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

Pillar 3 disclosures 2009

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

Contents

Overview and context

For the period ended 31 December 2009
All amounts are stated in £m unless otherwise indicated

Introduction

The Capital Requirements Directive (CRD) 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 evaluation process (Pillar 2) and 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. The disclosure requirements of Pillar 3 as defined by BIPRU 11 are based on The Co-operative Bank[1] Group which is part of the wider Co-operative Financial Services Group (CFS Group).

Frequency

This report will be published on an annual basis and will be 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 reporting period ended 31 December 2009.

Media and location

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

Verification

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

Merger of Co-operative Financial Services and Britannia

The merger of Co-operative Financial Services with Britannia has presented a truly unique opportunity to change the face of financial services in the UK. The legislation enabling co-operatives and building societies to merge came into force only in January 2009 and CFS and Britannia moved at pace to deliver the merger on 1 August 2009. On merger date, the assets and liabilities of Britannia were moved into The Co-operative Bank Group (Bank).

[1] Where reference is made to the 'Bank' within this disclosure, this refers to the combined entity (Co-operative Bank and Britannia).

Scope of application

For the period ended 31 December 2009
All amounts are stated in £m unless otherwise indicated

Scope of application of disclosure requirements

The disclosure requirements of Pillar 3 as defined by the prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) 11 are based on The Co-operative Bank Group.

The Bank also reports on a solo-consolidated basis which is limited to UK based companies which are wholly owned and funded by the Bank.

Operating company	Nature of business	Group capital regulatory returns	Solo consolidated capital returns
The Co-operative Bank plc	Banking	Yes	Yes
Asset finance companies	Leasing	Yes	Yes
Unity Trust Bank plc	Banking	Yes	No*
Co-operative Bank Financial Advisers	Financial advisers	Yes	No*
Co-operative Commercial Limited	Investment company	Yes	No*
The Covered Bond LLPs (heritage CFS and heritage Britannia)	Mortgage acquisition and guarantor of covered bonds	Yes	No*
Platform (PHL)	Mortgage origination	Yes	Yes
Mortgage Agency Services (MAS)	Mortgage lending (acquired)	Yes	Yes
Western Mortgage Services (WMS)	Mortgage administration	Yes	Yes
Britannia Treasury Services (Leek, Meerbrook and Dovedale)	Securitisation vehicles	Yes	No*
Illius Properties	Property investments	Yes	No*
Britannia International	Isle of Man based retail deposits	Yes	No*
Britsafe Insurance Services	Guernsey based mortgage indemnity insurer	No	No*

* A capital deduction is made to represent the equity investment in these companies.

Apart from Britsafe Insurance Services and Britannia International, where dividend payments are subject to local regulatory approvals, and the Covered Bond LLPs, there are no current or foreseen material restrictions or legal impediments to the movement of capital between UK based consolidated entities.

Scope of internal ratings based coverage

The FSA granted approval to the Bank for the use of the Internal Ratings Based (IRB) approach, effective from 1 January 2008, and as part of the merger approved the transfer of IRB permissions from Britannia to The Co-operative Bank. The Co-operative Bank IRB direction was amended accordingly. The scope of IRB permission is identified in the table on the following page.

A number of portfolios are on a three 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 include corporate lending to individuals, overseas corporates, Unity Trust Bank plc, 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	three year rollout to foundation IRB
	Public sector entities	Central governments and central banks	three year rollout to foundation IRB
	Registered social landlords RSL)/ housing associations	Corporates	three year rollout to foundation IRB
	Leveraged finance	Corporates	three year rollout to foundation IRB
	Specialised lending	Corporates	Foundation IRB (slotting approach)
	Asset finance	Corporates	Standardised (immaterial portfolio)
	Overseas corporates	Corporates	Standardised (immaterial portfolio)
	Corporate lending to individuals	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)
	Securitisation	Corporates	Foundation IRB (securitisation ratings based approach)
Other	Equity shares	Equity shares	Standardised (immaterial portfolio)
Unity Trust Bank	_	Institutions	Standardised (immaterial portfolio)
		Corporates	Standardised (immaterial portfolio)

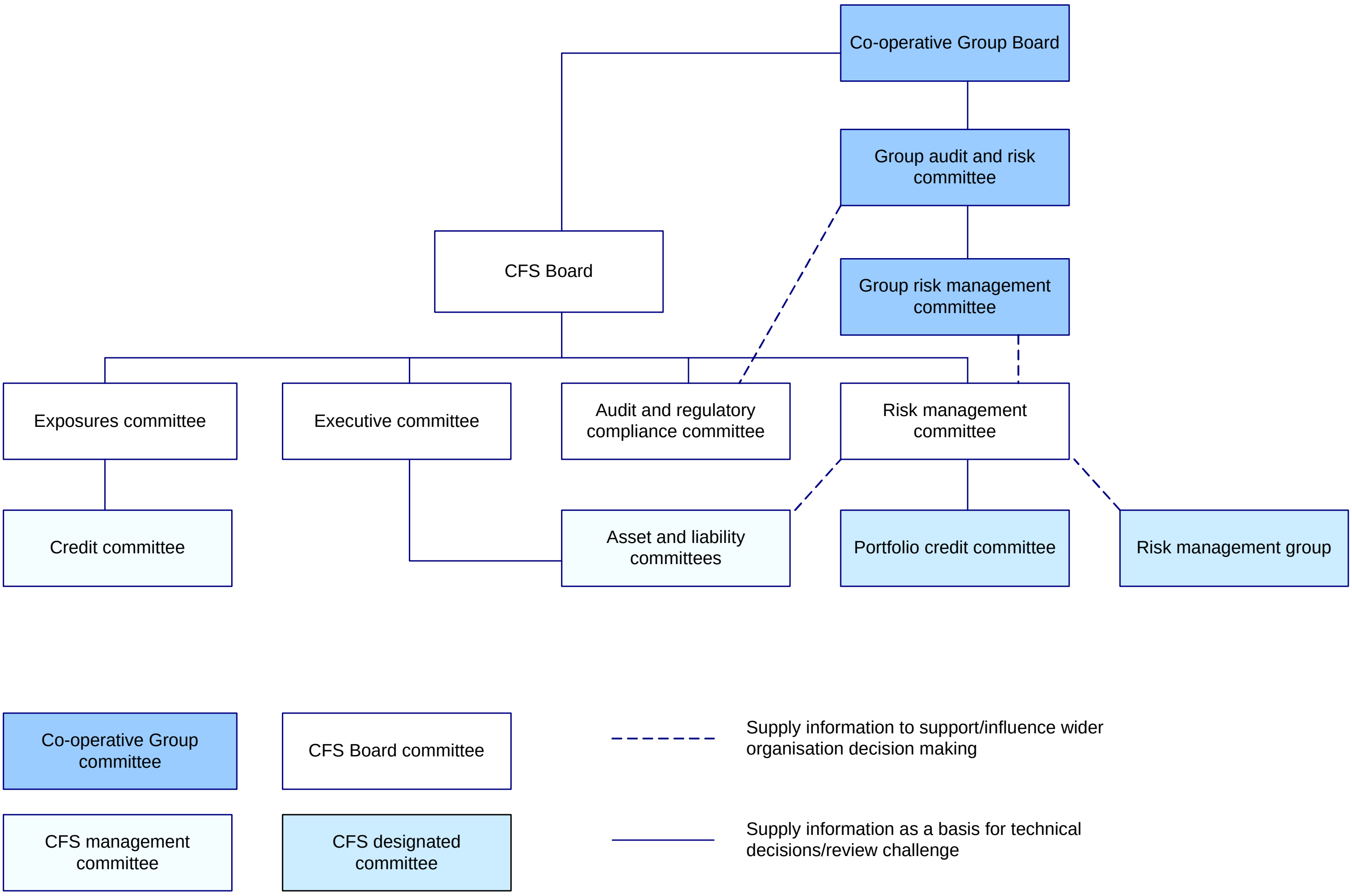
IRB model harmonisation

With effect from merger the capital requirements for wholesale risk have been determined using the CFS rating system for all exposures. Early harmonisation was appropriate due to the large number of common exposures.

For the other rating systems that overlap (corporate income producing real estate (IPRE), housing associations and prime retail mortgages) the calculation of capital requirements is currently determined using standalone models. Harmonisation plans currently cover:

- new models are being developed for corporate IPRE and RSL/housing associations. A phased move to the new models is planned throughout 2010; and
- CFS secured and Britannia member business rating systems will be merged on a phased basis. The first step to this will be harmonisation of the exposure at default (EAD)/loss given default (LGD) parameters with combined scorecards with long-run probability of defaults (PD), and risk grade mapping to follow. Harmonisation plans are currently under development and variable scalars will be considered as part of these plans.

The Co-operative Bank plc forms part of the CFS group of companies including Co-operative Financial Services Limited, Co-operative Insurance Society Limited (Life and Savings business), and CIS General Insurance Limited. These 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 Group Board has ultimate responsibility for the management of all risks across CFS.



Refer to page 6 CFS operational risk committee for operational risk responsibilities.

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) 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 the 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 and any breaches thereof;
- 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;
- review and discussion of technical risk issues identified as a result of internal audit work; and
- review and challenge the impact assessment of the strategic plan on the risk and capital profile of CFS.

CFS audit and regulatory compliance committee (ARCC): this committee provides independent oversight in relation to financial reporting; internal control; 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 portfolio credit committee (PCC): this committee is a designated committee reporting to RMC and chaired by the banking risk officer. It is responsible for defining Bank Group credit risk appetite; providing oversight and timely action in relation to credit risk management; monitoring, challenging and approving changes to Basel rating systems; and reviewing lending and arrears policies.

CFS asset and liability committees (ALCO): these committees are management committees of the Board which are chaired by the chief financial officer. 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 reviewed, challenged and approved (with escalation to RMC where required) and embedded within and across CFS. The committee also monitors all significant and emerging technical risks, and oversees the development and implementation of stress testing and risk appetite across CFS.

CFS credit committee: this committee is chaired by the banking risk officer. 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 business leader regulatory compliance and 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 function.

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, and embedded enterprise-wide, and has been refreshed as part of the merger with Britannia. This framework:

- includes processes for the 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
- enables 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, and model;
- 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.

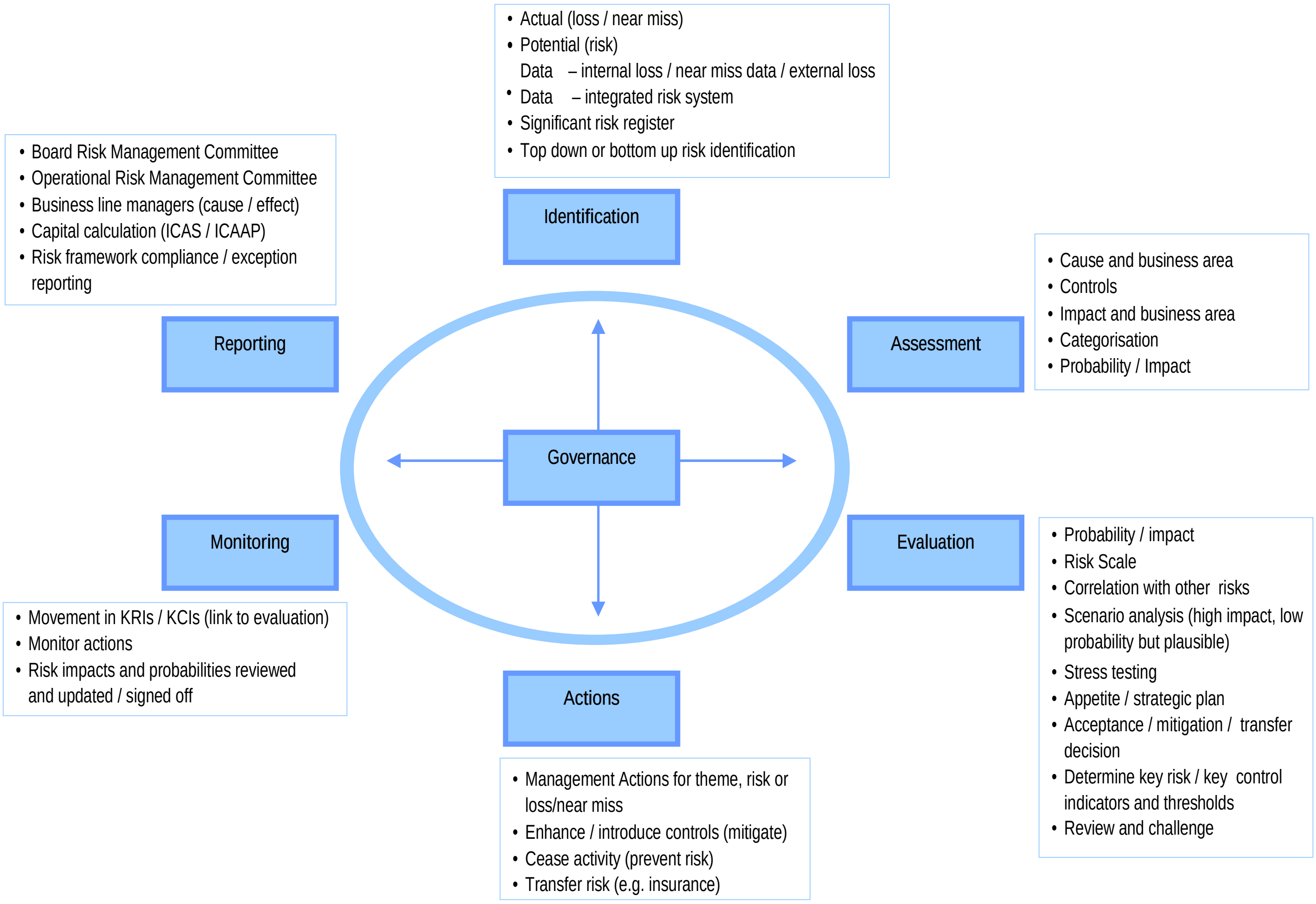
In addition, for all material risks within the Bank's risk profile, the approach to risk management is documented within a set of detailed risk management policies which are owned and approved by the relevant mandated Board committee.

Risk initiatives completed to date include, inter alia:

- harmonisation of the risk categorisation framework to include the Britannia risk profile;
- embedded and approved roles and responsibilities;
- ongoing enhancements to the integrated risk system to continue to capture and monitor all risks across the Bank and CFS;
- improved processes to identify and quantify emerging and actual risk losses;
- key risk and control indicators to assess the adequacy of risk adjusted capital to meet risk appetite and strategic planning targets; and
- appointment of the director of risk as chief risk officer (CRO) for providing oversight and assurance across the overall CFS risk management framework for all CFS risks (technical and operational) and related processes and controls. The CRO is independent from individual entities/business units, but there is common representation of both the CRO and chief financial officer (CFO) at Board, executive, RMC and ARCC. The CRO has the right of direct escalation to the chairs of the RMC and/or the ARCC.

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. In addition, CFS introduced a control self-assessment process which was rolled-out in 2009; and
- on a regular basis, risk and risk appetite management information, liquidity monitoring, stress testing, and quarterly technical risk reporting are undertaken.



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 banking risk officer. The policies determine the criteria for the management of retail, corporate and wholesale risk, including securitisation, 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 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[2].

Interest rate risk policy statements, approved by the CFS RMC on behalf of the Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. The policy is managed 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 balance sheet management manage the effect of interest rate changes on the Bank's overall net interest income. Treasury is responsible for interest rate risk management for 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 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.

Wholesale 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 market volatility within a statistical confidence level of 95% and a one day holding period. Simulation is being developed to provide VaR calculations to cover the combined core banking book positions. 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.

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[2] The Bank does not trade in complex financial derivatives, equities or commodities and has limited foreign currency activities.

Trading value at risk
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.

This illustrates the change in valuation on a fixed income portfolio experienced given a 1% increase and decrease in interest rates for wholesale (banking book and trading book combined).

PV100 is the effect on the net present value (NPV) of the wholesale portfolio to a parallel shift of 100 basis points upon the base yield curve. The effects of a 1% increase in interest rates are £0.4 million and a 1% decrease (£0.2 million).

Analysed by currency the year end position for wholesale banking book is represented in the table below:

	1% increase in interest rates £m 2009	1% decrease in interest rates £m 2009
Wholesale banking book	(0.5)	0.4
By currency:		
- GBP	1.0	(0.3)
- US dollars	(0.2)	-
- Euros	(0.9)	0.4
- Others	(0.4)	0.3
Treasury trading book	0.9	(0.6)
Total treasury	0.4	(0.2)

Currency risk
The Bank's wholesale 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 31 December 2009 the Group's open position was £0.7 million representing a potential loss of £nil 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 wholesale) uses a gap report and 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 wholesale portfolios, banking and investment books, and the rest of the Banks balance sheet. The following describes the Bank non-trading portfolios excluding these certain wholesale portfolios. These positions are managed by treasury. All interest rate risk is centralised into treasury using appropriate transfer pricing rates.

Gap reports are based on defined time periods. ALCO set guidance limits around the gap, principally that the sum of positions maturing in greater than 12 months and non-sensitive balances (includes non-maturity deposits) is no more than a set limit.

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. Treasury 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 gap report and applying a PV01 measure to the gap. The calculation for interest rate risk assumes external rates on variable rate retail products and new fixed rate business changes by fixed amounts based on the Bank's current view of pricing and margins.

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 one 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 five years. In a low base rate environment the amounts of deposits which can no longer re-price increases leading to an increase in interest rate risk in the 'core' bank.

The table illustrates the estimated change in net income over the 12 month period shown based on a 1% shock in interest rates at the beginning of the year across the yield curve on the Bank's balances excluding wholesale treasury and customer currency balances (subject to a 0% floor), which are managed within the treasury risk framework. The shock results are driven by product pricing and product mix. The extent of rate movements and low rate environment have impacted the repricing of liability products resulting in larger exposure to rate shocks.

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 £m	100bp parallel decrease £m
2009		
At 31 December 2009	(0.2)	1.9
Average during the period	(4.4)	5.7
Maximum during the period	3.4	25.6
Minimum during the period	(23.3)	(3.7)

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 RMC 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 utilising a mismatch model on a weekly basis:

- a moderate firm specific stress which assumes a credit rating notch downgrade and consequential outflows;
- a severe firm specific stress which assumes a two notch credit rating downgrade and consequential outflows;
- an idiosyncratic stress scenario which assumes a two notch credit rating downgrade and a 'run' on the Bank defined as twice the worst gross outflows experienced over the last ten years;
- a moderate market wide stress which assumes a restriction in the operation of wholesale markets; and
- a severe market wide stress which assumes a total restriction in the operation of wholesale markets.

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 has a high proportion of retail assets funded by retail deposits, ensuring there is no over reliance on wholesale funding. There is a target funding ratio set in line with the Board approved strategic plan, which is being met. The Group's structural liquidity risk management is therefore retail based and is dependent on behavioural analysis of both customer demand and deposit and loan drawdown profiles by product category based on experience over the last ten 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 £2.5 billion on behalf of the Bank, and actionable management actions are in place to provide an additional £1.5 billion of liquidity. These sources of liquidity totalling £4.0 billion are held in order to be available to meet unexpected liquidity requirements.

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.

The Bank has access to a variety of medium term wholesale funding sources: securitisation, covered bond and EMTN. The Bank will issue from the programmes as funding requirements and market conditions permit.

Post year end, the Bank completed its first RMBS on a merged basis in February 2010. A bond for £2.5 billion was created from the Silk Road programme which utilised prime mortgages as collateral.

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 first 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[3];
- 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 and regulatory advice and financial crime management; and
- internal audit act as the third 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 ARCC. 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 RMC.

2009 has seen the merger of The Co-operative Bank with Britannia. During 2009 – 2012 CFS has a significant change agenda to integrate and transform the combined business. Delivery and implementation of this change agenda is robustly planned and closely managed to ensure delivery is within clearly defined time, cost and quality criteria. As part of this the impact on the CFS operational risk profile (especially in terms of impact on our people, processes and systems) is assessed and managed (both in terms of reduction of risks through implementation of enhanced systems, and through close management of implementation of change).

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

Successful delivery of integration and transformation is managed and reported through appropriate governance and committee structures and through the operational risk framework.

As part of the integration activities, work continues to ensure that the operational risk framework supports successful management of operational risks within the business' appetite.

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

Business continuity framework
Business continuity is managed from within the operational risk team and sets out to take appropriate steps to minimise the risk of disruption in the event of a sudden, unplanned occurrence that could seriously disrupt customer service, or pose a risk to employees, business operations and/or reputation. This includes developing and exercising crisis and incident management teams to maintain appropriate preparedness in the event of a major operational disruption. In 2009, with the emergence of swine flu (H1N1), postal strikes and continued focus on liquidity planning, specific focus has been placed on maintaining and developing our capability to respond to these threats.

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; and
- 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 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. 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; support development and testing of business continuity arrangements for the business; and manage the CFS corporate insurance programme.

Operational risk themes
CFS categorises operational risk into a number of distinct themes for internal management, monitoring and reporting. These have been reviewed and revised to ensure their appropriateness for the merged organisation. Key operational risks managed by CFS are:

<u>Financial crime</u>
This relates to the effectiveness of controls to minimise financial losses arising from the fraudulent activities of employees, customers and third parties[4].

<u>Data security and confidentiality</u>
This enables the organisation to manage and monitor exposures in respect of the potential loss or theft of confidential customer information, recognising the increasing concerns of customers, regulatory authorities and the media in this area, as well as reflecting CFS' risk management culture.

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[4] 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; and
- 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 and facilities

The risk of loss arising from the ownership, management and security of, and threats to, the property and facilities used in CFS' business is managed in partnership with the wider Co-operative Group.

Business continuity

The risk of interruptions to business operations is managed through our business continuity and disaster recovery frameworks and corporate insurance programme, to ensure that CFS is able to respond effectively and continue operations in the event of a disaster, crisis or major incident.

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 could impact on CFS. Risks are monitored relating to the effectiveness of contracts and relationship management to ensure that expected performance levels are achieved.

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.

Management information

Accurate management information is key to decision making. This theme is newly introduced in 2009 enabling risks associated with availability, timeliness, accuracy and adequacy of management information to be separately tracked.

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; and
- regulation risk.

Group wide risks

Pension 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.

The combined entity is exposed to two distinct areas of pension risk:

- PACE – CFSMS and Bank are participating members of the Co-operative Group Pension (Average Career Earnings) – defined benefit scheme; and
- Britannia Pension Scheme – Bank is a participating member of the Britannia Pension Scheme – defined benefit and contribution sections, (defined benefit section closed to new members since 2001).

The Co-operative Group, alongside the scheme trustees, are responsible for the risk management arrangements for PACE, agreeing suitable contribution rates, investment strategies, etc, taking professional advice as appropriate.

CFSMS, alongside the scheme trustees, are responsible for the risk management arrangements for the Britannia Pension Scheme, agreeing suitable contribution rates, investment strategies, etc, taking professional advice as appropriate.

The Bank is therefore exposed to potential future increases in required contributions.

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

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.

Regulatory risk

Regulatory intervention and change is a permanent feature of any financial services business and can have a significant impact on profitability.

The following table shows the capital resources of the Bank Group as at 31 December 2009.

2009

	£m
Core tier one capital[5]	
Permanent share capital	230.0
Retained earnings	1,499.6
Share premium account	8.8
Core tier one capital	1,738.4
Perpetual non-cumulative preference shares	60.0
Total tier one capital before deductions	1,798.4
Intangible assets	(77.4)
Expected loss and securitisation position shortfall	(16.6)
Material holdings and investments that are not material holdings	(0.9)
Total tier one capital after deductions	1,703.5
Tier two capital[6]	
Upper tier two	
Upper tier two capital instruments	256.5
Revaluation reserves	2.9
Upper tier two capital[7]	259.4
Lower tier two capital instruments	614.0
Total tier two capital before deductions	873.4
Expected loss and securitisation position shortfall	(16.6)
Material holdings and investments that are not material holdings	(0.9)
Total tier two capital after deductions	855.9
Total capital resources	2,559.4

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 expected loss shortfall is shown net of tax.

When Britannia merged with The Co-operative Bank, lending portfolios were carried into the newly merged entity at their fair value, taking account of future lifetime expected loss on the lending portfolio. At 31 July 2009, the lifetime expected loss has been treated in the same manner as impairment provisions and therefore included in the expected loss and securitisation position shortfall.

In 2009 the Bank issued £175 million of share capital to its parent company, CFS Ltd, to reinforce its capital strength and give the Bank eligibility for the Government's Credit Guarantee Scheme.

The figures above are inclusive of the fair value assumptions since merger date.

[5] 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.

[6] Revaluation reserves relating to net gains in equities held in the available-for-sale financial assets category are included in lower tier two capital. The lower tier two capital includes five subordinated debt issues: £150 million Step Up Callable Subordinated notes 2019; £150 million Callable Subordinated notes 2021 fixed rate until 2016, then moving to floating rate; £126 million Callable Subordinated notes floating rate until 2016; £200 million Callable Subordinated notes fixed rate until 2024 and £150 million Callable Subordinated notes fixed rate until 2033. The rights of repayment to the holders of subordinated debt are subordinated to the claims of depositors and other creditors of the Bank. The values quoted are the face value of the individual instruments. More information on these can be found in the Bank's annual financial statements.

[7] Permanent interest bearing shares of Britannia converted to perpetual subordinated debt on merger, and are treated as upper tier two capital.

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 “1 in 25” 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 development.

The capital and liquidity management meeting (CAL) is 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 CAL 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 risk appetite reflects the amount and type of risk that the Bank is prepared to seek, accept or tolerate as defined in the following three capital objectives:

1. maintain capital quantity and quality adequate to cover existing and projected risks in the business;
2. maintain capital adequate to be confident of weathering extreme but plausible market scenarios; and
3. generate a good, stable return for members, balanced by a prudent level of leverage.

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 ICAAP which 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 risk, interest rate risk in the banking book (IRRBB), securitisation risk , 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 “1 in 25” economic stress, 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 such as payment protection insurance/financial services compensation scheme levy for which capital is held outside the Bank entity).

The Bank’s most material risk is credit risk, making up more than 79% 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 “1 in 25” economic stress. Having defined the “1 in 25” economic stress parameters, the Bank’s Pillar 2 risks are analysed to determine what, if any, additional capital the Bank needs to hold in such prevailing economic conditions.

Management actions that the Bank would take to respond to the “1 in 25” economic stress and their effect on the Bank’s internal capital adequacy are included within the model and reported in the ICAAP.

Pillar 1 capital requirement

For the period ended 31 December 2009
All amounts are stated in £m unless otherwise indicated

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

2009

	£m
IRB exposure class	
Central government and central bank	0.2
Institutions	85.6
Corporates	87.4
Securitisations	35.6
Retail exposures secured by real estate collateral	408.3
Qualifying revolving	66.2
Other retail exposures	54.7
Total IRB	*738.0*
Specialised lending	*415.8*
Standardised exposure class	
Central government and central bank	-
Regional governments or local authorities	1.5
Administrative bodies and non commercial	7.2
Multilateral development banks	-
International organisations	-
Institutions	7.2
Corporates	161.9
Secured on real estate property	0.1
Retail	2.5
Past due	9.3
Other items	37.5
Total standardised[8]	*227.2*
Total credit risk capital requirement	*1,381.0*
Trading book minimum capital requirements	
Interest rate position risk requirement	2.3
Equity position risk requirement	-
Option position risk requirement	-
Collective investment scheme position risk requirement	-
Counterparty risk capital component	2.1
Concentration risk capital component	-
In respect of all business activities	-
Commodity position risk requirement	-
Foreign currency position risk requirement	0.1
Trading book minimum capital requirements	*4.5*
Operational risk capital requirement	*128.6*
Total Pillar 1 capital requirement	*1,514.1*

[8] Other items within the standardised approach include equity shares with a balance sheet value of £7 million representing two 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.

Analysis of exposures

For the period ended 31 December 2009
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.

2009

Exposure class

	Repay on demand £m	Up to 1 yr £m	1-5yrs £m	5-10yrs £m	10-20yrs £m	Over 20yrs £m	Total exp £m	Average exp £m
IRB								
Central government and central bank	-	1,435.8	7.8	-	-	-	1,443.6	947.8
Institutions	-	3,618.9	2,238.3	-	11.4	18.9	5,887.5	4,812.7
Corporates	-	689.4	240.5	112.4	139.9	0.3	1,182.5	1,229.4
Securitisation positions	-	635.5	1,925.4	130.9	53.3	6.2	2,751.3	1,421.6
Retail mortgages	-	172.5	1,386.1	4,693.2	11,199.1	6,094.7	23,545.6	13,944.0
Qualifying revolving	2,557.2	-	-	-	-	-	2,557.2	2,645.7
Other retail exposures	52.5	33.9	538.0	191.9	-	-	816.3	825.0
Total IRB	2,609.7	6,586.0	6,336.1	5,128.4	11,403.7	6,120.1	38,184.0	25,826.2
Specialised lending	-	846.6	2,114.0	892.1	759.0	928.4	5,540.1	4,230.3
Standardised								
Central government and central bank	1,095.1	-	-	-	-	-	1,095.1	551.4
Regional governments or local authorities	-	47.4	45.2	0.3	1.8	1.8	96.5	90.5
Administrative bodies and non commercial	8.6	27.7	14.0	40.7	28.1	-	119.1	110.9
Multilateral development banks	-	-	-	-	-	-	-	-
International organisations	-	-	-	-	-	-	-	-
Institutions	-	470.0	-	-	-	-	470.0	343.7
Corporates	0.3	547.3	631.8	267.9	389.3	758.7	2,595.3	1,985.4
Secured on real estate property	-	1.3	-	-	-	-	1.3	1.3
Retail	18.5	0.4	5.1	9.9	5.2	9.0	48.1	41.8
Past due	-	8.6	31.3	10.9	5.4	22.1	78.3	56.4
Other items	826.0	-	-	-	-	-	826.0	677.6
Total standardised	1,948.5	1,102.7	727.4	329.7	429.8	791.6	5,329.7	3,859.0
Total credit risk exposures	4,558.2	8,535.3	9,177.5	6,350.2	12,592.5	7,840.1	49,053.8	33,915.5

The average exposure values reflect the impact of the merger with Britannia on 1 August 2009.

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 plc annual financial statements.

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. Specifically, in respect of the corporate and retail mortgage asset classes the prevailing collateral held against these exposures is not shown, however typical loan to value would provide adequate coverage and account for the much smaller amount of value adjustments which have been made. In addition to which lifetime expected loss adjustments have also been applied across certain exposure classes.

2009

Exposure class	Total exposure £m	Of which: Impaired exposures £m	Of which: Past due exposures not impaired £m	Value adjustments and provisions held against impaired exposures £m	Charge for value adjustments in the period £m
IRB					
Central government and central bank	1,443.6	-	-	-	-
Institutions	5,887.5	124.3	-	6.0	-
Corporates	1,182.5	40.0	-	19.5	4.5
Securitisations	2,751.3	25.0	-	8.5	(4.0)
Retail mortgages	23,545.6	1,553.6	393.2	2.3	1.5
Qualifying revolving	2,557.2	161.5	1.9	107.2	-
Other retail exposures	816.3	48.1	2.9	32.6	-
Total IRB	38,184.0	1,952.5	398.0	176.1	2.0
Specialised lending	5,540.1	559.4	66.0	11.5	9.6
Standardised approach					
Central government and central bank	1,095.1	-	-	-	-
Regional governments or local authorities	96.5	-	-	-	-
Administrative bodies and non commercial	119.1	0.9	-	0.6	0.1
Multilateral development banks	-	-	-	-	-
International organisations	-	-	-	-	-
Institutions	470.0	-	-	-	-
Corporates	2,595.3	17.4	-	1.4	-
Secured on real estate property	1.3	-	-	-	-
Retail	48.1	-	0.1	-	-
Past due	78.3	97.1	-	18.9	19.2
Other items	826.0	-	-	-	-
Total standardised	5,329.7	115.4	0.1	20.9	19.3
Total credit risk exposures	49,053.8	2,627.3	464.1	208.5	30.9

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.

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[9] 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. Specifically, in respect of the corporate and retail mortgage asset classes the prevailing collateral held against these exposures is not shown, however typical loan to value would provide adequate coverage and account for the much smaller amount of value adjustments which have been made.

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.

(*)The specialised lending category relates to the Private Finance Initiatives (PFI) and property exposures within the corporate exposure class.

2009

Exposure class/industry	Total exposure £m	Of which: Impaired exposures £m	Value adjustments and provisions held against impaired exposures £m	Charge for value adjustments in the period £m
Corporate exposure class				
Care	268.1	-	-	-
Education	381.4	-	-	-
Football clubs	88.8	33.0	14.8	1.0
Garages/retail motor vehicles	91.8	0.5	-	0.2
Hotels/restaurants/clubs/pubs	275.1	39.9	7.5	6.5
Housing associations	1,072.2	-	-	-
Leasing and other financial institutions	216.3	4.9	0.1	0.1
Manufacturing	257.4	15.1	8.0	7.2
Professionals	102.4	0.9	0.8	0.5
Public sector entities	31.0	1.1	0.6	-
Commercial investment	3,528.3	283.5	3.0	3.3
Residential investment	797.3	280.5	1.1	0.3
PFI and NHS lift schemes	254.5	-	-	-
Construction	467.5	17.7	3.1	1.4
Retail distribution	410.4	0.3	0.3	0.3
Services	688.1	23.3	11.3	9.8
Transport	238.4	11.0	-	1.5
Utilities	186.0	-	-	-
Other	41.1	1.7	0.2	0.4
Total	9,396.1	713.4	50.8	32.5
Analysed by approach:				
IRB corporates	1,182.5	40.0	19.5	4.5
Specialised lending (*)	5,540.1	559.4	11.5	9.6
Standardised corporates	2,595.3	17.4	1.4	-
Standardised past due	78.2	96.6	18.4	18.4
Total	9,396.1	713.4	50.8	32.5

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

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, judgments 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 and the total loss following that event. 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.

In corporate banking, collective provisions are raised in situations where there is some uncertainty over the recoverability of the customer lending but it is too early to raise a specific provision. As the recovery progresses, the collective provision will move across to a specific provision against the customer.

For residential mortgages, collective provisions can be made against accounts in arrears where an impairment trigger has occurred but individual provisions are not made. External credit reference information is used alongside internal default and possession rates for this purpose.

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 impaired mortgage accounts. Additionally, individual provisions are raised on accounts in arrears, but not impaired.

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 corporate, mortgage and unsecured retail lending balances past due but not yet impaired.

Fair value adjustments and provisions held against impaired exposures

When Britannia merged with The Co-operative Bank, the heritage Britannia lending portfolios were carried into the newly merged entity at their fair value, taking account of future lifetime expected loss on the lending portfolios at 31 July 2009. The lifetime expected loss adjustment is offset against the heritage Britannia gross lending balances in the combined entity's financial statements. For 2009 the balance sheet impairment provision and income statement charge in the Bank financial statements relates solely to heritage Bank lending portfolios. In future years this will also incorporate any loss provisions on new business generated by the merged entity and any additional loss provisions not covered by the lifetime expected loss calculation on the heritage Britannia lending portfolios.

Movement in value adjustments and provisions for impairment

For the period ended 31 December 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.

2009

	Corporate £m	Retail secured £m	Retail unsecured £m	Total £m
Opening balance	46.0	1.5	140.4	187.9
Amounts written off	(27.5)	(0.7)	(78.2)	(106.4)
Charge against profits	34.5	1.5	80.1	116.1
Recoveries	(0.1)	-	-	(0.1)
Any other adjustments	(1.0)	-	(2.5)	(3.5)
Closing balance	51.9	2.3	139.8	194.0

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 led to a loss of active markets or availability of traded prices for particular assets.
A £6 million 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:

	2009 £m
Opening balance	92.3
Charge for the period	(4.0)
Any other adjustments	(1.9)
Closing balance	86.4

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. 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.

2009	Credit quality step							
	1	2	3	4	5	6	Unrated	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Central governments and central banks	1,095.1	-	-	-	-	-	-	1,095.1
Regional governments or local authorities	-	-	-	-	-	-	96.5	96.5
Administrative bodies and non commercial	-	-	-	-	-	-	119.1	119.1
Institutions	450.0	20.0	-	-	-	-	-	470.0
Corporates	-	-	-	-	-	-	2,595.3	2,595.3
Secured on real estate property	-	-	-	-	-	-	1.3	1.3
Retail	-	-	-	-	-	-	48.1	48.1
Past due	-	-	-	-	-	-	78.3	78.3
Other items	-	-	-	-	-	-	826.0	826.0
Total standardised approach	1,545.1	20.0	-	-	-	-	3,764.6	5,329.7

Specialised lending

For the period ended 31 December 2009
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 of lending to PFI and property investment and development. The slotting approach is used and the table analyses exposure (EAD) only by slotting category and excludes the collateral held.

2009

Slotting category	Exposure value £m
Strong	373.8
Good	3,578.4
Satisfactory	673.1
Weak	463.1
Default	451.7
Total	5,540.1

Asset-backed securities (ABS)

The Bank has total ABS exposure of £2.8 billion. They are generally debt instruments that are held until they mature, although they may be sold or used as collateral for short-term borrowing (repos) in response to needs for liquidity or changes in interest rates. The Bank has no direct exposure to US sub-prime assets or US retail mortgage-backed securities.

ABS are assessed using the ratings-based approach, where risk weight percentages are applied to each deal depending on the external rating, seniority and granularity of the instrument.

The securitisation ratings based approach under foundation IRB is used to calculate risk weighted exposure amounts.

The portfolio consists of a diverse range of individual transactions where maximum exposures are limited according to their respective rating levels and the size of the transaction.

ABS securitisation exposures by risk band

External rating	Credit quality step	Senior and granular £m	Non-senior and granular £m	Non-senior and non granular £m
AAA or A1/P1	1	2,110	26	37
AA	2	14	172	22
A+	3	-	25	-
A or A2/P2	4	-	161	-
A-	5	-	24	-
BBB+	6	2	11	-
BBB	7	-	111	-
BBB-	8	-	7	-
BB+	9	-	-	3
BB	10	-	1	1
BB-	11	-	-	6
Rated below BB- or A3/P3	12	7	5	6
Total		2,133	543	75

Notwithstanding the risk banding allocation, all transactions where no value adjustment is held continue to meet their payment obligations and are expected to redeem in full.

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

Originated securitisations

Securitisation risk is the residual credit risk arising from retaining an interest in the Banks securitisation companies through the provision of subordinated debt and/or start up expense loans where applicable. The Bank has historically entered into securitisation transactions in which it sells mortgages to special purpose vehicles (SPVs). These SPVs are included as subsidiaries in the consolidated financial statements. The Bank continues to recognise these securitised assets as loans and advances to customers on the balance sheet and income from the securitised assets continues to be recognised as income. Securitisations provide a committed and linked source of funding for higher-risk mortgage lending.

The Co-operative Bank plc has 13 years’ experience issuing securitisations under the “Leek” programme, and has built up a depth of knowledge, processes and management information to deal effectively with these funding vehicles. Securitisation has historically been used as part of a balanced portfolio management approach whilst helping to increase the diversification of funding sources available whilst managing maturity mismatch risk and also assisting overall credit risk management.

Securitisations

For the period ended 31 December 2009
All amounts are stated in £m unless otherwise indicated

The appetite for securitisation risk is low, and the Bank has only acted as mortgage originator and servicing agent. The Bank does not provide liquidity facilities, bridging loans or repackaging nor does it act as underwriter or dealer in the securitisations. All transactions have relevant accounting and legal advice to ensure compliance with applicable regulatory/statutory rules and are also approved at Board level.

The table below shows the initial funded amount and value as at 31 December 2009 of subordinated and start-up loans in respect of securitisations sold to third party investors.

Originated securitisation exposures

	Initial funded amount £m	Value £m
Subordinated loans		
Leek Finance Number 15 plc	19	25
Leek Finance Number 16 plc	15	21
Leek Finance Number 17 plc	23	28
Total protected by Dovedale	57	74
Leek Finance Number 18 plc	23	27
Leek Finance Number 19 plc	18	18
Total not protected by Dovedale	41	45
Start up loans		
Leek Finance Number 19 plc	3	3
Total subordinated and start up loans	101	122

SPV Company	Total notes issued £m	Date of issuance	Notes Outstanding £m
Traditional			
Leek Finance Number 15 plc	1,080	April 05	267
Leek Finance Number 16 plc	961	October 05	332
Leek Finance Number 17 plc	1,168	April 06	531
Leek Finance Number 18 plc	1,048	October 06	628
Leek Finance Number 19 plc	833	April 07	611
Total	5,090		2,369
Synthetic			
Dovedale Finance Number One plc	102	June 06	64

The only risk-weighted exposures included in the capital calculation for the mortgages that have been securitised relate to the repurchase of £99 million AAA securities across Leek 17,18 and 19 (debt buy back) in July 2009. These exposures are included in the previous structured investment tables. All other mortgage risk has been transferred to the investors (other than the subordinated loans detailed above). The supervisory formula method under BIPRU 9 is followed in determining the capital exposure and treatment of any subordinated-loan exposure on which the Bank does not have protection via Dovedale.

Fitch, Moody's and Standard & Poor's have been used as external credit assessment institutions on all outstanding Leek securitisations. Dovedale was rated by both Moody's and Standard & Poor's.

Securitisations

For the period ended 31 December 2009
All amounts are stated in £m unless otherwise indicated

The Bank has not entered into any new securitisation transactions during 2009 that constitute significant risk transfer under the BIPRU 9 FSA framework. For corporate planning purposes it is assumed that such markets may re-open during 2010 and provide the Bank with the opportunity to access these markets to diversify funding sources and/or generate additional contingency collateral. Detailed disclosures around each remaining active (and historic) securitisation are published each quarter on the Britannia website at the following address: www.britannia.co.uk/home/bts/.

The Bank entered into one securitisation transaction during 2009, Leek 22, which was not subject to significant risk transfer rules under BIPRU 9. The notes issued by this company were retained and have been used in the Bank of England's Special Liquidity Scheme/Long Term Repo.

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.

The CRCU is responsible for the development, recommendation and monitoring of risk appetite, lending policy, rating systems and lending procedures across retail and corporate.

Unsecured lending – credit approval

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. Basel 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.

Mortgage lending – credit approval

The Bank uses a variety of models to assess new mortgage applications, depending on which part of the Group the application is received. The application models are integral in the assigning of the IRB rating band. The models have all been developed based on the profile of mortgage applicants received by the specific business area. Each model uses a combination of Experian data and information from the application form.

The calculation of the application scores and subsequent credit decisions are fully automated within the application processing system. The score is supplemented with lending policy and affordability checks, and, where necessary, applications are referred to underwriters to ensure compliance with policy and to allow expert judgment, within mandates.

Retail individual and portfolio limit setting

For the period ended 31 December 2009 the portfolio limits in place for the lending portfolios were those agreed for the heritage businesses prior to the merger, subsequently ratified by the new board. These were based on an overall assessment of the strategic fit of each sector taking into account the relative risk using outputs from the capital models, expected returns, and other factors. For retail unsecured lending, 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.

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 decisioning.

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 is a suite of bespoke, externally and internally 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.

Corporate lending – credit approval

The CFS corporate banking customer engagement model comprises of business development managers, relationship managers and support staff.

Corporate Banking is separate from the CRCU which 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 underwriting 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 underwriting 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 banking risk officer, credit and exposure committees are operated to sanction the largest credit applications.

The corporate underwriting 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 RMC 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 CRCU framework support the treasury business group.

Wholesale markets credit risk framework takes a 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 PD, to approve limits to individual counterparties within the parameters established by the credit risk policy. The RMC 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.

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. CFS RMC is provided with credit risk MI within the technical risk MI pack;
2. CFS RMG receive, review and challenge, on a regular basis, key credit risk MI within the technical risk pack;
3. CFS PCC MI drills down to considerably greater depth, examples being by risk pool, campaign or key characteristic; and
4. CRCU receive and review, on a regular basis, credit risk MI by, for example, 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 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; and
- high level credit risk performance.

Risk management group management information

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

Portfolio credit committee management information

The PCC MI is produced on a monthly basis, 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 (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, 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; and
- key characteristics monitored with trends analysed and 'point-in-time' values compared to development/validation samples.

Early warning 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
Several PD models for both new to Bank and existing customers have been built based on external bureaux 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.

Generally 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 estimates of how these grades would perform over an economic cycle. This is done by either using historic internal and external information, where possible, or by modelling the various risk grades under different stressed macroeconomic scenarios. Different long run PDs are assigned depending on product type and business area.

The LGD models are also tailored towards each business area. These are all parameter based systems using a combination of statistical modelling of internal historic data, forward looking forecasts (e.g. downturn house price assumptions) and, where necessary, internal and external expert views and information from external sources. 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 balances and costs, along with time to possession and sale parameters and discounting.

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 necessary at sector level, with a 5% floor being applied to individual mortgage accounts.

The models are applied to all residential mortgage accounts, £23.3 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 such as bankruptcy. This is more conservative than the BIPRU definition of 180 days for retail exposures.

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 predominantly 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 LRA PD is used to determine capital requirements.

Statistical techniques were used to develop homogenous LGD pools across the unsecured portfolio, whereas the long run average LGD (at development) was used for the up-to-date, arrears and charge off segments across the retail unsecured portfolio. These models directly estimate the average loss (percentage) of EAD over either a 24 (up-to-date and arrears) or a 36 (default and charge-off) 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 and further conservatism if required, 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). In line with BIPRU requirements, where exposure does not exceed current drawings the current drawings are taken as the EAD (e.g. loans).

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.

An assessment of EAD behaviour in varying economic conditions is used to determine the expected EAD in a downturn. Further adjustments are applied where necessary to ensure that the EAD is sufficient to cover the pool level current drawings.

These models are applied across the entire retail unsecured portfolio (credit cards, loans, and current accounts) which covers approximately two million accounts and £4.5 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 4.

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 plc'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.

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 LRA 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 underwriting (the credit team) using their expert judgment 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 a 'three year rollout to foundation IRB'. The element of the portfolio that falls under the 'three 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 <£0.35 million) and retail SME have been built and are pending approval subject to successful independent validations and will be implemented in 2010.

The models that will be developed for RSL/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 calibrated to the master grading scale.

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 either directly driven by the model or expert judgment 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 underwriting department merits closer management. This element of the portfolio is subject to regular review by the function leaders corporate underwriting and corporate credit, and the banking risk officer 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, three-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/or
- 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 2009, analysed by, the IRB models was £7.0 billion. Of this figure, regulatory slotting models were used to analyse and grade £0.8 billion PFI assets and £4.9 billion real estate assets.

Wholesale model

The wholesale model is used for all treasury counterparts, which are largely institutions but also include central government and central banks.

Credit ratings are derived from a variety of information sources including external credit assessment institutions (Moody's, Standard & Poor's, and Fitch) based on fundamental credit analysis to assign an appropriate internal rating grade (IRG) 0-10, and associated PD. More conservative, judgmental adjustment to counterparts' IRG (downward overrides) may be applied and the credit rationale is clearly stated in the appropriate credit review.

The PD methodology, developed with Ernst & Young (E & Y), is based upon annual corporate bond default statistics sourced from Moody's and Standard & Poor's.

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 used to generate the long run forward one year PD and are mapped against each of the IRGs.

Being based upon corporate default data PDs are deemed to be conservative for the mainly bank/sovereign wholesale portfolio for Pillar I and Pillar II (ICAAP) purposes. PDs are recalibrated annually and reported via the CRCU to the PCC and the RMC.

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

These models are used across the wholesale portfolio representing exposures of £7.3 billion at the reporting date.

Investments in structured products, totalling £2.8 billion, are separately rated using the ratings based approach as detailed in BIPRU 9.

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 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 PCC (chaired by the banking risk 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 ARCC approves the annual audit plan and copies of audit reports are circulated to the ARCC and/or the RMC 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 banking risk officer and presented to the PCC for the approval of any required action or acceptance as appropriate.

IRB approach: exposure 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.

2009

	PD band									
	0.00-0.10% £m	0.11-0.20% £m	0.21-0.30% £m	0.31-1.00% £m	1-5% £m	5-10% £m	10-50% £m	50-99% £m	Default £m	Total £m
Exposure value										
IRB Exposure class										
Central government and central bank	1,443.6	-	-	-	-	-	-	-	-	1,443.6
Institutions	4,254.2	894.9	653.8	63.3	-	-	-	-	21.3	5,887.5
Corporates	-	52.8	168.5	286.8	445.9	101.9	87.0	-	39.6	1,182.5
Total foundation IRB	5,697.8	947.7	822.3	350.1	445.9	101.9	87.0	-	60.9	8,513.6
RW %										
IRB exposure class										
Central government and central bank	0%	-	-	-	-	-	-	-	-	0%
Institutions	13%	24%	40%	80%	-	-	-	-	0%	18%
Corporates	-	26%	47%	70%	104%	142%	218%	-	0%	92%
Total foundation IRB	10%	24%	41%	72%	104%	142%	218%	-	0%	25%

IRB approach: exposures values analysed by expected loss (EL) grades

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

2009

IRB exposure class	EL grade 1 £m	EL grade 2 £m	EL grade 3 £m	EL grade 4 £m	EL grade 5 £m	EL grade 6 £m	EL grade7 £m	Total £m
Residential mortgages	15,251.4	590.1	1,648.9	1,343.2	2,579.4	1,325.7	806.9	23,545.6
Qualifying revolving	160.4	431.1	639.5	324.5	411.1	389.6	201.0	2,557.2
Other retail	42.9	-	-	226.3	292.1	200.6	54.4	816.3
Total retail IRB	15,454.7	1,021.2	2,288.4	1,894.0	3,282.6	1,915.9	1,062.3	26,919.1

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 grade 7	EL% = 100.00%

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

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, it is residential real estate collateral for retail mortgages or either residential or commercial 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 and 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[10].

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.

2009

Exposure class covered by collateral/guarantee	Exposure value covered by collateral after haircut £m	Exposure value covered by guarantee after haircut £m
Institutions	425.5	500.4
Corporates	245.4	-

[10] 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.

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

In relation to counterparty credit risk 2009	Banking book £m	Trading book £m	Total £m
Gross positive fair value of contracts	974.3	48.7	1,023.0

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, Moody's and Fitch, and expert judgment the Bank assigns an appropriate internal rating grade (IRG) 0-10, and associated 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 are three agreements in place where the Bank would be required to provide additional collateral based upon a downgrade by credit rating reference agencies. The required severity of the ratings downgrade and the amount of additional collateral varies for each arrangement. In each instance the additional amount of collateral is a dynamic rather than a static amount and is typically linked to a counterparty's underlying exposure to the Bank.

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.

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