share capital	55.0	55.0
Retained earnings	666.8	652.6
Share premium account	8.8	8.8
Core tier one capital	730.6	716.4
Perpetual non cumulative preference shares	60.0	60.0
Total tier one capital before deductions	790.6	776.4
Intangible assets	(2.3)	(5.2)
Expected loss shortfall	(39.2)	(52.4)
Securitisation positions	-	(15.7)
Total tier one capital after deductions	749.1	703.1
Tier two capital[8]		
Revaluation reserves	5.6	-
Long term subordinated debt	298.4	298.1
Total tier two capital before deductions	304.0	298.1
Expected loss shortfall	(39.2)	(52.4)
Securitisation positions	-	(15.7)
Total tier two capital after deductions	264.8	230.0
Total capital resources	1,013.9	933.1

Deductions
Intangible assets are deducted from tier one capital, this represents capitalised software. Under the IRB approach a deduction is made for expected losses in excess of impairment provisions made on customer lending, 50% is deducted from tier one and 50% from tier two capital. The current year expected loss shortfall is shown net of tax, following clarification of the treatment in 2008. In 2007 securitisation positions of £31.4 million, relating to Structured Investments below Moody's rating Ba3 or equivalent are deducted from capital, 50% deducted from tier one capital, and 50% from tier two capital. In 2008 downgraded Structured Investments below Moody's rating Ba3 or equivalent were fully written down.

On 26 January 2009, the Bank issued £120 million of share capital to its parent company, CFS Ltd to reinforce its capital strength and give the Bank eligibility of the Government's Credit Guarantee Scheme.

[7] Tier one capital includes share capital, retained earnings, and perpetual non cumulative preference shares. The preference shares carry the right to a fixed non cumulative preferential dividend at a rate of 9.25%, payable 31 May and 30 November. Retained earnings exclude gains or losses on cashflow hedges and available for sale assets.

[8] Revaluation reserves relating to net gains in equities held in the available for sale financial assets category are included in tier two capital. The tier two capital includes 2 subordinated debt issues, £150 million Step Up Callable Subordinated Notes 2019 and £150 million Callable Subordinated Notes 2021 fixed rate until 2016, then moving to floating rate. The rights of repayment to the holders of subordinated debt are subordinated to the claims of depositors and other creditors of the Bank. More information on these can be found in the Bank's annual financial statements.

The Bank has a robust capital management framework comprising:

- a strong well-established and embedded asset liability management control program;
- robust risk and capital quantification and mitigation techniques and processes;
- management actions linked through to stress testing and capital planning models, enabling a robust method of mitigating the effects of the severe economic stress;
- defined processes to invoke necessary management actions detailed in the Internal Capital Adequacy Assessment Process (ICAAP) submission document and in the Bank's Capital and Liquidity Management Policies; and
- detailed and documented on-going development and embedding plans for capital adequacy, capital allocation and risk appetite model development.

The capital management group are responsible for the further development of this framework including the FSA003 periodic MI submissions, overseeing the Bank's capital reporting processes, agreeing, reviewing and discussing the current and projected Capital Resources 'vs' Capital Requirements for the Bank, and for challenging and agreeing capital allocation assumptions and funding implications. The capital management group also: monitor, review, and challenge the Bank's risk appetite (with approval from Board), and regularly review, challenge and agree the allocation of capital for Bank Retail, Corporate and Wholesale sectors based on the capital requirements and the projected return on capital.

The Bank's risk appetite is defined and quantified as:

- the total (and in due course, the individual) amount of risk that the Bank is willing to take relative to its required return based upon its Internal Capital Adequacy requirement; and
- the degree by which the amount and types of risk are consistent with the Bank's strategy and provides sufficient compensation, given the cost of capital to support those risks.

Assessing Adequacy of Internal Capital

The Bank's approach to assessing adequacy of its internal capital to support current and future requirements is conducted via the Bank's Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP has been constructed in two stages:

Stage 1 **-** initially assesses the capital adequacy of the Bank's Pillar 1 charge (credit, market and operational risks), and analyses and quantifies, where appropriate, additional Pillar 2 risks (including operational risk add-on, concentration risk, pension scheme, interest rate risk in the banking book (IRRBB) and trading book, liquidity risk, reputational risk, and contagion risk).

Stage 2 - models the Bank's three-year strategic plan earnings and balance sheet in order to ensure that its Pillar 1 and Pillar 2 capital requirements are met during a severe economic recession, over the plan period, utilising appropriate management actions, but without recourse to support from CFS or the Co-operative Group, except for specific event risks.

The Bank's most material risk is credit risk, making up more than 70% of the Basel II risk weighted exposure amounts (RWEA) before business risk. On this basis, the Bank's principal stress in determining its Pillar 2 capital is that of credit quality deterioration as a result of a severe economic recession and high interest rates. Having defined the severe economic recession stress test parameters, the Bank's Pillar 2 risks are analysed to determine what additional capital the Bank needs to hold in such prevailing economic conditions.

Management actions that the Bank will take to respond to the severe economic stress and their effect on the Bank's Individual Capital Assessment (ICA), capital planning and liquidity position are included within the model and reported in the ICAAP.

Pillar 1 capital requirement

For the year ended 10 January 2009
All amounts are stated in £m unless otherwise indicated

The table below analyses the Pillar 1 capital requirement by approach and exposure class:

IRB exposure class	2008 £'m	2007 £'m
Central Government and Central Bank	0.2	0.2
Institutions	52.1	39.2
Corporates	83.7	61.8
Securitisations	1.9	2.8
Retail exposures secured by real estate collateral	36.5	25.5
Qualifying revolving	77.3	91.1
Other Retail exposures	61.0	62.4
Total IRB	*312.7*	*283.0*
Specialised lending	*186.6*	*180.1*
Standardised exposure class		
Regional Governments or Local Authorities	1.3	3.6
Administrative Bodies and Non Commercial	5.2	4.0
Institutions	6.9	7.7
Corporates	114.7	82.8
Secured on real estate property	0.1	-
Retail	2.2	2.6
Past due	1.3	1.4
Other items	17.7	16.2
Total standardised[9]	*149.4*	*118.3*
Total credit risk capital requirement	*648.7*	*581.4*
Trading Book minimum capital requirements		
Interest rate position risk requirement	3.0	2.2
Counterparty risk capital component	2.2	0.1
In respect of all business activities	-	-
Foreign currency position risk requirement	0.2	0.1
Trading Book minimum capital requirements	*5.4*	*2.4*
Operational risk capital requirement	*70.8*	*68.6*
Total Pillar 1 capital requirement	*724.9*	*652.4*

[9] Other items within the standardised approach include equity shares with a balance sheet value of £13 million representing 3 separate investments. It is subject to the standardised approach as an immaterial portfolio and not considered material for Pillar 3 disclosure purposes relating to equity shares.

All amounts are stated in £m unless otherwise indicated

Credit Risk Analysis

Credit risk exposure data in the tables below is equivalent to Exposure at Default (EAD) under the IRB approach or exposure post credit conversion factor net of individual provisions for the standardised approach.

Analysis of Exposure (EAD) by Residual Maturity

The following table represents the Bank's exposure value (equivalent to EAD) relating to both on and off balance sheet exposures, including commitments analysed by approach, exposure class and residual maturity. Analysis of average exposure is also provided.

2008

Exposure class	Repay on demand	Up to 1 yr	1-5yrs	5-10yrs	10-20yrs	Over 20yrs	Total Exp	Average Exp
IRB								
Central Government and Central Bank	-	372.1	18.6	8.4	-	-	399.1	372.7
Institutions	-	2,764.8	766.2	36.2	1.3	2.3	3,570.8	3,339.3
Corporates	-	725.1	292.8	85.9	85.6	1.5	1,190.9	1,150.4
Retail mortgages	-	15.4	177.7	487.2	1,605.5	2,019.2	4,305.0	4,152.7
Qualifying revolving	2,795.3	-	-	-	-	-	2,795.3	2,608.9
Other retail exposures	38.3	36.1	580.3	192.2	-	-	846.9	829.7
Securitisation positions	-	-	25.2	4.0	-	-	29.2	37.6
Total IRB	2,833.6	3,913.5	1,860.8	813.9	1,692.4	2,023.0	13,137.2	12,491.3
Specialised lending	-	895.4	733.8	282.0	346.0	581.0	2,838.2	2,771.3
Standardised								
Regional Governments or Local Authorities	-	73.4	5.2	0.7	0.1	-	79.4	101.5
Administrative Bodies and Non Commercial	9.3	30.6	8.3	20.6	24.6	20.9	114.3	85.8
Institutions	-	425.4	0.4	-	-	-	425.8	462.4
Corporates	-	429.9	471.5	340.0	176.2	11.4	1,429.0	1,350.0
Retail	10.6	8.8	3.6	8.5	4.8	0.1	36.4	39.5
Secured on real estate property	-	-	1.3	-	-	-	1.3	2.5
Past due	10.6	-	-	-	-	-	10.6	10.5
Other items	513.4	-	-	-	-	-	513.4	490.8
Total standardised	543.9	968.1	490.3	369.8	205.7	32.4	2,610.2	2,543.0
Total credit risk exposures	3,377.5	5,777.0	3,084.9	1,465.7	2,244.1	2,636.4	18,585.6	17,805.6

All amounts are stated in £m unless otherwise indicated

2007

Exposure class	Repay on demand	Up to 1 yr	1-5yrs	5-10yrs	10-20yrs	Over 20yrs	Total Exp	Average Exp
IRB								
Central Government and Central Bank	-	268.6	69.8	8.4	-	-	346.8	186.9
Institutions	-	2,291.8	799.1	38.2	1.1	1.4	3,131.6	3,426.7
Corporates	-	656.6	360.6	109.0	66.6	0.3	1,193.1	1,347.6
Retail mortgages	-	16.1	135.6	459.5	1,337.3	1,570.3	3,518.8	3,382.1
Qualifying revolving	2,675.2	-	-	-	-	-	2,675.2	2,843.7
Other retail exposures	37.4	33.5	571.5	220.6	-	-	863.0	867.0
Securitisation positions	-	-	25.2	19.6	-	-	44.8	90.4
Total IRB	2,712.6	3,266.6	1,961.8	855.3	1,405.0	1,572.0	11,773.3	12,144.4
Specialised lending	-	783.9	844.9	213.3	351.4	362.4	2,555.9	2,239.7
Standardised								
Regional Governments or Local Authorities	-	5.8	74.4	7.0	1.1	1.3	89.6	94.2
Administrative Bodies and Non Commercial	4.7	5.2	19.0	17.2	22.2	-	68.3	91.1
Institutions	-	460.4	2.4	5.3	-	-	468.1	451.0
Corporates	-	202.4	346.7	15.7	133.8	336.7	1,035.3	739.8
Retail	16.3	1.2	6.7	11.4	6.8	0.1	42.5	45.2
Past due	11.9	-	-	-	-	-	11.9	11.3
Other items	497.4	-	-	-	-	-	497.4	513.1
Total standardised	530.3	675.0	449.2	56.6	163.9	338.1	2,213.1	1,945.7
Total credit risk exposures	3,242.9	4,725.5	3,255.9	1,125.2	1,920.3	2,272.5	16,542.3	16,329.8

The Co-operative Bank Group is predominantly UK based, non UK lending is not material and exposures by geographic location will not be disclosed. This is in line with the segmental analysis provided in The Co-operative Bank p.l.c. annual financial statements.

All amounts are stated in £m unless otherwise indicated

Analysis of exposures, impaired and past due exposures, value adjustment and provisions, charges for value adjustments during the period by exposure class

The table provides an analysis of total exposures (equivalent to EAD) relating to both on and off balance sheet exposures including commitments by approach and exposure class. Analysis is also provided showing the amount of the total exposure that is impaired and also past due but not impaired, the value adjustment and provisions raised against the impaired assets and the charges for value adjustments made in the year.

2008

Exposure class	Total exposure	Of which: Impaired exposures	Of which: Past due exposures not impaired	Value adjustments and provisions held against impaired exposures	Charge for value adjustments in the period
IRB					
Central Government and Central Bank	399.1	-	-	-	-
Institutions	3,570.8	-	-	-	-
Corporates	1,190.9	54.9	-	28.6	2.1
Retail mortgages	4,305.0	12.4	9.0	1.5	1.5
Qualifying revolving	2,795.3	178.5	3.1	115.0	-
Other retail exposures	846.9	42.2	2.9	25.4	-
Securitisations	29.2	25.2	-	12.5	12.5
Total IRB	13,137.2	313.2	15.0	183.0	16.1
Specialised lending	2,838.2	45.1	-	6.5	6.6
Standardised approach					
Regional Governments or Local Authorities	79.4	-	-	-	-
Administrative Bodies and Non Commercial	114.3	4.0	-	0.5	0.5
Institutions	425.8	-	-	-	-
Corporates	1,429.0	3.5	-	0.4	0.4
Retail	36.4	0.5	0.1	-	-
Secured on real estate property	1.3	-	-	-	-
Past due	10.6	20.6	-	10.0	1.6
Other items	513.4	-	-	-	-
Total standardised	2,610.2	28.6	0.1	10.9	2.5
Total credit risk exposures	18,585.6	386.9	15.1	200.4	25.2

Institutions on the IRB approach include the Treasury bond portfolio, against which an additional £10 million collective provision has been raised in 2008 reflecting a reduction in current market values.

All amounts are stated in £m unless otherwise indicated

2007

Exposure class	Total exposure	Of which: Impaired exposures	Of which: Past due exposures not impaired	Value adjustments and provisions held against impaired exposures	Charge for value adjustments in the period
IRB					
Central Government and Central Bank	346.8	-	-	-	-
Institutions	3,131.6	-	-	-	-
Corporates	1,193.1	53.1	-	27.4	11.3
Retail mortgages	3,518.8	9.1	7.4	0.3	0.3
Qualifying revolving	2,675.2	165.8	2.1	99.5	-
Other retail exposures	863.0	42.3	0.6	25.4	-
Securitisations	44.8	-	-	-	-
Total IRB	11,773.3	270.3	10.1	152.6	11.6
Specialised lending	2,555.9	12.9	-	0.6	-
Standardised approach					
Regional Governments or Local Authorities	89.6	-	-	-	-
Administrative Bodies and Non Commercial	68.3	-	-	-	-
Institutions	468.1	-	-	-	-
Corporates	1,035.3	-	-	-	-
Retail	42.5	0.1	0.8	-	-
Past due	11.9	19.4	-	7.5	2.3
Other items	497.4	-	-	-	-
Total standardised	2,213.1	19.5	0.8	7.5	2.3
Total credit risk exposures	16,542.3	302.7	10.9	160.7	13.9

Within the Pillar 3 disclosure value adjustments are defined as being individual impairments and provisions are defined as collective impairments in line with British Bankers' Association (BBA) guidance. Individual impairments are made against corporate and retail mortgage assets.

All amounts are stated in £m unless otherwise indicated

Analysis of exposures, impaired and past due exposures, value adjustment and provisions, charges for value adjustments during the period by industry for Corporate exposure class

The table below provides an industrial analysis[10] for Corporate exposure class, across all approaches of total exposures (equivalent to EAD), relating to both on and off balance sheet exposures including commitments by approach and exposure class. Analysis is also provided showing the amount of the total exposure that is impaired, the value adjustment and provisions raised against the impaired assets and the charges for value adjustments made in the year.

The analysis includes Corporate exposure class for IRB approach and standardised approach, all specialised lending exposures in addition to past due exposure class within the standardised exposure class relating to Corporates.

2008

Exposure class/Industry	Total exposure	Of which: Impaired exposures	Value adjustments and provisions held against impaired exposures	Charge for value adjustments in the period
Corporate exposure class				
Care	261.2	0.2	0.2	-
Education	320.6	-	-	-
Football clubs	105.8	50.5	28.2	1.1
Garages/ Retail Motor vehicles	104.9	0.4	-	(0.1)
Hotels/Restaurants/Clubs/Pubs	172.5	4.1	0.7	0.7
Housing Associations	140.7	-	-	-
Leasing and other Financial Institutions	177.7	9.9	0.1	(1.1)
Manufacturing	285.2	5.5	4.6	0.1
Professionals	96.7	0.7	0.3	0.3
Public Sector Entities	35.0	-	-	-
Property and Construction	2,180.8	45.4	7.4	6.6
Retail Distribution	450.1	0.4	0.3	-
Services	698.7	6.2	3.1	2.1
Transport	290.2	-	-	-
Utilities	116.7	0.4	0.4	0.3
Other	31.9	0.4	0.2	0.7
Total	**5,468.7**	**124.1**	**45.5**	**10.7**
Analysed by Approach:				
IRB Corporates	1,190.9	54.9	28.6	2.1
Specialised lending	2,838.2	45.1	6.5	6.6
Standardised Corporates	1,429.0	3.5	0.4	0.4
Standardised Past due	10.6	20.6	10.0	1.6
Total	**5,468.7**	**124.1**	**45.5**	**10.7**

[10] The industry analysis used is consistent with the industrial analysis used for management information purposes within the Bank.

All amounts are stated in £m unless otherwise indicated

2007

Exposure class/Industry	Total exposure	Of which: Impaired exposures	Value adjustments and provisions held against impaired exposures	Charge for value adjustments in the period
Corporate exposure class				
Care	191.7	0.2	0.2	-
Education	231.6	-	-	-
Football clubs	110.0	50.9	27.3	11.4
Garages/ Retail Motor vehicles	100.1	0.3	0.2	-
Hotels/Restaurants/Clubs/Pubs	172.3	0.6	0.2	-
Housing Associations	138.8	-	-	-
Leasing and other Financial Institutions	161.5	8.1	1.1	-
Manufacturing	251.0	5.3	4.6	1.4
Professionals	98.6	0.7	0.1	-
Public Sector Entities	27.4	-	-	-
Property and Construction	2,035.7	13.4	0.6	-
Retail Distribution	372.8	0.2	0.1	0.1
Services	594.0	5.3	1.1	0.7
Transport	269.6	0.3	-	-
Utilities	14.5	-	-	-
Other	26.6	0.1	-	-
Total	4,796.2	85.4	35.5	13.6
Analysed by Approach:				
IRB Corporates	1,193.1	53.1	27.4	11.3
Specialised lending	2,555.9	12.9	0.6	-
Standardised Corporates	1,035.2	-	-	-
Standardised Past due	11.9	19.4	7.5	2.3
Total	4,796.2	85.4	35.5	13.6

Impairment on loans and advances

Loans and securities are considered impaired where it is determined that the Bank will be unable to collect all principal and interest outstanding, according to the contractual terms of the agreements.

The loan portfolios are reviewed on a continuous basis to assess impairment. In determining whether a bad debt provision should be recorded, judgements are made as to whether there is objective evidence that a financial asset or portfolio of financial assets is impaired as a result of loss events that occurred after recognition of the asset and prior to the balance sheet date.

Collective provisions

Personal advances are identified as impaired by taking account of the age of the debt's delinquency, by product type. The provision is calculated by applying a percentage rate to different categories and ages of impaired debt. The provision rates reflect the likelihood that the debt in that category/age will be written off or charged off at some point in the future. The rates are based on historical experience and current trends, incorporate the effects of discounting at the customer interest rate and are subject to regular review. The provision is the product of the rate and the spot balance for the relevant arrears bucket. Collective provisions are also raised against identified fraud accounts.

Individual provisions

Mortgage accounts are identified as impaired by taking account of the age of the debt's delinquency on a case-by-case basis based on arrears data held within the mortgage system. Individual provisions are also raised on a case-by-case basis for each mortgage account in arrears. Each corporate account is assessed and allocated a 'risk grade' to enable the Bank to monitor the overall quality of its lending assets. Those of lesser quality, where the lending is potentially at risk and provisions for future loss may be required, are centrally monitored with specific management actions taken at each stage within laid down procedures and specific provisioning criteria. Provisions represent the likely net loss after realisation of any security or management actions.

Past due but not impaired

Loans and securities are considered past due where the contractual interest or principal payment are in arrears, but the Bank believes that impairment is not appropriate as a trigger point for impairment has not been reached, this could be the stage of collection of amounts owed to the Bank or a specific event such as bankruptcy.

Past due but not impaired exposures represent mortgage and unsecured retail lending balances past due but not yet impaired.

Movement in value adjustments and provisions for impairment

For the year ended 10 January 2009
All amounts are stated in £m unless otherwise indicated

Allowance for impairments relating to loans and advances to customers

The following table represents the movement in allowance for impairments relating to loans and advances to customers.

The provisions within the Corporate portfolio are spread over the Corporate exposure classes for foundation IRB, specialised lending and standardised approach, in addition to Retail SMEs on the standardised approach. The retail secured provisions relate to Retail exposures secured by real estate collateral exposure class on the Retail IRB approach and the retail unsecured provisions relate to exposures within the qualifying revolving and other retail exposure classes within the Retail IRB approach.

2008

	Corporate	Retail secured	Retail unsecured	Total
Opening balance	35.5	0.3	124.9	160.7
Amounts written off	(2.2)	(0.3)	(64.9)	(67.4)
Charge against profits	12.0	1.5	83.3	96.8
Recoveries	0.2	-	-	0.2
Any other adjustments	0.5	-	(2.9)	(2.4)
Closing balance	46.0	1.5	140.4	187.9

2007

	Corporate	Retail secured	Retail unsecured	Total
Opening balance	26.9	0.6	127.8	155.3
Amounts written off	(4.6)	(0.6)	(87.7)	(92.9)
Charge against profits	14.1	0.3	87.6	102.0
Recoveries	0.1	-	-	0.1
Any other adjustments	(1.0)	-	(2.8)	(3.8)
Closing balance	35.5	0.3	124.9	160.7

Allowance for impairments relating to debt securities

The provisions within the Treasury portfolio relate to exposures to institutions and investment in securitisations. The impact of the ‘credit crunch’ and subsequent reductions in liquidity in wholesale markets, have lead to a loss of active markets or availability of traded prices for particular assets. A £10m collective provision is in place against institutions, the remainder of the provision relates to the securitisation position Basel exposure class.

The following table represents the movement in allowance for impairments relating to debt securities:

	2008	2007
Opening balance	31.8	-
Charge against profits	50.7	31.8
Any other adjustments	9.8	-
Closing balance	92.3	31.8

All amounts are stated in £m unless otherwise indicated

Risk Weighted Exposure amounts calculated in accordance with the Standardised Approach

For those exposures subject to the standardised approach a significant portion are unrated. There are some rated exposures to institutions within Basel defined immaterial portfolio. The nominated external credit assessment institutions (ECAIs) or export credit agency for these is Moody's. In 2007, there were £17.0m of rated Corporates the nominated ECAI for these was Standard and Poor's. The bank complies with the credit quality assessment scale in allocating external credit ratings to the credit quality steps as defined by the FSA. There is no credit risk mitigation associated with the exposures on the standardised approach.

The table analyses exposures post credit conversion factor and net of provisions subject to the standardised approach by associated credit quality step.

2008	Credit Quality Step							
	1	2	3	4	5	6	Unrated	Total
Regional Governments or Local Authorities	-	-	-	-	-	-	79.4	79.4
Administrative Bodies and Non Commercial	-	-	-	-	-	-	114.3	114.3
Institutions	406.8	17.5	-	-	-	-	1.5	425.8
Corporates	-	-	-	-	-	-	1,429.0	1,429.0
Retail	-	-	-	-	-	-	36.4	36.4
Secured on real estate property	-	-	-	-	-	-	1.3	1.3
Past due	-	-	-	-	-	-	10.6	10.6
Other items	-	-	-	-	-	-	513.4	513.4
Total standardised approach	406.8	17.5	-	-	-	-	2,185.9	2,610.2

2007	Credit Quality Step							
	1	2	3	4	5	6	Unrated	Total
Regional Governments or Local Authorities	-	-	-	-	-	-	89.6	89.6
Administrative Bodies and Non Commercial	-	-	-	-	-	-	68.3	68.3
Institutions	434.3	26.1	-	-	-	-	7.7	468.1
Corporates	-	-	-	17.0	-	-	1,018.3	1,035.3
Secured on real estate property	-	-	-	-	-	-	-	-
Retail	-	-	-	-	-	-	42.5	42.5
Past due	-	-	-	-	-	-	11.9	11.9
Other items	-	-	-	-	-	-	497.4	497.4
Total standardised approach	434.3	26.1	-	17.0	-	-	1,735.7	2,213.1

All amounts are stated in £m unless otherwise indicated

Specialised Lending Analysis by Slotting Category

There is a specialised lending portfolio within the Corporate sector consisting largely of lending to Private Finance Initiatives (PFI) and Property investment and development. The slotting approach is used and the table analyses exposure (EAD) by slotting category.

Slotting Category	2008 Exposure value	2007 Exposure value
Strong	206.1	226.1
Good	2,450.5	2,261.1
Satisfactory	104.8	55.8
Weak	31.7	-
Default	45.1	12.9
Total	2,838.2	2,555.9

All amounts are stated in £m unless otherwise indicated

The Co-operative Bank Group holds investments in structured investments (£74 million) and credit trading funds (£25 million). An impairment provision of £82.3 million (2007: 31.8 million) has been raised against the structured investments and credit trading funds to reflect current market conditions. At the financial year end 2008 there was a combined exposure of £29.2 million (2007: £108 million) for capital adequacy purposes, well within the stated Board appetite. The exposure value is different to that reported in the financial statements due to the exclusion of available for sale fair value movements for capital adequacy purposes.

The Bank is not an originator of securitisations.

The securitisation ratings based approach under foundation IRB is used to calculate risk weighted exposure amounts. ECAIs used for the securitisations are listed in the table below.

The table below provides analysis of securitisation exposures analysed by ECAI into risk weight bands.

2008

			Risk weight banding		
IRB Exposure Type	ECAI	Total	20%	75%	1250%
Corporate	Moody's	25.2	-	25.2	-
	Standard & Poor's	4.0	-	4.0	-
	Total	29.2	-	29.2	-

2007

			Risk weight banding		
IRB Exposure Type	ECAI	Total	20%	75%	1250%
Corporate	Moody's	88.4	-	25.2	63.2
	Standard & Poor's	19.6	19.6	-	-
	Total	108.0	19.6	25.2	63.2

The structured investments with a Moody's rating Ba3 or below attracting a risk weighting of 1250% and are deducted from capital, these downgraded investments have been fully provided against in 2008.

There were no securitised revolving exposures held during the reporting period.

The Credit Risk Control Unit (CRCU) function provides an independent view of credit risk in order to support the business management functions decision making. CRCU does not directly benefit from decisions to extend credit. The CRCU provides risk oversight by virtue of its independence from the Business Management functions. The CRCU function is in house and is not outsourced.

CRCU performs the following tasks and responsibilities related to its role:

- Design and implementation of risk assessment and rating systems;
- Testing, validating, documenting and monitoring of risk assessment and rating systems;
- Production and analysis of summary reports of risk assessment and rating systems;
- Maintenance of policy, procedures and upkeep of various returns and reporting requirements;
- Monitoring system decision overrides and exceptions;
- Ongoing review and update to models used in the risk assessment process;
- Benchmarking against third-party data and vendor model sources;
- Reviewing the risk criteria to ensure they remain predictive of risk;
- Independent validation;
- Production of management information; and
- Liaise with FSA regarding proposed changes to rating systems (new models and material changes arising from annual model reviews) and forecast regulatory capital levels.

Credit Approval

The Credit Risk Control Unit (CRCU) is responsible for the development, recommendation and monitoring of Risk Appetite, Lending Policy, Rating Systems and Lending Procedures across Retail and Corporate.

Credit Approval – unsecured lending

The application and behavioural scoring systems which form the main components of the IRB models are integral to the credit risk management processes across the unsecured Retail business area and are used to support new lending decisions, and ongoing portfolio management.

The decision systems are generally fully automated with manual intervention only required in the event of referrals being triggered or customer appeal[11] Basel probability of default (PD) segmentation has been developed to replicate the same hierarchical logic as the customer level segmentation used within credit risk to undertake lending decisions. The score used within a particular PD model is either the application score or behaviour score dependant upon the type and age of the product mix of a particular customer.

Credit Approval – mortgage lending

The Bank re-entered the mortgage market in 2000 and therefore initial models have limitations due to the amount of available data, in particular, the number of defaults. The Bank has, therefore, adopted a roadmap approach to the development of mortgage PD models whereby, initially, internal and external expert judgement has been used to augment Bank data to add robustness to the models. As more data is accumulated over time, it is expected that reliance on expert judgement will decrease. Separate PD models have been developed for new applicants (application PD) and existing customers (behaviour PD). One of the key drivers in the credit approval process for mortgages is the Experian Delphi Score, a generic bureau score. This score is the key component of the mortgage application PD model, alongside other key application characteristics. For existing mortgage customers, the PD models utilise a number of risk indicators alongside the generic bureau score, Delphi for Customer Management.

Retail Individual and Portfolio Limit Setting

For Retail unsecured lending, there are currently no limits set at portfolio level. Individual limits are set using application score combined with income for new to bank customers or behavioural score combined with account turnover for existing customers, thus being derived from the key drivers of the IRB rating systems. There are target limits on PD and expected loss (EL) in the Bank's Credit Risk Appetite statement, against which performance is monitored. For mortgages, the Bank Credit Risk Appetite statement articulates a sector limit for non-core mortgages.

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[11] although for mortgage lending, there is a greater dependency on policy rules with an element of expert judgement.

Retail Pricing and Profitability

Overall lending and credit approval strategies are determined based on profitability, via models that calculate net contribution by risk segment. The strategies are translated into score cut offs, utilising the same application or behavioural scores that are the key components of the Retail IRB models. Therefore, this ensures that there is a very strong link between the IRB models and front-line.

Personal Lending Policy

The Bank's Personal Lending Policy is to establish credit criteria which determine the optimum balance between volume growth (generating higher income) and higher bad debts, so as to maximise overall profitability. The majority of retail credit risk related decisions are based on well founded and robust decision mechanisms designed to segregate customers into risk categories. There are a suite of bespoke, externally developed application and behavioural scorecards derived from sound historic data. It is the responsibility of the CRCU to design, select, implement, maintain and monitor these systems.

Retail Credit Strategy

Application scorecards are used to determine lending decisions to those customers with no existing relationship with the Bank (primarily accept/reject, price and loan/limit amount). They include both demographic, financial and credit reference agency data and form part of an automated application decision process.

Behavioural scorecards are used to make existing account lending decisions including credit limit increases/decreases, pricing, further advances, authorisation decisions, collections activity and card reissue. They are applied at customer and account level, include both account and customer level data and credit reference agency data, refreshed monthly, and are applied through the use of automated decision systems.

Strategies in relation to the use of all automated decision systems are set to ensure that the outcomes conform to the Bank's appetite for risk and meet minimum targets for Return on Capital. Ongoing evaluation of the effectiveness of individual strategies is undertaken.

Credit approval – Corporate lending

The CFS Corporate Banking customer engagement model comprises of Business Development Managers, Relationship Managers and Support Staff.

Corporate Banking division is separate from the Credit Risk Control Unit (CRCU) who is responsible for the development, recommendation and monitoring of Risk Appetite, Lending Policy, Rating Systems and Lending Procedures. The CRCU is, in turn, separate from the Corporate Advances team who are responsible for the sanctioning and control of the lending portfolio.

The lending portfolio is largely controlled by a small number of experienced credit risk sanctioners within the centrally based Corporate Advances team, independent from the income generating area. Lending discretions are based on the risk profile of the customer and the amount of the exposure. The lending discretion of the Director of Banking Risk and Capital Management, Credit and Exposure Committees are operated to sanction the largest credit applications.

The Corporate Advances team is resourced by experienced lenders who use the relevant Rating Systems and other tools to analyse the underlying business and the counterparty's management to assess the risk of lending proposition and its ability to repay the borrowing. Other factors considered include the potential impact of economic changes, the stability of the counterparty and their ability to withstand such change.

Corporate Credit Policy

The Bank's Corporate Sector Policy is to maintain a broad sectoral spread of exposures which reflect the Bank's areas of expertise. Credit exposures to corporate and business banking customers are assessed individually. The quality of the overall portfolio is monitored, using a credit grading system calibrated to expected loss. All aspects of credit management are controlled centrally. The Risk Management Committee receives regular reports on the performance of the portfolio. The Exposures Committee receives regular reports on new facilities and changes in facilities, sector exposures, bad debt provisions and the management of problem loans.

Larger corporate facilities are sanctioned by the Board's Exposures Committee who also review, each month, facilities granted within the Chief Executive's discretion.

Wholesale Credit Policy

Teams of risk managers and the Credit Risk Control Unit (CRCU) framework support the Treasury business group.

Wholesale markets credit risk framework takes an holistic approach to risk management with, at its centre, a credit risk policy which governs the types of exposure the business can take and sets concentration parameters.

To complement this, individual authority is delegated in terms of Internal Rating Grade (IRG) and associated Probability of Default (PD), to approve limits to individual counterparties within the parameters established by the credit risk policy. The Risk Management Committee receives regular reports on the performance of the portfolio. The Exposures Committee receives regular reports on changes in exposure limits, watchlist and problem counterparty information.

Limits on exposures to counterparties are principally (99% of all approvals) established from Internal Rating Grades 0-10 (10 being default) and associated PDs to Total Potential Limits (TPL) using a Limit matrix.

Scope and nature of credit risk reporting systems and processes

For the year ended 10 January 2009
All amounts are stated in £m unless otherwise indicated

Risk Reporting

The following general approach has been applied to the design and development of the risk reporting framework. All management information (MI) is sourced from common, verified data sources thus presenting an accurate and consistent view of risk profile and performance across the organisation:

1. Risk Management Committee (RMC) is provided with Credit Risk MI within the technical significant risk MI pack.
2. Risk Management Group (RMG) receive, review and challenge on a regular basis, key credit risk MI within the technical significant risk pack and summary MI on credit risk rating systems and their performance.
3. Credit Risk Control Unit (CRCU) MI drills down to considerably greater depth, examples being by risk pool, campaign or key characteristic.

For all stakeholders, where appropriate and/or on demand, a more detailed level of information is provided to support the diagnosis of any anomalies or issues arising from the more summarised data. Selected elements of the MI at all levels may be tabled for discussion and review at the Sector Forums. The forums act as an interface between the risk functions and the business, providing a platform for internal review and challenge of significant risks.

Risk Management Committee Management Information

The RMC technical significant risk MI pack includes the following key information:

- Capital requirements vs capital availability for the Bank.
- Risk Appetite – presenting current position with respect to each element of the Risk Appetite statement.
- A backdrop of key economic trends pertaining to the Bank's credit risk experience.
- A combination of trend and 'point-in-time' information to illustrate both the current position and how each portfolio is changing.
- High level credit risk performance.

Risk Management Group Management Information

The technical significant risk MI pack is presented regularly to RMG for review, challenge and approval prior to submission to the RMC.

The RMG also review, challenge and approve on a regular basis, summary MI on credit risk rating systems, models, and their performance as well as MI on stress testing approaches, assumptions and results.

Credit Risk Control Unit Management Information

The CRCU MI is produced at timely intervals, with different MI produced for each business area. This MI drills down to considerably greater depth than the Executive packs. Reports include:

- Risk profile – represented through a combination of trends in IRB parameters (probability of default (PD), loss given default (LGD) and exposure at default (EAD)), sector cap utilisation and distribution of exposures across risk pools. There is also an overview of key changes to credit risk criteria to provide context for identified changes in risk profile.
- Capital/Risk weighted exposure amount (RWEA) summary – providing a profile of minimum capital requirement, RWEA's, analysis of the relationship between expected loss, provisioning and forecast bad debt levels, to a low level of granularity.
- Key trends in both Basel II models and underlying scorecards and systems, demonstrating how each portfolio is changing and whether these changes remain within pre-set tolerances.
- Pool migration for the appropriate measures, with movements demonstrated through transition matrices.
- Model forecasting accuracy, including actual default rates monitored against forecast PD and pre-defined tolerance limits.
- Key characteristics monitored with trends analysed and 'point-in-time' values compared to development/validation samples.

RAG indicators are provided where appropriate, and any exceptions highlighted and escalated as necessary.

Sector specific Management Information

MI for the wholesale sector is prepared for the Corporate and Markets Division (CAM), Interest Rate and Market Risk Management Group and Treasury Risk and Compliance Committee meetings on a monthly basis, as part of the Sector Forums. Reports include:

- early warning signals;
- risk concentrations and investment portfolio analysis;
- expected loss values versus limit;
- trend analysis; and
- stress scenarios.

The identification of any exceptions and agreed mitigating action are included should they occur. Reporting is at sub-portfolio level.

Retail models

Residential mortgages

The Bank re-entered the mortgage market in 2000 and has observed very limited historical losses on this portfolio to date. As such, it has been necessary to use both internal and external data alongside expert view in the development of the PD and LGD models. A Roadmap Approach has been adopted for mortgage IRB model development, whereby as internal loss data increases the level of external data and expert view used within the models will diminish.

Separate PD models for both new to bank and existing customers have been built based on external bureau and loan specific information to calculate a 12 month PD. The definition of default for the mortgage portfolio is taken as 180 days past due, but also includes the relevant 'unlikeliness to pay elements' as outlined in BIPRU requirements. The ratings philosophy of these PD models has been determined to be more Point in Time (PiT) in nature. This will result in ratings migration as the quality of the portfolio changes as the economic environment changes.

Long Run PDs by grade have been developed by incorporating these PiT PDs with additional conservative estimates of how these grades would perform over an economic cycle. This is done by modelling the various risk grades under different stressed macroeconomic scenarios.

The LGD model is a parameter based system and uses a combination of statistical modelling, both internal and external expert view and information from external sources. As members of a data pooling consortium, pooled data was used to inform and validate parts of the calculation.

The key components of the model are Probability of Possession Given Default (PPGD) and expected shortfall. Any estimated recoveries post sale are excluded from the loss estimate.

The core component of the PPGD model is loan to value (LTV) and as a parameterised model it offers the flexibility to apply different scenarios.

The expected shortfall calculation uses an estimate of future house prices, a statistically based haircut scorecard (the difference between actual and forecasted house price) and projected balance at sale (including costs), along with time to possession and sale parameters.

In calculating capital, a downturn LGD is used. This is achieved by flexing the key components of the LGD model - reducing future house price estimates, increasing time to sale parameters and increasing possession rates.

The regulatory LGD floor of 10% is applied where applicable.

The models are applied to all 51,000 residential mortgage accounts, £4.1 billion exposure.

Qualifying revolving and other retail exposures

Rather than building bespoke Basel models the underlying business scorecards are calibrated to a Basel compliant definition of PD. The direct usage of the underlying scorecards for the derivation of PD facilitates compliance with the Use Test. The definition of default for unsecured exposures is taken as 90 days past due, but also includes the relevant 'unlikeliness to pay' elements as outlined in BIPRU requirements.

Upon acceptance, credit score is used to determine PD up until the behaviour score is deemed sufficiently mature. The ratings philosophy of the PD models is deemed to be predominantly PiT therefore changes in the quality of the portfolio will be reflected via ratings migration and default rate within pools will remain stable.

The PD models produce an initial point estimate of default rate that is then uplifted to reflect a long run average (LRA) PD. The uplifts are applied at pool level and are estimated using a combination of internal data and a cash flow model that is linked to economic scenarios. The scenarios used in the cash flow model are consistent with those used for Pillar 2 stress testing. The LRA PD is used to determine capital requirements.

Statistical techniques were used to develop homogenous LGD pools across the unsecured portfolio. These models directly estimate the average loss (percentage) of Exposure at point of Default (EAD) over a 36 month recovery period for each pool. Economic impacts are then considered via assessment of key drivers and further truncations of the recoveries. Due to historical collections policies it was not possible to model LGD to write-off and as such the estimates are inherently conservative.

Standard discounting principles are applied in conjunction with the cost of collections to determine the ultimate LGD used for capital calculation.

Statistical techniques were used to develop homogenous EAD pools across segments of the unsecured portfolio whereby the exposure exceeded current drawings (credit cards and current accounts).

A variable horizon, momentum approach is used to directly estimate the average default weighted EAD percentage for each homogenous pool. The EAD therefore reflects the exposure at point of default from a position of non-default, given that the account will move into a position of default at any point in a 12 month time horizon.

The EAD is inclusive of any interest accrued and collections charges.

EAD (£) = Current Exposure * EAD (%)

Further adjustments are applied where necessary to ensure that the EAD (£) is sufficient to cover the pool level current drawings.

The definition of default is taken as 90 days past due in line with internal reporting, more conservative than the BIPRU definition of 180 days past due for retail exposures.

These models are applied across entire retail unsecured portfolio (credit cards, loans, current accounts) which covers approximately 2 million accounts and £5.8 billion exposure.

Corporate models

Corporate Banking Asset Class uses a combination of models and approaches to manage its portfolio as outlined in the table on page 3.

There are two externally developed PD models in use for grading and monitoring the IRB portion of the Corporate Asset Class; namely, Moody's KMV RiskCalc version 3.1 (UK) for the unquoted Corporate borrowers (Total Balance Sheet Assets >£0.35 million) and CreditEdge version 8 (European) for non-financial UK quoted p.l.c.s. After assessing these two external models for their suitability to grade the CFS portfolio, the Moody's KMV Expected Default Frequencies generated from the CreditEdge and RiskCalc PD models were calibrated in house to create a single Master Grading Scale (grades 1-14 with the latter being Default) and the results externally validated and approved by the RMG and RMC (previously RMWG and RMC).

The ratings philosophy of these PD models is defined as ‘near Point in Time models’. This will result in ratings migration as the quality of the portfolio changes over the economic cycle.

The Long Run Average PD methodology benefits from the PD models being developed externally and then calibrated using the Bank's own default experience across its portfolio. In view of the relatively low number of defaults across the UK plc element of the Corporate Banking portfolio, use was made of the ‘Cathcart Low Default Portfolio Model’ (see FSA website for further information on this model) to inform its calibration and the Cathcart model was also used as a benchmark for the unquoted Corporate PD model.

Slotting models are used to analyse and monitor the Specialised Lending exposures to Property and PFIs. The PFI and Property Investment and Development ‘slotting models’ are based on BIPRU criteria, which map to 5 FSA supervisory categories with predefined risk weights from Strong to Default (Slotting Model Categories 1-5 respectively).

The Master Grading Scale and Slotting grades can only be overridden by Corporate Advances (the Credit Team) using their expert judgement based on information not available in the model such as account behaviour or other qualitative factors to ensure that the grade fully reflects all available information used to assess the credit risk of the customer. The rationale supporting such overrides is captured in a structured database to facilitate interrogation to inform future model refinement and development.

The remainder of the Corporate Asset Class portfolio is subject to ‘3 year rollout to Foundation IRB’. The element of the portfolio that falls under the ‘3 Year Rollout to Foundation IRB’ is subject to the same criteria for grading and closely monitoring higher risk (non-Default) and Default situations. Any situations that reach Default will be graded on the Master Grading Scale at Grade 14 and are the subject of separate analysis to inform the development of the new models.

Models for Corporate (total assets <£0.35m) and Retail SME have been built and are pending approval subject to successful independent validations and will be implemented in 2009.

The models that will be developed for Housing Associations and Charities / Not for Profit organisations will be expert judgment models as the portfolios have such low levels of default that traditional model building techniques cannot be employed. The technique involves compiling a scorecard between credit and business experts and then converting that scorecard into a PD model for Basel purposes.

The Leveraged Finance model will be built in a similar way to the replacement Slotting Models, where a third party supplier will be engaged to assist with the model building stage and external data will be used to assist with validation.

In addition to grade migration, arising that is either directly driven by the model or expert judgement overrides being applied, there is an additional Watchlist marker that is applied to help identify where a situation has not reached the point of Default but is one that the Corporate Advances Department merits closer management. This element of the portfolio is subject to regular review by the Heads of Corporate Advances, the Director of Banking Risk and Capital Management together with their respective peers in Corporate Banking and the CRCU as good risk practice and a means of informing future model refinement or development with key risk drivers.

The Corporate Bank applies a single 'Definition of Default' across its whole portfolio (Foundation IRB, Specialised Lending, 3-Year Rollout and Immaterial). This is taken as being one or more of the following:

- where the Bank considers that the borrower is unlikely to repay its credit obligations without recourse by the Bank to actions such as realising security (if held);
- the borrower is past due more than 90 days on any material credit obligation; and
- the borrower has committed an act of default; i.e. bankruptcy, filing for receivership, liquidation etc.

This is more conservative than the BIPRU definition of a combination of 90 and 180 days past due which can be applied for different Asset Classes within Corporate Banking: i.e. Public Sector.

Under Foundation IRB, the regulatory given criteria for LGD (Secured by real estate collateral 35% and Senior Unsecured 45%) and EAD (100%) are applied to the PD elements of the Corporate Asset Class. The FSA prescribed risk weightings for the Slotting Models are applied to the Specialised Lending element of the Corporate Asset Class and the Standardised approach is used for the remainder of the Corporate portfolio in accordance with the CRD Approach agreed with the FSA.

The total Corporate Banking committed exposure across the different Basel exposure classes at the end of 2008 analysed by the IRB Models was £1.3 billion, of which £0.3 billion related to UK quoted plcs and the remainder were unquoted Corporate exposures. Exposures of £1.0 billion were analysed using the PFI slotting model and £2.0 billion using the IPRE (income producing real estate) model.

Wholesale model
The wholesale model is used for all Treasury counterparts, which are largely institutions but also include Central Government and Central Bank.

Credit ratings from ECAIs, Moody's and Fitch, and expert judgement are used to assign an appropriate Internal Rating Grade (IRG) 0-10, and associated probability of default (PD). More conservative, judgemental adjustment to Counterparts' IRG (downward overrides) may be applied provided the credit rationale is clearly stated in the appropriate credit review.

The PD methodology, provided by Ernst & Young (E&Y), is based upon annual corporate bond default statistics sourced from Moody's and Standard & Poor's. PDs are recalibrated annually and reported via the CRCU to the RMG and RMC.

The annual corporate bond default statistics contain over 37 years of data, hence cover at least a full economic cycle, therefore the one year figures quoted in the studies are taken as the long run forward 1 year PD and are mapped against each of the IRG's.

Being based upon corporate default data PDs are deemed to be conservative for the mainly bank / sovereign Treasury portfolio for Pillar I and Pillar II (ICAAP) purposes, given that banks fail but are supported and seldom default.

Central governments and central banks may attain a zero PD within the limit matrix.

These models are used across the Treasury Portfolio representing exposures of £3.5 billion at the reporting date.

Since the Basel II Programme closed in December 2007, the independent validation of the rating models has continued to be undertaken as part of business as usual with external guidance where appropriate.

All developments have been subject to assessment against a comprehensive validation framework, which incorporates all relevant requirements from the prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU).

This approach has been applied to all the unsecured Retail Credit Risk models. Where more limited statistical analysis has been possible then a subset of the full validation framework has been used. This approach has been applied to the Retail Mortgages, Treasury and Corporate Rating Systems (with the exception of the Specialised Lending portfolio modelling, where the slotting criteria is used).

For each rating system, the outcome of the validation process has been fully documented and presented to the CRCU forum. All future model developments and material adjustments are validated against a clear and robust framework by independent resource.

The key medium for review and approval of the IRB rating systems and/or models is the CRCU forum.

This forum is provided with sufficient information to understand:

- broadly, how the models work with key assumptions and approach;
- the key risk drivers;
- the data that has been used, the amount and quality of historical data;
- the calibration process including the provision of data on measures of discriminating power of the systems / models;
- the independent validation process for each model, confirming it was against Basel II standards, and by whom; and
- any caveats or issues arising from the independent validation and how they have been addressed.

Ongoing performance monitoring of the IRB ratings systems/models is undertaken and the results are disseminated at different levels of detail across the organisation.

The independent CRCU teams, staffed with appropriately qualified and experienced professionals, play a key role in the ongoing oversight of the IRB systems/models as the second line of defence. The RMG (chaired by the Chief Financial Officer) hold overall responsibility and accountability for approval of rating models, approaches and their performance. Internal audit provide additional oversight and assurance to senior management, acting as the third line of defence. The Audit and Regulatory Compliance Committee (ARCC) approves the annual audit plan and copies of Audit Reports are circulated to the ARCC and/or the Risk Management Committee as appropriate.

Performance monitoring of the IRB rating systems and/or models is designed to address a number of aspects:

- models performance as predicted;
- models discriminating effectively;
- the risk profile of the population being modeled is stable or changing; and
- key drivers of any changes in performance / risk profile.

Annual review of models

All models are subject to Annual Reviews to ensure they continue to perform satisfactorily in line with the regulatory requirements and to identify any changes that are required to improve their ability to differentiate levels of credit risk. If the actual performance falls outside of expected criteria then this review process will be undertaken earlier. In all instances, the results of the CRCU Review will be reviewed by the Director Banking Risk & Capital Management and presented to the CRCU forum and the RMG for the approval of any required action or acceptance as appropriate.

All amounts are stated in £m unless otherwise indicated

IRB Approach: exposures values and exposure weighted average risk weight for each exposure class by PD band for Foundation IRB

The table below analyses exposure (exposure at default), and risk weight percentage for each IRB exposure class by PD band for exposures subject to Foundation IRB approach.

2008

	PD band									
Exposure value	0.00-0.10%	0.11%-0.20%	0.21-0.30%	0.31-1.00%	1-5%	5-10%	10-50%	50-99%	default	Total
IRB Exposure class										
Central Government and Central Bank	399.1	-	-	-	-	-	-	-	-	399.1
Institutions	2,451.3	867.5	216.3	35.7	-	-	-	-	-	3,570.8
Corporates		97.7	173.7	349.7	286.7	121.8	106.4	-	54.9	1,190.9
Total Foundation IRB	2,850.4	965.2	390.0	385.4	286.7	121.8	106.4	-	54.9	5,160.8
RW %										
IRB Exposure class										
Central Government and Central Bank	1%	-	-	-	-	-	-	-	-	1%
Institutions	13%	24%	50%	82%	-	-	-	-	-	18%
Corporates	-	35%	38%	67%	99%	136%	246%	-	-	88%
Total Foundation IRB	11%	25%	44%	68%	99%	136%	246%	-	-	33%

2007

	PD band									
Exposure value	0.00-0.10%	0.11%-0.20%	0.21-0.30%	0.31-1.00%	1-5%	5-10%	10-50%	50-99%	default	Total
IRB Exposure class										
Central Government and Central Bank	346.8	-	-	-	-	-	-	-	-	346.8
Institutions	2,681.9	330.2	114.4	5.1	-	-	-	-	-	3,131.6
Corporates	30.2	158.3	253.7	528.0	123.6	42.4	3.7	-	53.2	1,193.1
Total Foundation IRB	3,058.9	488.5	368.1	533.1	123.6	42.4	3.7	-	53.2	4,671.5
RW %										
IRB Exposure class										
Central Government and Central Bank	1%	-	-	-	-	-	-	-	-	1%
Institutions	12%	29%	47%	72%	-	-	-	-	-	16%
Corporates	26%	35%	47%	77%	94%	153%	162%	-	-	65%
Total Foundation IRB	11%	31%	47%	77%	94%	153%	162%	-	-	27%

All amounts are stated in £m unless otherwise indicated

IRB Approach: exposures values analysed by EL grades

The table below analyses each Retail IRB exposure class by EL grade, calculated as expected loss as percentage of EAD.

2008

IRB exposure class	EL grade 1	EL grade 2	EL grade 3	EL grade 4	EL grade 5	EL grade 6	Default	Total
Residential mortgages	3,625.9	98.1	197.5	159.5	198.7	12.9	12.4	4,305.0
Qualifying revolving	142.2	406.0	707.4	457.6	443.4	459.9	178.8	2,795.3
Other retail	35.6	-	-	217.5	280.1	274.9	38.8	846.9
Total retail IRB	3,803.7	504.1	904.9	834.6	922.2	747.7	230.0	7,947.2

2007

IRB exposure class	EL grade 1	EL grade 2	EL grade 3	EL grade 4	EL grade 5	EL grade 6	Default	Total
Residential mortgages	3,007.2	77.5	185.0	78.4	151.9	9.7	9.1	3,518.8
Qualifying revolving	115.8	297.9	593.1	510.0	426.1	559.8	172.5	2,675.2
Other retail	51.6	-	-	202.7	275.5	296.9	36.3	863.0
Total retail IRB	3,174.6	375.4	778.1	791.1	853.5	866.4	217.9	7,057.0

EL grades are defined below:

EL grade 1	EL% < 0.05%
EL grade 2	0.05% =< EL% < 0.07%
EL grade 3	0.07% =< EL% < 0.20%
EL grade 4	0.20% =< EL% < 0.40%
EL grade 5	0.40% =< EL% < 2.00%
EL grade 6	2.00% =< EL% < 100.00%

EL = EAD x PD x LGD
EL% = EL / EAD

All amounts are stated in £m unless otherwise indicated

IRB Approach: Actual value adjustments in the preceding period

Within the Pillar 3 disclosure value adjustments are defined as being individual impairments and provisions are defined as collective impairments in line with BBA guidance. The table below analyses individual impairments made in the reporting period. Individual impairments are made against the corporate and retail mortgage IRB exposure classes.

	2008	2007
IRB Exposure class	Actual value adjustments in the year	Actual value adjustments in the year
Central Government and Central bank	-	-
Institutions	-	-
Corporates	2.1	11.3
Retail Exposures secured by real estate collateral	1.5	0.3
Qualifying revolving	-	-
Other retail exposures	-	-
Total	3.6	11.6

The actual value adjustment made in the year represents the individual impairment charge relating to exposures on the IRB approach.

The Corporate impairment charge tends to be more volatile due to the nature and timing of one off charges. In the last year issues arising from the higher risk sectors have continued to be addressed.

The secured mortgage book continues to enjoy extremely low levels of default averaging less than one quarter the rate experienced by other Council of Mortgage Lender member institutions. The subsequent impairment reflects the relatively low average loan to value ratio and the affordability tests applied within our credit assessments.

No defaults were observed for Treasury exposures.

<u>IRB Approach: Firms estimates against actual losses over a longer period</u>

This information will not be disclosed until 2010 in line with the Basel ll Accord as proposed by the BBA Pillar 3 working group. This will allow for more meaningful comparative data to be collected.

<u>IRB Approach: PD, LGD and EAD outcomes against estimates</u>

This information will not be disclosed until 2010 in line with the Basel ll Accord as proposed by the BBA Pillar 3 working group. This will allow for more meaningful comparative data to be collected.

All amounts are stated in £m unless otherwise indicated

The Bank uses collateral and guarantees to mitigate credit risk. Collateral is regularly revalued and guarantees reviewed to ensure continuing effectiveness. The majority of collateral held is not eligible financial collateral, but is real estate collateral either as retail mortgages or real estate collateral held against Corporate lending.

When calculating the value of collateral for regulatory capital risk mitigation purposes, the appropriate valuation criteria contained within BIPRU is applied. When assessing the collateral valuations for Corporate Lending Policy purposes, a more conservative written down value is used, stepped according to the risk level of the asset.

Property collateral for Corporate lending is categorised as security for property development or investment customers (i.e. "property" lending) or owner occupied premises to secure mainstream loan and overdraft facilities. Other security is taken, but only in modest proportion to the total portfolio, includes Life Policies, Stocks & Shares, cash cover and debentures / floating charges. Where exposures are agreed on a secured basis, security cover is recognised only where:

- the security is legally enforceable and is of a tangible nature and type;
- an appropriate, recent and reliable valuation is held; and
- a prudent margin is applied to the valuation, for the type of security involved.

Third party unsupported guarantees are generally excluded unless the guarantor has a risk grade better than the first party being guaranteed and is considered good for their security. Any shortfall of security for an exposure is regarded as unsecured and assessment includes this element of residual risk. Risk mitigation is not material to the Treasury portfolio[12].

Robust policies are in place to manage collateral and valuation with daily monitoring undertaken within Treasury operations. Repos and secured lending positions are revalued daily and whilst monitored daily, margin calls on collateralised swaps are on a weekly basis. Eligible financial collateral for Basel reporting include gilts held as part of reverse repo agreements and cash as part of collaterised swaps or against corporate lending. The guarantees are parental guarantees held against subsidiary exposures. The table below analyses exposure values covered by eligible financial collateral by IRB exposure class.

2008

Exposure class covered by collateral /guarantee	Exposure value covered by collateral after haircut	Exposure value covered by guarantee after haircut
Institutions	505.4	163.1
Corporates	4.3	-

2007

Exposure class covered by collateral /guarantee	Exposure value covered by collateral after haircut	Exposure value covered by guarantee after haircut
Institutions	651.5	273.8
Corporates	0.2	-

[12] Portfolio comprises of parental guarantees in support of trading activity of subsidiaries; Repo agreements (currently UK Gilts); and cash collateralised long dated swaps providing hedges for corporate loans. Credit risk policy determines parameters within which risk may be mitigated and is managed accordingly.

All amounts are stated in £m unless otherwise indicated

The table shows the Bank's exposure to over–the-counter (OTC) derivatives.

In relation to counterparty credit risk	Banking Book	Trading Book	Total
2008			
Gross positive fair value of contracts	131.7	71.3	203.0
2007			
Gross positive fair value of contracts	78.6	9.6	88.2

The Bank does not utilise netting agreements for the settlement of OTC derivatives and no cash collateral was held against OTC derivatives at the reporting date.

The counterparty credit risk mark to market method is used to measure exposure value for counterparty credit risk. The Bank does not utilise credit derivatives within its credit risk management framework.

In the use of Treasury credit ratings from ECAIs (External Credit Assessment Institutions), Moody's and Fitch, and expert judgement the Bank assigns an appropriate Internal Rating Grade (IRG) 0-10, and associated Probability of Default (PD), based upon a limit matrix, which determines the Total Potential Limit (TPL) capacity for any single counterpart or counterparty group. Derivative limits are established, as for other traded products with reference to the limit matrix. The maximum term permitted for Treasury products differs dependent upon the IRG shown on the limit matrix table. The provision of collateral can be used to extend term beyond that shown on the limit matrix.

All counterparties are pro-actively monitored through real-time external rating alerts, and media intelligence gathering. Management actions are taken promptly in response to adverse market conditions or ratings actions and counterparts reviewed on a rolling programme basis in accordance with Credit Risk Policy taking a 'risk based approach'.

Credit trends, credit spreads and market intelligence are under close review day-to-day as are annual, semi-annual and quarterly interim results and loss announcements as they emerge.

There is only one agreement in place where the bank would be required to provide collateral based on a downgrade in credit rating, the amount against which collateral would be required to be provided is equivalent to a VaR figure as determined by the counterpart on the basis of 95th percentile statistical confidence of 10 days volatility for transactions falling under the Credit Support Annex (CSA) as published by the International Swaps and Derivatives Association (ISDA).

Wrong way risk is not material to the Treasury portfolio, however, it may occur. An example of conjectural wrong way risk is that fluctuations in the interest rate causes changes in the value of the derivative transactions but could also impact the credit worthiness of the counterparty. Or, for instance, a macro factor wrong way risk, as an additional source of risk, is rightly of concern to banks and regulators. Such factors are taken into account when counterpart/ country reviews are undertaken.

Item	Description
3 year rollout to Foundation IRB	Portfolios where PD models are being developed by the Bank which will allow use of Foundation IRB Approach (within 3 years). The Pillar 1 capital requirement for these portfolios is currently calculated using the standardised approach.
Application PD	Retail PD model for new customers based on application score, derived from data provided on an application form or credit reference data.
Application score	The credit score calculated on the application data alone. Typically, data provided on an application form and/or credit reference data.
Basel II	Basel II is the regulatory code defining the method by which the Bank calculates its regulatory capital requirements. This is achieved by delivering Pillar 1, Pillar 2 and Pillar 3.
Basel II IRB Permission Application Pack (PAP)	A financial institution planning to use the IRB approach for calculation of its credit risk capital requirement needs to apply for permission from the FSA. The information submitted should at least include: 1. Cover letter requesting the approval; 2. Description of / approach to the control environment; IT infrastructure; validation; data standards; reconciliations / performance monitoring; IRB rating systems (including models); outputs; 3. Documentation of above; 4. Implementation plan (including roll-out); 5. Self-assessment.
Basel Accord	The key Accord to come from the Basel Committee refers to capital adequacy - ensuring that financial institutions retain enough capital to protect themselves against unexpected losses.
Behaviour PD	Retail PD model for existing retail customers based on behaviour score, may also be referred to as behavioural PD.
Behaviour score (behavioural scorecard)	A credit risk scoring system for retail customers assessing the performance of an existing customer's account. Typically using data from previous performance of a customer's account and/or credit reference data.
BIPRU	Part of Financial Services Authority (FSA) handbook setting out prudential requirements: The Prudential sourcebook for banks, building societies and investment firms. Available to view on www.fsa.gov.uk.
BIS	Bank of International Settlements (BIS) is an international organisation which fosters international monetary and financial co-operation and serves as a bank for central banks.
Bureau information	The information resulting from an enquiry to a credit bureau's database, or contained on the customer management monthly update file. This includes judgments, bankruptcy, voters roll, previous search and shared financial/non-financial account information.
Corporate SME	Definition used where the reported sales for the consolidated group of which the firm is a part is less than €50 million.
Credit quality assessment scale	Published by the FSA in accordance with the Capital Requirements Regulations 2006 which maps the external credit rating provided by eligible ECAIs and ECAs to credit quality steps.
Credit quality steps	A credit quality step in a credit quality assessment scale as set out in BIPRU 3.4 (Risk weights under the standardised approach to credit risk) and BIPRU 9 (Securitisation).
CreditEdge version 8 (European)	(also referred to as CreditEdge) External supplier PD generation model used for analysis of quoted Corporate borrowers (UK based and non financial plcs).

Item	Description
CSA	Credit Support Annex is used in documenting collateral arrangements between two parties that trade privately negotiated (over-the-counter) derivative securities. The trade is documented under a standard contract called a master agreement, developed by the International Swaps and Derivatives Association (ISDA). The two parties must sign the ISDA master agreement and execute a credit support annex before they trade derivatives with each other.
Default	Circumstances in which probability of default is taken as 100% for the purposes of the calculation of regulatory capital and compliance with Basel ll. This is defined as where the customer reaches a predefined arrears status (90 days past due for most borrowing) or where the Bank may consider the borrower is unlikely to repay its credit obligation in full without recourse by the Bank to actions such as realising security.
Delphi score	Risk scorecard developed by Experian (Credit Reference Agency) on pooled data, provided by all contributing credit grantors. Characteristics are based on payments, usage and delinquency across all accounts that an individual has. Expressed as a score, this enables a lender to have an industry-wide view of the credit risk and predicted future performance of a customer applying for a lending product.
Draw down risk	The risk to a lender that a customer will withdraw additional funds up to their maximum facility limit.
EAD	Exposure at default, a Basel ll Pillar 1 parameter - the amount estimated to be outstanding at the time of default.
ECA	Export credit agencies are private or quasi-governmental institutions that act as intermediaries between national governments and exporters to issue export financing. The financing can take the form of credits (financial support) or credit insurance and guarantees (pure cover) or both, depending on the mandate the ECA has been given by its government. ECAs can also offer credit or cover on their own account.
ECAI	External Credit Assessment Institution is a credit rating agency e.g. Moody's, Standard and Poor's, Fitch. A credit rating agency (CRA) is a company that assigns credit ratings for issuers of certain types of debt obligations as well as the debt instruments themselves.
EL	Expected Loss, a Basel ll pillar 1 calculation - The amount estimated under the IRB approach to be lost on current exposures due to potential defaults on existing and committed lending over a one year time horizon.
Experian	A credit reference agency used by the Bank. They provide generic scorecards for new and existing customers.
Exposure	The maximum loss the Bank might suffer if: (a) a customer (or counterparty) or a group of connected customers fail to meet their obligations; or (b) it realises assets or off-balance sheet positions.
FIRB	Foundation internal ratings based approach (see IRB), uses standard LGD and EAD parameters but PD is estimated by the Bank.
FSA	Financial Services Authority, an independent body that regulates the financial services industry in the UK.
FSA003	Standard prudential report produced by banks providing capital resources and capital requirement information to the FSA on a regular basis.
ICA	Individual Capital Assessment - output from ICAAP.
ICAAP	Individual Capital Adequacy Assessment Process - capital assessment process stipulated within Basel II incorporating all risk exposures, effectively Pillar 2 element of Basel II framework.
ICAS	Individual Capital Adequacy Standards is the framework used by the FSA to calculate the Individual Capital Requirements of each financial firm affected by the Prudential Sourcebook.
IIF	Institute of International Finance is a world wide association of financial institutions. Provides analysis and research on central issues including regulatory, financial and economic policy issues and advocates best practice and industry standards.

Item	Description
Internal Rating Grade	For Corporate exposures the Bank has adopted an Internal Rating Based approach in accordance with Basel II guidelines. Exposures are sanctioned based on an assessment of the risks' and are allocated a Risk Grade or Rating extracted from a suite of Basel compliant models. These models have been implemented with outputs calibrated to reflect the Corporate portfolio or FSA slotting standards as appropriate. For Treasury exposures individual counterparties may be allocated credit ratings obtained from External Credit Assessment Institutions. These ratings combined with expert judgement drive the formulation of internal rating grades ranging from 0 to 10 and associated probability of default (PDs). These internal rating grades form the basis of the Treasury Counterparty Limit Matrix.
IRB	Internal ratings based approach - approach stipulated within Basel II allowing a more sophisticated and risk sensitive approach to calculate credit risk.
IRRBB	Interest rate risk in the Banking Book
IRS	The Integrated Risk System holds details (including actions to be taken, key indicators, controls in place and required, and commentary) of all risks, near misses and events across CFS.
ISDA	International Swaps and Derivatives Association is the global trade association for over-the-counter (OTC) derivatives, and maintainers of the industry-standard ISDA documentation.
KRI	Key risk indicators.
KCI	Key control indicators.
Leveraged Finance	Stems from lending to companies with a high ratio of debt to market value, or leverage, but has expanded to include a wide variety of borrowers whose debt is considered to be high-risk, or non-investment grade, by rating agencies such as Standard & Poor's, Moody's and Fitch.
LGD	Loss Given Default is a Basel ll Pillar 1 parameter - an estimate of the actual loss that would occur in the event of default expressed as a percentage of the EAD.
LRA PD	A long run average PD is reflective of the long run average default rates expected over a full economic cycle. Also referred to as long run PD.
LTV	Loan To Value is the ratio of current exposure value to the value of the asset held as security.
Master Grading Scale	Brings together the respective expected default frequency (EDF) from Moody's KMV RiskCalc and CreditEdge models to produce a Basel ll compliant Corporate Banking PD.
Moody's KMV RiskCalc version 3.1 (UK)	(Also referred to as RiskCalc) External supplier PD generation model used for analysis of unquoted Corporate borrowers with total balance sheet assets greater than £0.35 million.
PD	Probability of Default, a Basel ll Pillar 1 parameter under IRB approach, estimate of the probability that a borrower will default in next 12 months.
PFI	Private Finance Initiative.
Pillar 1	Pillar 1 Capital is a prescribed measure of capital required by a bank representing the minimum capital requirements. The Pillar 1 capital ratio is calculated using regulatory capital and risk weighted exposure amounts (RWEA). The total capital ratio must be no lower than 8%.
Pillar 2	Pillar 2 is the Basel ll terminology for the internal capital adequacy assessment process, which reviews the capital calculation derived within the Pillar 1 work and calculates the additional capital required through various economic cycles, in addition to other risks not covered under Pillar 1.

Item	Description
Pillar 3	Under Basel ll Pillar 3 covers market discipline. Market discipline takes the form of standard disclosure requirements that are intended to provide information about a bank's exposure to risks and risk assessment processes. The aim is to provide a means of disclosure comparable between banks.
PIT	Point in time refers to Basel ll modelling approach which assesses the risk of an account at a single point in time.
Prepayment risk	The risk to a lender that part or all the principal of a loan will be paid prior to the scheduled maturity. For a bondholder, prepayment risk refers to the possibility the issuer will redeem a callable bond prior to maturity. Prepayments generally occur when market rates of interest decline following the loan origination. Prepayment generally results in reduced cash flow for a bondholder when proceeds from the redemption are reinvested at a reduced interest rate.
Provisions	Collective provision balance.
PPGD	Probability of Possession Given Default is the probability that a proportion of mortgages (secured accounts) will to go to repossession.
PV01/PV100	Daily calculation of the effect on the net present value (NPV) of Treasury portfolios to both parallel and specific point of yield curve stress testing (i.e. non-linear yield curve shifts). Analysis includes daily parallel shifts in yield curve rates of +/- 1, 10 & 100 bps with the resultant change in NPVs representing the potential change in portfolio values (PV01 being represented by the +/- 1bp shift).
Qualifying revolving	Qualifying Revolving Retail Exposure e.g. overdraft, credit cards.
Rating systems	System for implementing scorecards and ranking customers/accounts by risk. May also include decision systems which use the ratings as a key input.
Retail SME	Loans extended to small businesses and managed as retail exposures are eligible for retail treatment under Basel ll, provided the total exposure of the banking group to a small business borrower (on a consolidated basis where applicable) is less than €1 million. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold.
Retail Banking	A division of the Bank which is responsible for personal banking, and small business banking. Income streams include interest on unsecured lending and, fees from ATMs, interest and fees on mortgages.
Retail IRB Approach	Internal Ratings Based approach for Retail customers stipulated within Basel II allowing a more sophisticated and risk sensitive approach to calculate credit risk. More advanced than Foundation IRB approach as PD, LGD and EAD parameters are estimated by the Bank.
Risk grade	Credit risk score or output from a rating system or Basel ll Pillar 1 Model.
Risk unit	Used within Treasury operations, expresses all interest rate mismatches in terms of a common unit of measurement that is easily understood and managed at trader level intraday (i.e. 1 unit is the equivalent of a £1m position at 1 year).
RWEA	Risk weighted exposure amounts or risk weighted assets, amount of exposure deemed 'at risk' according to FSA prescribed calculation for Pillar 1 capital requirement.
Scorecard	A set of questions (called characteristics) that provide the most predictive information on future account performance. The account receives points (or weighting) for each question depending on the answer. These points are then added together to create a score.
Scorecard characteristic	A piece of information which has been statistically proven (in conjunction with other characteristics) to predict future account performance. The characteristics are held on each account/application and are used together to create a scorecard.

Item	Description
Slotting approach	An approach applied to specialised lending exposures to calculate Pillar 1 capital requirement and EL. For each of 5 risk categories that maybe assigned to a specialised lending customer, a set percentage based on the slotting category is applied to the account exposure value to derive capital requirement and expected loss.
SME	Small and medium sized entities.
Specialised lending	A specific Basel portfolio type which are Corporate exposures which possess the following characteristics: 1. the exposure is to an entity which was created specifically to finance and/or operate physical assets; 2. the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; and 3. the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.
Standardised approach	Under Basel ll, the basic method of calculating Pillar 1 capital requirements based on supervisory defined factors which are applied to exposure values based on external credit ratings of the customer.
Stress testing	Assessing the risk of a portfolio using a what-if approach to represent various economic changes, for example, a rise in unemployment.
TOM	Target operating model is a prospective vision of business architecture that aligns operating capacities and strategic objectives, and provides a comprehensive view of the core business areas, processes and structures.
Total Potential Limit (TPL)	For Treasury exposures - the maximum aggregate exposure (Total Potential Limit) extended to any single counterparty. For Retail/Corporate customers - the total exposure up to and including any shadow limits which a customer could utilise.
Trading book	In relation to the Bank’s business or exposures, means its proprietary positions in financial instruments: 1. which are held for resale and/or are taken on by the firm with the intention of benefiting in the short term from actual and/or expected differences between their buying and selling prices or from other price or interest-rate variations; and 2. taken in order to hedge other elements of the trading book.
Value adjustments	Individual impairment balance.
VaR	Value at risk; a standard variance-covariance (VCV) methodology at a 95% confidence level (1 day holding period is used). Procedure for estimating the probability of portfolio losses exceeding some specified proportion based on a statistical analysis of historical market price trends, correlations, and volatilities.
Wrong way risk	This type of risk occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty.