The Co-operative Bank plc
Pillar 3 disclosures 2012

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1. Overview and context

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

1.1 Introduction

The Capital Requirements Directive (CRD), initially introduced on 1 January 2007, sets out the disclosure requirements for firms operating under its 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 the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU 11) are based on The Co-operative Bank plc including its subsidiaries (hereafter referred to as 'the Group') which is part of the wider Co-operative Banking Group. The Co-operative Banking Group is an internal brand, which is a consolidation of the following entities: CFS Management Services Ltd, CFS Services Ltd, CIS General Insurance Ltd, Co-operative Insurance Society Ltd, Co-operative Asset Management Ltd and Co-operative Bank plc.

1.2 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. These disclosures are based on the reporting period ended 31 December 2012.

1.3 Media and location

The report will be published on the Co-operative Banking Group website: www.co-operativebankinggroup.co.uk.

1.4 Verification

These disclosures have been internally reviewed and verified. They will be externally verified only to the extent they are equivalent to those made under accounting requirements.

2. Scope of application

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

2. Scope of application

The disclosure requirements of Pillar 3, as defined by BIPRU 11, are based on the Group. Remuneration disclosures are excluded from the scope of these disclosures and will be disclosed separately, in accordance and in compliance with FSA PS10/21, within the financial statements directors' remuneration report (page 20). The financial statements will be published on The Co-operative Banking Group website: www.co-operativebankinggroup.co.uk.

The Group also reports on a solo-consolidated basis which is limited to UK based companies which are wholly owned and funded by the Group. Based on the BIPRU 11 requirement this Pillar 3 disclosure is reported on a Group basis only. The Group is defined as The Co-operative Bank consolidated with its subsidiaries as follows:

Operating company	Nature of business	Group capital regulatory returns	Solo consolidated capital returns
The Co-operative Bank plc	Banking	Yes	Yes
Co-operative Commercial Limited	Investment company	Yes	No*
Unity Trust Bank plc (held through Co-operative Commercial Limited)	Banking	Yes	No*
Britannia Treasury Services Limited	Holding Company	Yes	Yes
Platform companies	Mortgage origination	Yes	Yes
Mortgage Agency Services Number One, Two, Four – Six Limited	Mortgage lending (acquired)	Yes	Yes
Western Mortgage Services Limited	Mortgage administration	Yes	Yes
Asset finance companies	Leasing	Yes	Yes
Britannia Asset Management Limited	Holding Company	Yes	Yes
Britannia Development and Management Company Limited	Property Investments	Yes	Yes
Britannia Life Direct Limited	Financial Services	Yes	Yes
Illius Properties Limited	Property investments	Yes	No*
Britannia International Limited	Isle of Man based retail deposits	Yes	No*
Moorland Covered Bonds LLP	Mortgage acquisition and guarantor of covered bonds	Yes	No
Leek Finance (Number Seventeen – Twenty Two) plcs	Securitisation vehicles	Yes	No
Silk Road Finance (Number One – Three) plcs	Securitisation vehicles	Yes	No
Cambric Finance Number One plc	Securitisation vehicle	Yes	No
Meerbrook Finance (Number One – Four, Six) Limited	Securitisation vehicles	Yes	No

* A capital deduction is made to represent the equity investment in these companies. No equity investment is held in securitisation vehicles hence no capital deduction at a solo consolidated level.

There are no current or foreseen material restrictions or legal impediments to the movement of capital between UK based consolidated entities, with the exception of:

- Britannia International, where dividend payments are subject to local regulatory approvals;
- Securitisation vehicles and Covered Bond LLP with assets being ring-fencing within such entities; and
- Unity Trust Bank plc which being separately regulated needs to maintain a minimum prescribed level of capital.

2. Scope of application continued

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

2.1 Scope of IRB coverage

The FSA has granted approval to the Group for the use of the internal ratings based (IRB) approach[1]. The scope of IRB permission is identified in the table below. The areas falling outside the scope of the IRB permission and remaining on standardised approach include Unity Trust Bank plc, asset finance and equity shares.

Coverage of IRB recognition granted and approaches by business area/portfolio

Business area	Portfolio	IRB exposure classes	CRD approach
Retail	Mortgages (including Buy to Let 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	Standardised (immaterial portfolio)
	Business Banking	Corporates	Foundation IRB
	Public sector entities	Central governments and central banks	Standardised (immaterial portfolio)
	Registered social landlords (RSL)/housing associations	Corporates	Foundation IRB
	Leveraged finance	Corporates	Standardised (immaterial portfolio)
	Specialised lending	Corporates	Foundation IRB (slotting approach)
	Asset finance	Corporates	Standardised (immaterial portfolio)
Treasury	Central governments and central banks	Central governments and central banks	Foundation IRB
	Financial institutions	Institutions	Foundation IRB
	Structured investments/credit trading funds	Corporates	Foundation IRB (securitisation ratings based approach)
	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)
Operational Risk			Standardised approach
Market Risk			Standardised approach

2.2 IRB model harmonisation

With effect from the merger between Britannia Building Society and the Bank on 1 August 2009, the capital requirements for wholesale risk have been determined using the Group rating system for all exposures. Early harmonisation was appropriate due to the large number of common exposures, and the heritage Britannia commercial lending income producing real estate models have now been replaced with new slotting models covering the combined portfolio of the business. For prime retail mortgages the calculation of capital requirements is largely determined using standalone models, which are gradually being harmonised. A harmonised exposure at default (EAD) model was implemented in 2012. This gives a single structure to the EAD calculation for all mortgages, though the specific parameters it uses continue to reflect the differences in the respective portfolios where appropriate. The next step will be a harmonised loss given default (LGD) model, followed by combined scorecards with long run probability of defaults (PD) and risk grade mapping.

1 Effective from 1 January 2008 and as part of the merger in 2009, the FSA approved the transfer of IRB permissions from Britannia Building Society to The Co-operative Bank. The Co-operative Bank IRB direction was amended accordingly.

3. Capital adequacy

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

The Bank's policy is to maintain a capital base so as to ensure investor, creditor and market confidence and to sustain future development of the business. However, the Bank still recognises the need to maintain a balance between the potential higher returns that might be achieved with greater gearing, and the advantages and security afforded by a sound capital position.

The Bank's capital position remains acceptable with a period end Core Tier 1 ratio of 8.8% (31 December 2011: 9.6%). Throughout 2012, the Bank and its individually regulated operations have complied with all externally imposed capital requirements.

Since the year end, the Bank has completed a securitisation transaction to reduce risk on the balance sheet, which has improved the Core Tier 1 ratio by 0.4%, which would increase the year end ratio to 9.2% on a pro forma basis. This transaction is one of a range of actions targeted as part of a strategic review at improving our capital strength.

A capital buffer above Individual Capital Guidance (ICG) is being maintained, to provide the ability to absorb capital shocks.

3.1 Capital ratios

Table 1 – Capital ratios

Capital ratios	2012 %	2011 %
Core Tier 1	**8.8%**	9.6%
Tier 1	**9.4%**	10.1%
Total capital	**14.4%**	14.7%

Core Tier 1 ratio has reduced by 0.8% to 8.8% as at 31 December 2012. This is due to a 18% (£369.6m) decrease in Core Tier 1 after deductions, offset by a 12% (£2,351.3m) decrease in risk weighted assets. The reduction in Core Tier 1 is primarily due to the £673.7m before tax statutory loss (£508.1m after tax). The result for the year was principally driven by a £468.7m credit impairment, £150m asset impairment and £149.7m Payment Protection Insurance (PPI) provision offset by a £96.8m operating profit in the core business. Core Tier 1 has also benefited from an £80m capital injection from the Co-operative Banking Group.

The reduction in risk weighted assets is primarily due to a 21% (£2,016.9m) reduction in corporate risk weighted assets. The change is driven by the reassessment of the carrying value corporate real estate exposures together with ongoing review of regulatory capital requirements. Slotting models are used to analyse and monitor specialised lending exposures to property which are assigned to FSA supervisory categories with predefined risk-weights. A significant proportion of loans have been downgraded with many moving into default. Loans in default have a zero risk weight (but a 50% Expected Loss). Downgrades are the primary reason for the reduction in corporate risk weighted assets.

In addition, other Corporate and Business Banking (CABB) risk weighted assets, mainly Optimum, have decreased by 9% (£425.5m) due to continuing run-off of the book. Market and counterparty risk weighted assets have increased by £441.0m. This was primarily due to increased holdings of short dated gilts, UK covered and UK government guaranteed bond holdings which were purchased to invest the Bank's surplus liquidity.

Total excess of expected loss over impairment, a deduction from capital resources, has increased by £91m. Although credit impairments have increased significantly this has been more than exceeded by higher expected loss which has been driven by Corporate downgrades.

In accordance with FSA guidance to the British Bankers' Association (BBA), the allocation of the expected loss shortfall across different tiers of capital has changed (see section 3.2.1). 2011 capital ratios have been recalculated on this basis.

3.2 Capital resources

The Bank's regulatory capital is analysed into two tiers:

Tier 1 capital:

Tier 1 capital includes share capital, retained earnings, and non-cumulative irredeemable preference shares. Retained earnings exclude gains or losses on cash flow hedges and available for sale assets.

Tier 2 capital:

Revaluation reserves relating to net gains on equity held in the available for sale financial assets category are included in Tier 2 capital. The Tier 2 capital includes subordinated debt issues and perpetual subordinated bonds (PSBs). The rights of payment to the holders of this debt are subordinated to the claims of depositors and other creditors of the Bank. More information on these can be found in the 2012 financial statements.

3. Capital adequacy continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

3.2 Capital resources continued

The following table shows the capital resources of the Group as at 31 December 2012.

Table 2 – Capital resources

	2012	2011
Core Tier 1 capital before regulatory deductions:		
Permanent share capital	**410.0**	410.0
Retained earnings	**1,813.4**	1,686.0
Minority interests	**32.0**	30.2
Losses for the year	**(508.1)**	–
Share premium account	**8.8**	8.8
Total Core Tier 1 capital before regulatory deductions	**1,756.1**	2,135.0
Regulatory deductions from Core Tier 1 capital:		
Intangible assets	**(27.9)**	(71.1)
50% of excess of expected losses over impairment (net of tax)	**(159.7)**	(114.2)
50% of securitisation positions	**(0.7)**	(2.3)
Total Core Tier 1 capital after regulatory deductions	**1,567.8**	1,947.4
Other Tier 1 capital:		
Non-cumulative irredeemable preference shares	**60.0**	60.0
Regulatory deductions from other Tier 1 capital:		
50% of tax on excess of expected losses over impairment	**51.8**	41.1
50% of material holdings	**(2.0)**	(1.3)
Total Tier 1 capital after regulatory deductions (1)	**1,677.6**	2,047.2
Tier 2 capital before regulatory deductions:		
Revaluation reserves	**2.0**	2.9
Collective provisions	**0.7**	0.7
Subordinated notes and perpetual subordinated bonds	**1,112.1**	1,084.0
Total Tier 2 capital before regulatory deductions	**1,114.8**	1,087.6
Regulatory deductions from Tier 2 capital:		
50% of excess of expected losses over impairment (gross of tax)	**(211.5)**	(155.3)
50% of securitisation positions	**(0.7)**	(2.3)
50% of material holdings	**(2.0)**	(1.3)
Total Tier 2 capital after regulatory deductions (2)	**900.6**	928.7
Total capital resources	**2,578.2**	2,975.9

(1) Tier 1 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 cash flow hedges and available for sale assets.

(2) Tier 2 capital includes permanent interest bearing shares of Britannia Building Society which converted to perpetual subordinated debt on merger and revaluation reserves relating to net gains in equities held in the available for sale financial assets category. Tier 2 capital also includes seven subordinated debt issues: £37.8m Step Up Callable Subordinated notes 2019, fixed rate until 2014, then moving to a floating rate; £8.8m Callable Subordinated notes 2021 fixed rate until 2016, then moving to floating rate; £275m Subordinated notes, fixed rate until 2021; £235.4m Subordinated notes, fixed rate until 2022; £28.6m Callable Subordinated notes floating rate until 2016; £200m Callable Subordinated notes fixed rate until 2024 and £150m 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 prior to any issue costs and fair value adjustments arising from the merger with Britannia Building Society. More information on these can be found in the Bank's annual financial statements.

3.2.1 Deductions

Intangible assets deducted from Tier 1 capital represent capitalised software. Under the Internal Ratings Based (IRB) approach, a deduction is made for expected losses in excess of impairment provisions made on customer lending. In accordance with guidance from the FSA to the BBA, 50% is deducted from Core Tier 1 net of tax and 50% from Tier 2 capital gross of tax. Other Tier 1 capital is adjusted by the remaining 50% tax on the excess of expected losses over impairment. The figures above are inclusive of the fair value adjustments on merger.

3. Capital adequacy continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

3.3 Capital requirements

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

In the table below and, unless otherwise stated, throughout the document exposures are reported as exposure at default (EAD). For IRB exposures, EAD is defined as the amount estimated to be outstanding at the time of default. This includes undrawn commitments after credit conversion factors and the result of netting and potential future exposures for derivatives. For standardised exposures, EAD includes undrawn commitments post credit conversion factor and is net of provisions.

Table 3 – Pillar 1 capital requirements

IRB exposure class	Capital requirement £m	Risk weighted asset £m	Exposure at default £m	Average risk weight %	Average exposure at default £m
2012					
Central government and central bank	–	0.4	7,330.0	–	6,777.0
Institutions	80.7	1,008.8	5,431.8	19%	5,390.0
Corporates	131.1	1,638.7	2,800.1	59%	3,301.2
Securitisations	7.6	94.7	422.8	22%	587.8
Retail exposures secured by real estate collateral	409.8	5,122.6	24,539.3	21%	25,066.7
Qualifying revolving	61.4	767.1	2,219.3	35%	2,244.0
Other retail exposures	56.2	702.8	751.4	94%	762.9
Total IRB	746.8	9,335.1	43,494.7	21%	44,129.6
Specialised lending	305.5	3,818.9	5,615.6	68%	4,351.2
Standardised exposure class					
Central government and central bank	–	–	–	–	–
Regional governments or local authorities	2.0	24.5	121.2	20%	135.5
Administrative bodies and non-commercial	6.1	76.3	83.1	92%	83.1
Institutions	3.6	45.2	225.7	20%	271.5
Corporates	166.3	2,077.7	2,076.0	100%	2,820.4
Secured by mortgages on residential property	0.4	5.8	16.5	35%	13.1
Secured by mortgages on commercial real estate	0.1	0.9	0.9	100%	0.9
Retail	–	0.3	0.4	75%	0.4
Past due	17.9	223.8	149.0	150%	86.0
Other items (1)	29.3	366.3	1,036.0	35%	1,026.9
Total standardised	225.7	2,820.8	3,708.8	76%	4,437.8
Total credit risk	1,278.0	15,974.8	52,819.1	30%	52,918.6
Interest rate position risk requirement	29.1	363.8	n/a	n/a	n/a
Counterparty risk capital component	10.1	126.3	n/a	n/a	n/a
Foreign currency position risk requirement	0.2	2.5	n/a	n/a	n/a
Total trading book	39.4	492.6	n/a	n/a	n/a
Operational risk	115.3	1,441.3	n/a	n/a	n/a
Total Pillar 1	1,432.7	17,908.7	n/a	n/a	n/a

3. Capital adequacy continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

Table 3 – Pillar 1 capital requirements continued

IRB exposure class	Capital requirement £m	Risk weighted asset £m	Exposure at default £m	Average risk weight %	Average exposure at default £m
2011					
Central government and central bank	1.8	21.9	8,203.5	–	5,972.6
Institutions	74.8	934.7	4,258.3	22%	4,762.8
Corporates	82.5	1,031.1	1,290.7	80%	1,316.4
Securitisations	10.5	131.6	902.4	15%	1,080.7
Retail exposures secured by real estate collateral	448.4	5,604.5	25,118.1	22%	25,697.5
Qualifying revolving	56.2	702.6	2,293.9	31%	2,316.0
Other retail exposures	50.9	636.8	765.0	83%	811.6
Total IRB	725.1	9,063.2	42,831.9	21%	41,957.6
Specialised lending	444.8	5,560.0	5,711.3	97%	5,716.5
Standardised exposure class					
Central government and central bank	–	–	–	–	–
Regional governments or local authorities	1.9	23.4	117.2	20%	105.8
Administrative bodies and non-commercial	6.6	82.2	90.2	91%	94.2
Institutions	5.0	63.1	315.8	20%	366.0
Corporates	238.7	2,983.7	2,985.7	100%	2,808.5
Secured by mortgages on residential property	0.3	3.5	10.0	35%	7.1
Secured by mortgages on commercial real estate	0.1	0.9	0.9	100%	0.9
Retail	–	0.3	0.4	75%	3.6
Past due	16.1	201.5	104.3	193%	85.0
Other items (1)	56.4	705.6	1,070.0	66%	892.8
Total standardised	325.1	4,064.2	4,694.5	87%	4,363.9
Total credit risk	1,495.0	18,687.4	53,237.7	35%	52,038.0
Interest rate position risk requirement	1.5	19.0	n/a	n/a	n/a
Counterparty risk capital component	2.6	32.2	n/a	n/a	n/a
Foreign currency position risk requirement	–	0.4	n/a	n/a	n/a
Total Trading book	4.1	51.6	n/a	n/a	n/a
Operational risk	121.7	1,521.0	n/a	n/a	n/a
Total Pillar 1	1,620.8	20,260.0	n/a	n/a	n/a

(1) Other items within the standardised approach include equity shares with a balance sheet value of £5.7m (2011: £7m) 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.

The reduction in risk weighted assets is primarily due to a 21% (£2,016.9m) reduction in corporate risk weighted assets (see section 3.1). In addition, other CABB risk weighted assets, mainly Optimum, have decreased by 9% (£425.5m) due to continuing run-off of the book. Interest rate position risk, counterparty risk and foreign currency risk weighted assets have increased by £441.0m. This was primarily due to increased holdings of short dated gilts, UK covered and UK government guaranteed bond holdings which were purchased to invest the Bank's surplus liquidity. Corporate IRB exposures have increased substantially since last year primarily as a result of the implementation of the RSL PD model, with a corresponding decrease in corporate standardised exposure.

3. Capital adequacy continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

3.4 Basel III

3.4.1 Impact of Basel III on Regulatory Capital

The Bank also monitors its capital position under forthcoming Basel III regulations. These regulations (CRD IV) have yet to be finalised within the European Union. Basel III regulations will be implemented on a transitional basis from their effective date to full implementation in 2022 (at the earliest). During the transitional period to full implementation of Basel III, the Bank will have the opportunity to generate additional capital from earnings and to implement management actions in order to mitigate the impact of Basel III and meet target capital ratios. The Bank expects to be able to comply fully with the new requirements when they become applicable, including the proposed minimum leverage ratio of 3%.

The table on the following page shows the capital resources of the Bank as at 31 December 2012 on a Basel III basis. The first column shows the impact of applying year one transitional rules to the December 2012 position. The second column shows the December 2012 capital position under full implementation of Basel III rules. Under transitional rules, capital deductions are phased in from year 2 therefore the first column does not show Basel III capital deductions. The exception to this is deductions for deferred tax assets which are phased in from year 1 as required by FSA. Transitional rules relating to grandfathering of capital instruments apply in the first year with the cap on Additional Tier 1 and Tier 2 instruments set at 90% of their nominal value as at 31 December 2012. During the transitional period, the bank will actively seek to replace capital instruments which are no longer eligible with Basel III compliant issuance. This will significantly improve the final position shown in the table, which does not include future issues of eligible instruments. The table is based on the reporting template in Annex VI of the EBA Consultation Paper on Draft Implementing Technical Standards on Disclosure for Own Funds by institutions (EBA/CP/2012/04), 7 June 2012. It has been completed according to the regulations as stated in the European Commission's 20 July 2011 draft CRR along with the FSA's public statement 'CRDIV transitional provisions on capital resources'. For clarity, only those parts of the table with relevance to the Bank are shown. As regulations are still to be finalised, no details of capital requirements have been included. This corresponds with the disclosure approach specified by the FSA.

3.4.2 Leverage ratio

The leverage ratio as at December 2012, based on final Basel III rules, is 2.24%. If the ineligible Tier 1 capital instruments are included (perpetual preference shares) then the ratio is 2.35%. The leverage ratio is calculated as Basel III Tier 1 capital after deductions divided by adjusted balance sheet exposure. Exposures are calculated using instructions for Basel III Quantitative Impact Studies and related FAQs. Derivative balances are adjusted to reflect the exposure used for capital purposes, off-balance sheet commitments are added and some deductions from Tier 1 are also deducted from the exposure.

3. Capital adequacy continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

This is the only table within this document that discloses capital information on a Basel III basis. All other sections within this document are reported under a Basel II basis.

Table 4 – Basel III

	Year 1 Basel III transitional rules £m	Basel III final rules £m
2012		
Common Equity Tier 1 capital: instruments and reserves		
Permanent share capital and the related share premium account	**418.8**	**418.8**
Retained earnings	**1,813.4**	**1,813.4**
Available for sale and cash flow hedge reserves	**93.7**	**93.7**
Minority Interests (1)	**32.0**	**11.5**
Independently reviewed interim profits net of any foreseeable charge or dividend	**–**	**–**
Common Equity Tier 1 (CET1) capital before regulatory adjustments	**2,357.9**	**2,337.4**
Common Equity Tier 1 (CET1) capital: regulatory adjustments		
Prudential valuation in trading book	**(7.0)**	**(7.0)**
Intangible assets (net of related tax liability) (2)	**–**	**(27.9)**
Deferred tax assets not arising from temporary differences (3)	**(1.4)**	**(14.1)**
Cash flow hedge reserves	**(63.7)**	**(63.7)**
Expected loss shortfall (4)	**–**	**(537.4)**
Securitisation positions treated as deduction (5)	**–**	**–**
Losses for the year	**(508.1)**	**(508.1)**
Filter for unrealised gains on debt instruments held in the available for sale category (6)	**(27.9)**	**–**
Unrealised gains or losses on available for sale assets (revaluation reserve) (6)	**(2.0)**	**–**
Qualifying AT1 deductions that exceed AT1 capital (7)	**(242.6)**	**–**
Total regulatory adjustments to Common Equity Tier 1 (CET1)	**(852.7)**	**(1,158.2)**
Common Equity Tier 1 (CET1) capital	**1,505.2**	**1,179.2**
Additional Tier 1 (AT1) capital: instruments		
Perpetual non-cumulative preference shares (8)	**54.0**	**–**
Minority interest (1)	**–**	**2.5**
Additional Tier 1 (AT1) capital before regulatory adjustments	**54.0**	**2.5**
Additional Tier 1 (AT1) capital: regulatory adjustments		
Intangible assets (2)	**(27.9)**	**–**
Expected loss shortfall (half) (4)	**(268.7)**	**–**
Total regulatory adjustments to Additional Tier 1 (AT1) capital	**(296.6)**	**–**
AT1 adjustments in excess of AT1 capital	**242.6**	**–**
Additional Tier 1 (AT1) capital	**0.0**	**2.5**
Tier 1 capital (T1 = CET1 + AT1)	**1,505.2**	**1,181.7**

3. Capital adequacy continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

Table 4 – Basel III continued

	Year 1 Basel III transitional rules £m	Basel III final rules £m
2012		
Tier 2 (T2) capital: instruments and provisions		
Capital instruments (9)	**1,113.5**	**–**
Minority interests (1)	**–**	**3.4**
Collective provisions	**0.7**	**0.7**
Tier 2 (T2) capital before regulatory adjustments	**1,114.2**	**4.1**
Tier 2 (T2) capital: regulatory adjustments		
Expected loss shortfall (half) (4)	**(268.7)**	**–**
Revaluation reserves (6)	**2.0**	**–**
Total regulatory adjustments to Tier 2 (T2) capital	**(266.7)**	**–**
Tier 2 (T2) capital	**847.5**	**4.1**
Total capital (TC = T1 + T2)	**2,352.7**	**1,185.8**

(1) Minority interest represents the Bank's interest in Unity Trust Bank. Under Basel III the amount of minority interest which can be recognised is reduced over the transitional period and allocated between the different tiers of capital.

(2) Under Basel III intangible assets change from being a deduction from Tier 1 to a deduction from CET1.

(3) Deferred tax assets not arising from temporary differences move from being risk weighted to being a deduction from CET1. A transitional percentage of 10% has been applied in the first year in line with FSA requirements.

(4) Expected loss shortfall change from being deducted half from Tier 1 and half from Tier 2 to a full deduction from CET1. Under Basel II rules the deduction is net of tax, whereas under Basel III they are gross with the full change applying immediately.

(5) Securitisation positions rated at 1250% are not shown as a deduction but are risk weighted.

(6) Some prudential filters which apply under Basel II do not apply under Basel III.

(7) The amount of qualifying deductions allowed against Additional Tier 1 exceeds the Bank's Additional Tier 1 resources and so is shown as a deduction against CET1. Under full implementation deductions are made in full from CET1.

(8) Perpetual non-cumulative preference shares have a cap of 90% of the nominal value applied (£54m). The remaining £6m is included in Tier 2 capital prior to the application of the Tier 2 cap.

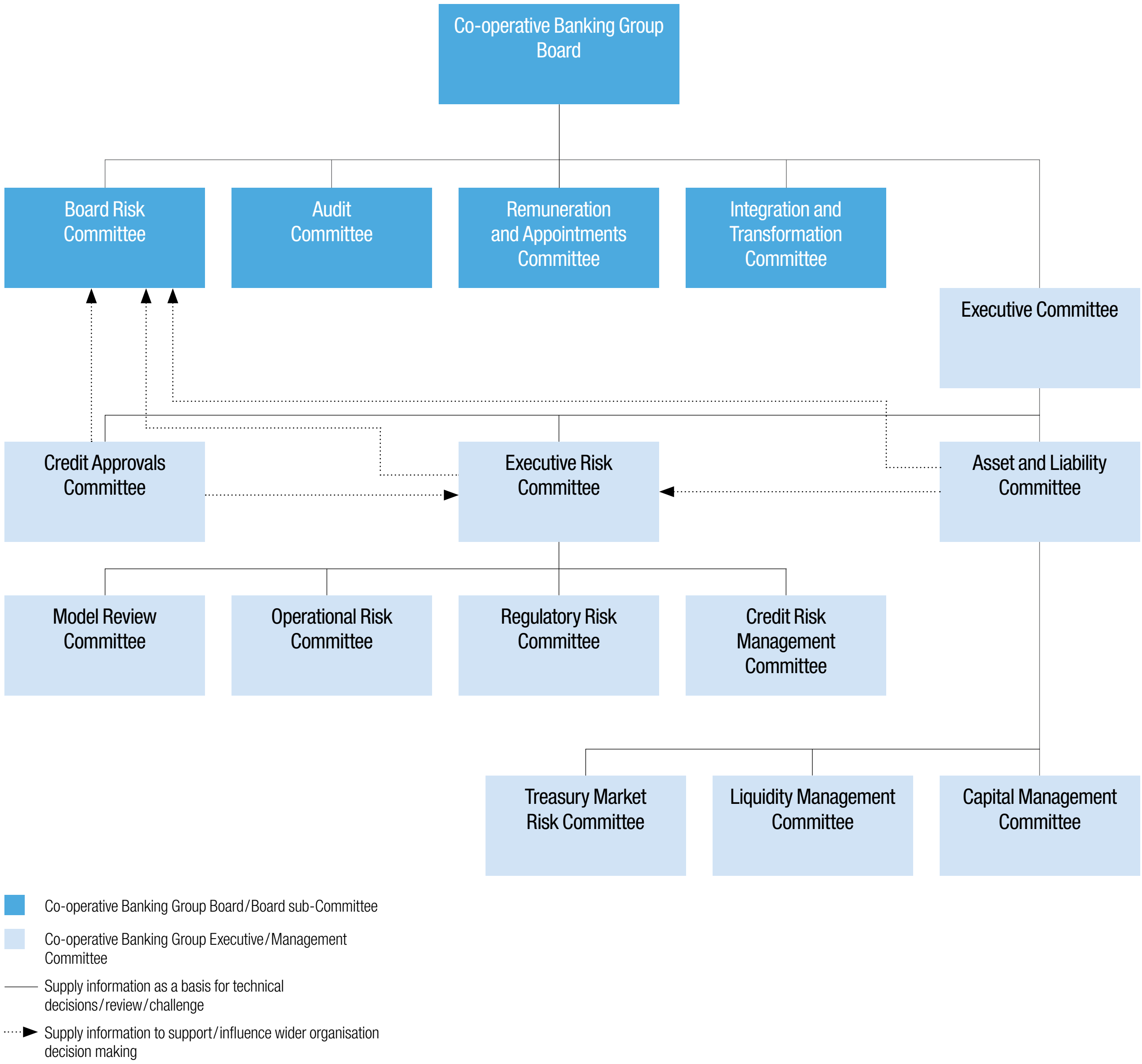
(9) The year one transitional cap has a small impact on the recognised value of Tier 2 instruments. The cap is based on the nominal value of the underlying instruments at 31 December 2012. As a result of the merger with Britannia Building Society in 2009, some of the Bank's Tier 2 instruments are reported net of fair value adjustments and so the total value of the Tier 2 instruments only just exceeds the year one cap.

4. Board and Risk Committee structure

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

In 2012 the Banking Group undertook a wide ranging review of its risk management framework delivering significant change in organisational design, committee structures, management information (MI) and reporting. This included the redesign of the way the Banking Group classifies the risks it faces, the way that risk appetite is established and the structure and application of the authority delegated by the Board to manage the risk within that agreed appetite.

The Banking Group has developed and implemented a common governance and organisation structure, which supports all of the Boards within the Banking Group. The following diagram is that part of the governance structure applicable to The Co-operative Bank plc and its subsidiaries.



4. Board and Risk Committee structure continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

The Co-operative Banking Group Board

The Co-operative Banking Group Board (the Board) is responsible for approving the Banking Group 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 levels of capital and liquidity held are consistent with the risk profile of the business.

Board delegation

The Board has established Board sub-committees and senior management committees whose responsibilities include:

- overseeing 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 sub-committees and the Chief Executive Officer (CEO) who may, in turn, delegate authority to appropriate executive directors and their senior line managers.

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.

Board Risk Committee (BRC)

The BRC provides oversight and advice to the Board on current and potential risks and the overall risk framework. Its responsibilities include:

- reviewing and challenging the design, implementation, quality and effectiveness of the risk management framework including internal controls and principal risk coverage;
- monitoring the organisation's performance and compliance against high-level risk appetite limits and tolerances;
- monitoring identified risk control failings and weaknesses and management actions taken to resolve them; and
- reporting on the effectiveness of the risk management framework and systems to the Board.

Audit Committee (AC)

The AC provides oversight on financial reporting, internal control, regulatory compliance and external and internal audit. Its responsibilities include:

- assisting the Board in carrying out its responsibilities relating to internal control, including control breaches and remediation; and
- exercising oversight of identified risk control framework failings and weaknesses as well as management actions taken to resolve them.

Remuneration and Appointment Committee (REMCO)

The terms of reference of the REMCO are explained in the Director's Report of the 2012 Financial Statement.

Integration and Transformation Committee

The role of the Integration and Transformation Committee is to provide oversight by in depth review of transformation activity within the organisation in order to give assurance on progress.

Executive Committee

The Executive Committee manages the business in line with the Board risk appetite statement. It also maintains oversight of risk management processes and management information. Its responsibilities include:

- overseeing the establishment and maintenance of appropriate risk management systems and controls in line with the Board agreed risk management framework;
- supporting the CEO in developing, reviewing and approving detailed risk appetite limits and tolerances as delegated by the Board, and
- ensuring the implementation of the risk strategy set by the Board so as to deliver an effective risk management environment for the Banking Group.

Credit Approvals Committee

The Credit Approvals Committee supports the CEO in carrying out responsibilities, including but not limited to:

- sanctioning large counterparty transactions, and
- managing large exposure positions.

Executive Risk Committee (ERC)

The ERC is chaired by the Chief Risk Officer (CRO). Its purpose is to provide a mechanism to ensure all Banking Group risks are reviewed, challenged, and approved (with escalation to BRC where required). Its responsibilities include:

- monitoring all significant and emerging risks against risk appetite;
- overseeing the development and implementation of stress testing and risk appetite across the Banking Group;
- driving the detailed implementation of the Banking Groups risk management framework approved by the Board;
- supporting the CEO in developing the risk strategy, risk management framework, and risk appetite statement with recommendations to BRC and to the Board for approval where required; and
- monitoring the business's risk profile against the agreed limits and tolerances and reporting on these to the BRC.

4. Board and Risk Committee structure continued

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

Asset and Liability Committee (ALCO)
ALCO is chaired by the CEO. It is primarily responsible for overseeing the management of capital, market, liquidity and funding risks. Its responsibilities include:

- identifying, managing and controlling the Banking Group balance sheet risks in executing its chosen business strategy;
- ensuring that the capital and solvency position is managed in line with policy and that adequate capital is maintained at all times;
- overseeing and monitoring relevant risk control frameworks; and
- recommending to the CEO and ERC relevant principal risk policies and detailed risk appetite limits for approval.

To assist in carrying out these responsibilities, ALCO is supported by a Treasury Market Risk Committee (TMRC), Liquidity Management Committee (LMC) and Capital Management Committee (CMC).

Risk and capital management sub-committees

Model Review Committee (MRC)
The MRC provides oversight and challenge of model governance across the Banking Group in support of the Enterprise Risk Director.

Operational Risk Committee (ORC)
The ORC is chaired by the Operational Risk Director. It monitors significant operational risks and controls as well as the management actions taken to mitigate them to an acceptable level or transfer them.

Regulatory Risk Committee (RRC)
The RRC supports the Regulatory Risk Director in oversight of:

- regulatory reporting requirements;
- ongoing regulatory engagement;
- conduct of business issues including fair treatment of customers; and
- the maintenance of the appropriate authorisations for the regulated entities within the Banking Group (including oversight of any variation to permission).

Credit Risk Management Committee (CRMC)
The CRMC advises and supports the Credit Risk Director. Its responsibilities include:

- designing the credit risk control implementation approach, the credit control framework and making recommendations to the ERC;
- reviewing and recommending to the ERC the Banking Group credit risk policy and credit measurement methodologies;
- defining and recommending the credit risk appetite and limits to the ERC; and
- reviewing and challenging the Banking Group's credit risk processes and procedures including the credit risk rating systems.

Treasury Market Risk Committee (TMRC)
The role of the TMRC is to review, challenge and monitor the market risk profile for the Banking Group, in line with policy and within risk appetite.

Liquidity Management Committee (LMC)
The role of the LMC is to enable more detailed discussion on all aspects of Banking Group liquidity risk management, monitoring and control including operational issues in respect of covered bond and residential mortgage backed security funding activities. It also recommends actions to ensure the Banking Group's liquidity position remains in line with agreed levels. The LMC is responsible for making recommendations to ALCO as appropriate.

Capital Management Committee (CMC)
The role of the CMC is to review, challenge and monitor the capital adequacy of the Banking Group, in line with capital policy and within risk appetite. The CMC is responsible for making recommendations to ALCO as appropriate.

There is also a framework of sector specific management forums supporting risk and capital management, optimising performance and monitoring adherence to policy.

5. Risk management policies and objectives

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

5.1 Roles and responsibilities

The Banking Group operates a three lines of defence governance model to ensure appropriate responsibility and accountability is allocated to the management, reporting and escalation of risks.

Business management act as the first line of defence. They are responsible for identifying where the business area is exposed to risks, including from the development of new products, processes or other business change. They also manage the risks that reside within their business areas on a day-to-day basis, implementing effective monitoring and control processes to ensure that the business' risk profile is understood and maintained within the Board defined risk appetite.

The risk function act as the second line of defence. They oversee and challenge the implementation and monitoring of the risk framework and consider current and emerging risks across the Bank. They also provide review and challenge of the delegated authority framework and oversee appropriate escalation of breaches, mitigating actions and reporting to the ERC.

Internal Audit act as the third line of defence. They are responsible for independently verifying that the principal risk control framework has been implemented as intended across the business and independently challenge the overall management of the framework to provide assurance to the Audit Committee and senior management on the adequacy of both the first and second lines.

5.2 Recovery and resolution planning (RRP)

RRP is a Bank of England/FSA requirement, which has two distinct elements:

- the recovery plan is the Group's menu of options for addressing a range of financial stresses caused by idiosyncratic problems, market wide stresses, or both; and
- resolution planning is the provision of information and analysis to the authorities, in order to help them prepare a resolution plan for the Group.

There are six separate modules of RRP, all of which have gone through formal governance approval. The approval route is as follows:

- Executive team;
- Executive Risk Committee (ERC);
- Board Risk Committee (BRC); and
- the Board.

In addition, as the recovery plan (module two) has been live since June 2012, a series of management information triggers and early warning signals are reported each month to ERC, for the committee to determine whether to recommend the invocation of the recovery plan.

5.3 Management Information (MI)

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

- The Board and BRC are provided with risk MI within the CRO Report.
- The ERC receive, review and challenge, on at least a monthly basis, key risk MI within the ERC Risk Report. This report includes a holistic view of the Group risk profile for all risk types including:
  - capital requirements versus capital availability for the Group;
  - a combination of trend, 'point in time' and forecast information to illustrate both the current position and how each portfolio is changing; and
  - high level credit risk performance.

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.

5.4 Risk management framework

The risk management framework for the Banking Group has been subject to a significant review and restructure to ensure it best reflects the size and complexity of the organisation and its growth ambitions. The review included the Board agreed risk approach, risk taxonomy, organisational design and the way in which risks that the Banking Group faces are identified, classified, monitored and reported on.

The risk management framework policy sets out the above in detail including:

- risk management principles and strategy;
- risk governance structure, including committee oversight;
- risk roles, accountabilities and responsibilities;
- risk taxonomy, including ownership and oversight, and
- the risk management process including identification, measurement, management, monitoring and reporting.

Each risk within the risk taxonomy has its own risk policy and control standard that outlines the approach and ownership for that risk.

The Board is aware that, as the acquisition of Verde bank progresses; the risk profile of the Bank will continue to evolve. A considerable amount of work is underway to implement and embed the improvements to the risk management framework that were designed in 2012 and align it to the project work underway for Verde.

6. Risk categorisation

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

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

- credit risk;
- market risk;
- liquidity and funding risk;
- reputational risk;
- pension risk;
- strategic and business risk;
- conduct risk; and
- operational risk.

6.1 Credit risk

One of the principal risks identified in the risk management framework is credit risk. Credit risk is the current or prospective risk to earnings and capital arising from a borrower's failure to meet the terms of any contract with the Group or their failure to perform as agreed. This includes the risk that expected default rates are exceeded due to a concentration of assets within a portfolio, to a given risk event (Concentration risk). Credit risk is an integral part of our business activities and it is inherent in both 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, securities borrowing and lending transactions).

The principal risk policy for credit risk is approved annually by the ERC and defines appropriate standards and principles for the effective management of credit risk throughout the Group.

The key principles of the policy are:

- credit risk management is fully embedded in Group operations and the business is managed in line with the risk strategy and risk appetite set by the Board;
- identified, emerging or current risks are actively managed in line with the Group's overall risk management approach of identification, measurement, management, monitoring and reporting;
- risk measurement is based on a set of metrics/ratios which are aligned with the risk appetite and support the limits framework;
- timely processes for assessing and reviewing credit risks throughout the credit life cycle are established and documented including completion of risk reports; and
- credit risk decisions are supported by fully evidenced rationale with all material credit risk exceptions reported promptly to the Credit Risk Director.

All authority to take credit risk derives from the Banking Group's Board. This authority is delegated to the CEO and then on to other individuals. The level of credit risk authority delegated depends on seniority and experience, and varies according to the quality of the counterparty, associated security or collateral held.

6.2 Market risk

Market risk is the risk that the value of assets and liabilities, earnings and/or capital may change as a result of changes in market prices of financial instruments. The majority of the Group's market risk arises from changes in interest rates.

Interest rate risk policy statements, approved by the ERC on behalf of the Board, specify the scope of the Banking Group's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the TMRC and ALCO. Their prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Group's assets and liabilities. The Group seeks to minimise the volatility of future earnings from interest rate changes and all interest rate risk exposure is removed from the retail and CABB divisions and consolidated at the centre where it is managed from the core balance sheet within agreed limits. Treasury is responsible for interest rate risk management for the Group. 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 TMRC and ALCO review the balance sheet risk positions and the utilisation of wholesale market risk limits.

6.2.1 Treasury interest rate risk

Treasury executes short term funding and hedging transactions with the wholesale markets on behalf of the Group 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.

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. The VaR methodology employed is historical simulation using a time series of one year to latest day and was £0.4m at the 31 December 2012 for the trading portfolios (2011: £0.4m). 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.

PV100 illustrates the change in valuation on a fixed income portfolio experienced given a 1% increase and decrease in interest rates, representing the treasury banking book and treasury trading book. 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 Group 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.

6. Risk categorisation continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

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

Table 5 – Interest Rate Risk

	2012		2011	
	1% increase in interest rates £m	**1% decrease in interest rates £m**	1% increase in interest rates £m	1% decrease in interest rates £m
Wholesale Banking Book	**(1.6)**	**9.8**	15.1	(16.0)
By currency:				
– GBP	**(1.2)**	**9.4**	15.0	(15.9)
– US dollars	**(0.2)**	**0.1**	0.2	(0.2)
– Euros	**(0.2)**	**0.3**	(0.1)	0.1
Treasury Trading Book	**(1.4)**	**4.8**	–	–
Total Treasury	**(3.0)**	**14.6**	15.1	(16.0)

Movement within the banking book is driven by a growth in Treasury net asset positions in 2012 (a negative PV100 reflects a net asset position). There were open trading book positions at the end of 2012, with no open positions at the end of 2011.

6.2.2 Currency risk

The Group's treasury foreign exchange activities primarily involve:

- 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 intraday trading and overnight positioning in major currencies to generate incremental income.

At 31 December 2012 the Group's open position was £2.7m (2011: £0.4m) representing a potential loss of £0.1m given a 3% depreciation in sterling (2011: £nil). The Group's open position is monitored against limits in addition to the limits in place on individual currencies. All figures are in £ sterling equivalent.

6.2.3 Non-treasury interest rate risk

The Group (excluding wholesale) uses a gap report and earnings approach for 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.

TMRC monitors the non-trading interest rate risk which is split between certain wholesale portfolios, banking and investment books, and the rest of the Group's balance sheet. The following describes the Group's 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) does not exceed a set limit.

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 (along with interest bearing non-maturity deposits) is 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 in fixed rate assets in periods up to five years to smooth the income based upon the prevailing interest rate environment.

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. Drawdown risk, in particular for fixed rate mortgages, is managed through weekly balance sheet meetings. The balance sheet management team undertakes hedges for interest rate risk using derivative instruments and investment securities which are executed via the treasury markets team to external wholesale markets, and loans and deposits which are executed internally with the treasury markets team.

Basis risk is the risk that different assets and liabilities reprice with reference to different indices and at different times. This exposes the Group to income volatility if indexes do not move in a ratio of one to one. The overall exposure to basis risk has remained a net base rate asset throughout 2012 as customers continue to favour variable rate mortgages (where the introductory rate is linked to Bank of England base rate) and administered and fixed rate savings. Basis risk is monitored by TMRC and ALCO monthly and action is taken as required, which includes pricing, new products or external hedging.

The following table illustrates the greater than 12 month net gap position at the end of the year on the Group's balances excluding wholesale treasury and customer currency balances, which are managed within the treasury risk framework. The gap results are driven by product pricing and product mix. The gap is calculated by placing all assets and liabilities at the earliest of their repricing or maturity date and then summing by time band. The aim is to have assets evenly spread so that the Group is not exposed to sudden rate movement. The net position shows the amount that the Group is either over or under invested in the month. A £100m positive gap position would equate to the Group's income increasing by £1m per annum if rates increased by 1%. The maximum sensitivity for the period shown below equates to approximately a £10.9m decrease in income if rates increased by 1%.

6. Risk categorisation continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

Table 6 – Net greater than 12 month gap position

	2012 £m	2011 £m
As at 31 December	**(928)**	(279)
Average during the year	**(612)**	(330)
Maximum during the year	**(1,090)**	806
Minimum during the year	**(248)**	(51)

Movement in average position for the year is driven by a negative (under invested) position throughout the year.

6.3 Liquidity and funding risk

Liquidity and funding risk is the risk that the Group's resources will prove inadequate to meet its liabilities as they contractually fall due or as a result of any contingent or discretionary cash outflows that may occur in a stress. It arises from the mismatch of timings of cash flows generated from the Group's assets and liabilities (including derivatives). Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed in line with policies developed by LMC and ALCO. The Group's liquidity management policies are reviewed and approved annually by the BRC (on behalf of the Board) and compliance reviewed weekly by LMC and monthly by ALCO. The Group's policy is to ensure that sufficient funds are available at all times to meet demands from depositors, to fund agreed advances, to meet other commitments as and when they fall due, and to ensure the Board risk appetite is met.

The Board's risk appetite for liquidity risk is defined in terms of:

- survival periods which measures the degree of sufficiency of liquid assets to support the Bank's activity over time under a number of stress scenarios;
- adherence to strategic liquidity risk measures; and
- compliance with all regulatory liquidity risk limits.

The stress tests encompass survival across various timescales (from three months to one year) and a range of adverse liquidity events, both firm specific and market wide, which cover all aspects of the liquidity risk to which the Group is exposed. These stress tests include a number of downgrade scenarios, from one notch to multi-notch long term and short term downgrades.

The strategic measures approved by the Board include:

- liquid asset ratio – the ratio of liquid assets to total assets;
- customer loan/deposit ratio– the ratio of customer loans to customer deposits;
- encumbrance ratio – the ratio is defined as the percentage of encumbered asset over total assets;
- regulatory limits – Internal Liquidity Guidance and Net Stable Funding Ratio; and
- internal liquidity stress tests – the survival period of the bank under a range of stressed scenarios.

The Group monitors its liquidity position on a daily basis and has weekly LMC which operates to oversee the operational liquidity management. A range of indicators to detect early signs of liquidity risk either in the market or specific to the Group are also monitored. LMC discuss the actual liquidity position and projected position incorporating business plans. More frequent meetings are held if necessary, ie when the markets have a heightened period of stress or liquidity shortage. The meetings ensure that the business plans are accurate and can be flexed as required.

The liquidity position is reported monthly to ALCO and the Board. It also monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed, and regularly assesses its funding position. This is supported with detailed contingency funding plans and recovery options, which are tested and reviewed on a regular basis. The Group's liquidity management framework is designed in line with FSA BIPRU regulations and industry guidelines.

The main liquidity risk measures used by the Group as at 31 December 2012 were as follows:

Table 7 – Liquidity risk

	2012	2011
Liquid asset ratio	**14.6%**	15.5%
Customer loan/deposit ratio	**92%**	94%
Encumbrance ratio	**27%**	24%

6. Risk categorisation continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

6.4 Operational risk

Operational risk is defined within the Banking Group 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.

6.4.1 Operational risk framework

The 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 control procedures and contingency planning. Operational risks and key controls are formally reviewed on a regular basis. Significant operational risks (losses and near misses) and the associated capital requirements are regularly reported to the ORC, the ERC and the BRC. These meet regularly to monitor the suitability of the risk management framework and management of significant risks within the Banking Group. The framework is subject to regular internal audit review in line with the Banking Group's rolling risk based audit plan.

6.4.2 Corporate insurance programme

The Banking Group 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 the Banking Group's 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.

6.4.3 Responsibilities

Each executive has a nominated risk co-ordinator who is a member of the ORC and is responsible for ensuring the consistent application of the operational risk framework in their division. The central operational risk team facilitates the identification, management and reporting of operational risks across the Banking Group in line with regulatory and business requirements, and provides oversight for business continuity and the corporate insurance programmes.

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

Operational risk theme	Description
Financial crime	This relates to the effectiveness of controls to minimise financial losses arising from the fraudulent activities of employees, customers and third parties (1).
Compliance (with regulatory and legal requirements)	As a regulated business, the Banking Group places great emphasis on maintaining compliance with our regulatory and legal obligations by: • regulatory – supporting the Banking Group's 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 proactively manage legal issues in relation to commercial, contractual, employment and litigation activities.
People	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 the Banking Group's business is managed in partnership with the wider Co-operative Group.
Business continuity framework	Business continuity arrangements are in place which set out to minimise the risk of disruption in the event of a sudden, unplanned occurrence that could seriously disrupt business operations. This includes developing and exercising crisis and incident management teams to maintain appropriate preparedness in the event of a major operational disruption.
Suppliers	The Banking Group 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 the Banking Group. 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.
Data governance	Accurate MI is key to decision making. Risks relate to availability, timeliness, accuracy and adequacy of both financial and customer/operational data. A data governance committee has been established to review and enhance standards around the use and storage of data.

(1) 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.

6. Risk categorisation continued

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

6.5 Reputational risk

Reputational risk is defined as the risk associated with an issue which could in some way be damaging to the brand of The Co-operative Banking Group, either through its strategic decisions, business performance, an operational failure or external perception. As part of the assessment and control of this risk, business performance and risk profile across all risk themes are closely monitored and reviewed. The business proactively monitors and manages media, public and customer opinion and works closely with external rating agencies to ensure fair and balanced representation. This approach helps maintain member, customer and market confidence.

6.6 Strategic and business risk

Strategic and business risk arises from changes to the Banking Group's business and the environment in which it operates, specifically the risk of not being able to carry out the Banking Group's business plan and desired strategy. This includes Contagion risk, the risk that an issue in one area of our business could have a detrimental impact on another. The Group's strategy is to grow our business in order to achieve the Banking Group's vision of becoming the compelling co-operative alternative in the markets in which we compete. The main risks to delivering the business plan and achieving the strategy are the challenging economic environment, the changing regulatory environment and the significant change programme being managed within the Group and the wider Co-operative Group. The Board and Executive set and monitor the strategic plan in the light of this background having considered the stresses that extreme but plausible scenarios could have upon it.

6.7 Conduct risk

Conduct risk is the risk that the Banking Group's behaviours, offerings or interactions will result in unfair outcomes for customers. Accordingly, conduct risk may arise from any aspect of the way a business is conducted, the sole test being whether the outcome is an unfair one for customers. The Banking Group mitigates and prevents emerging conduct risk through established systems and controls including ongoing oversight and monitoring from risk functions. Significant conduct risks are reported through existing management structures and committees and challenged by the BRC.

6.8 Pension risk

Pension risk is defined as the risk of exposure to pension scheme liabilities and risks inherent in the valuation of scheme liabilities and assets resulting in a detriment to Banking Group capital. Risks are identified at The Co-operative Group level, with the impact of any potential changes to contribution assessed under the Banking Group's risk management framework.

The Banking Group is exposed to pension risk through two schemes:

- Pace – CFS Management Services Ltd (CFSMS) and the Bank are participating members of the Co-operative Pension Scheme (Pace) – defined benefit and contribution scheme; and
- Britannia Pension Scheme – CFSMS is the principal employer of the Britannia Pension Scheme – defined benefit and contribution sections (defined benefit section closed to new members in 2001, defined contribution section closed to new members in October 2012).

The Pace Trustee, in consultation with The Co-operative Group, is responsible for the risk management arrangements for Pace, agreeing suitable contribution rates, investment strategy and for taking professional advice as appropriate. The Britannia Pension Scheme Trustee, in consultation with CFSMS, is responsible for the risk management arrangements for the Britannia Pension Scheme, agreeing suitable contribution rates, investment strategy and for taking professional advice as appropriate. The Group is therefore exposed to potential future increases in required contributions and capital set aside for pension risk.

7. Capital and liquidity risk management framework

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The Group's capital and liquidity management framework comprises:

- a defined risk appetite, controls and governance in the Group's capital and liquidity management policies;
- articulation of how capital and liquidity risk are identified, measured, monitored and managed in the Internal Capital Adequacy Assessment Process (ICAAP), Individual Liquidity Adequacy Assessment (ILAA) and procedures and governance in place to mitigate the risk;
- capital and liquidity risk quantification and mitigation techniques and processes;
- management actions linked through to stress testing and capital and liquidity planning models, enabling a method of mitigating the effects of a number of stress scenarios for varying periods of time and to ensure that the Bank operates within its agreed risk appetite parameters in all planning models; and
- ongoing development and enhancement of the Group's capital and liquidity risk appetite framework.

The Group is also progressing towards implementation of Basel III and other UK and EU risk and capital requirements. These include the CRD IV and considerations resulting from the reports issued on banking reform.

The Capital Management Committee (CMC) is responsible for the further development of this framework. CMC is also responsible for:

- the FSA003+ periodic MI submissions;
- overseeing the Group's capital reporting processes;
- agreeing, reviewing and discussing the current and projected capital resources versus capital requirements for the Group;
- for challenging and agreeing capital allocation assumptions and funding implications; and
- for making recommendations to ALCO as appropriate. ALCO is responsible for ensuring the Group has sufficient capital to meet current and future requirements.

The CMC also: monitors, reviews, and challenges the Group's risk appetite (with approval from Board), and regularly reviews, challenges and agrees the allocation of capital for Group retail, corporate and wholesale sectors based on the capital requirements and the projected return on capital.

The Liquidity Management Committee (LMC) is responsible for detailed liquidity planning, including reviewing and challenging the current and projected liquidity resources versus liquidity requirements for the Group, and for making recommendations as appropriate to ALCO. The meeting also reviews all MI which is supplied to ALCO to ensure consistency and set the liquidity risk status score. The meeting is held at least monthly and more frequently as required. The ALCO is responsible for agreeing funding plans and ensuring that the Group has sufficient liquidity resources to meet its current and future requirements. The committee also agrees liquidity transfer pricing assumptions and implications. The Board's risk appetite for liquidity risk is defined as survival in a number of stress tests, adherence to specific ratios and compliance with all regulatory limits. The stress tests encompass survival across various timescales and a range of adverse liquidity events, both firm specific and market wide, which covers all aspects of the liquidity risk the Group is exposed to.

The Group monitors its liquidity position on a daily basis and then reports stress testing scenarios and the risk appetite to the 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.

7.1 Assessing the adequacy of internal capital

The Group's approach to assessing adequacy of its internal capital to support current and future requirements is conducted via the Group'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 five year plan earnings and balance sheet in order to ensure that its Pillar 1 and Pillar 2 capital requirements are met during a severe but plausible stressed environment over the plan period, utilising appropriate management actions, but without recourse to support from The Co-operative Banking Group or The Co-operative Group.

The Bank's most material risk is credit risk, making up 89% of the Basel II risk weighted asset (RWA) 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 the Bank's chosen view of stress conditions.

7.2 Assessing the adequacy of liquidity

The Group's approach to assessing the adequacy of its liquid assets to support potential liquidity events is documented in the Individual Liquidity Adequacy Assessment (ILAA) which has been constructed by:

Stage 1 – assessing the FSA standard stresses to establish what the liquidity impact may be on the Group.

Stage 2 – undertaking an internal assessment looking at the Group's business model to identify the potential liquidity events which may impact the Group and to assess how these are identified, measured, monitored, managed and mitigated. These scenarios are documented in the ILAA and are reviewed on an annual basis or more regularly if the business model changes.

The most material liquidity risk is withdrawal of customer deposits as the Group is strongly customer funded. Mitigants to address this include good customer service, transparent products and the ethical policy.

8. Credit risk exposures

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The following section provides detail of how credit exposure is managed across the Bank.

8.1 Analysis of exposures by maturity

The following table represents the Group's exposure analysed by approach, exposure class and residual maturity.

Table 8 – Analysis of exposure at default by residual maturity

Exposure class	Repayable on demand/ undated £m	Up to 1 year £m	1–5 years £m	5–10 years £m	10–20 years £m	>20 years £m	Total £m
2012							
IRB							
Central government and central bank	–	4,904.2	1,074.3	1,147.5	178.7	25.3	7,330.0
Institutions	–	2,206.4	2,806.3	289.2	54.1	75.8	5,431.8
Corporates	–	649.4	864.3	236.6	462.4	587.4	2,800.1
Securitisations	–	155.1	151.4	56.5	57.4	2.4	422.8
Retail mortgages	–	145.5	1,084.4	2,687.0	12,626.5	7,995.9	24,539.3
Qualifying revolving	2,219.3	–	–	–	–	–	2,219.3
Other retail exposures	48.0	42.4	500.8	160.1	0.1	–	751.4
Total IRB	2,267.3	8,103.0	6,481.5	4,576.9	13,379.2	8,686.8	43,494.7
Specialised lending	–	904.9	2,044.7	963.1	767.5	935.4	5,615.6
Standardised							
Central government and central bank	–	–	–	–	–	–	–
Regional governments or local authorities	–	47.4	19.8	13.9	36.1	4.0	121.2
Administrative bodies and non-commercial	1.6	4.8	16.9	6.5	30.7	22.6	83.1
Institutions	–	225.6	0.1	–	–	–	225.7
Corporates	0.3	125.1	893.3	380.1	640.6	36.6	2,076.0
Secured by mortgages on residential property	1.6	–	0.8	3.0	–	11.1	16.5
Secured by mortgages on commercial real estate	–	0.9	–	–	–	–	0.9
Retail	0.4	–	–	–	–	–	0.4
Past due	–	2.5	88.4	–	58.1	–	149.0
Other items	1,036.0	–	–	–	–	–	1,036.0
Total standardised	1,039.9	406.3	1,019.3	403.5	765.5	74.3	3,708.8
Total credit risk exposures	3,307.2	9,414.2	9,545.5	5,943.5	14,912.2	9,696.5	52,819.1

8. Credit risk exposures continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

8.1 Analysis of exposures by maturity continued

Table 8 – Analysis of exposure at default by residual maturity continued

Exposure class	Repayable on demand/ undated £m	Up to 1 year £m	1–5 years £m	5–10 years £m	10–20 years £m	>20 years £m	Total £m
2011							
IRB							
Central government and central bank	–	6,435.6	375.6	819.1	461.3	111.9	8,203.5
Institutions	–	2,497.6	1,403.0	300.7	17.7	39.3	4,258.3
Corporates	–	349.4	585.0	168.5	161.6	26.2	1,290.7
Securitisations	–	349.0	315.7	170.2	57.3	10.2	902.4
Retail mortgages	–	134.0	1,115.1	2,683.4	11,878.3	9,307.3	25,118.1
Qualifying revolving	2,293.9	–	–	–	–	–	2,293.9
Other retail exposures	46.2	43.1	490.3	185.4	–	–	765.0
Total IRB	2,340.1	9,808.7	4,284.7	4,327.3	12,576.2	9,494.9	42,831.9
Specialised lending	–	948.2	1,957.2	875.9	846.3	1,083.7	5,711.3
Standardised							
Central government and central bank	–	–	–	–	–	–	–
Regional governments or local authorities	–	52.1	13.2	7.2	40.6	4.1	117.2
Administrative bodies and non-commercial	2.9	22.0	13.2	46.3	3.7	2.1	90.2
Institutions	–	315.7	0.1	–	–	–	315.8
Corporates	1.2	236.5	852.1	457.4	660.3	778.2	2,985.7
Secured by mortgages on residential property	–	3.8	0.2	2.0	–	4.0	10.0
Secured by mortgages on commercial real estate	–	0.9	–	–	–	–	0.9
Retail	0.4	–	–	–	–	–	0.4
Past due	–	3.5	83.0	17.8	–	–	104.3
Other items	1,070.0	–	–	–	–	–	1,070.0
Total standardised	1,074.5	634.5	961.8	530.7	704.6	788.4	4,694.5
Total credit risk exposures	3,414.6	11,391.4	7,203.7	5,733.9	14,127.1	11,367.0	53,237.7

The Group is predominantly UK based with non-UK lending at immaterial levels. Corporate IRB exposures have increased substantially since last year primarily as a result of the implementation of the RSL PD model. The increase in exposures to institutions under the standardised approach is driven by new bond positions. The reduction in exposures to central governments and central banks under the standardised approach is due to the maturity of positions with the Bank of England.

8. Credit risk exposures continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

8.2 Analysis of impaired and past due exposures

The following table represents the Group's exposure at default analysed by approach, exposure class and residual maturity. The table provides an analysis of exposures at default, impaired, past due, value adjustments and provisions and charges for value adjustments during the period by exposure class and rating approach.

Table 9 – Analysis of impaired and past due exposures

Exposure class	Exposure at default £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
2012					
IRB					
Central government and central bank	7,330.0	–	–	–	–
Institutions	5,431.8	–	–	–	–
Corporates	2,800.1	63.3	0.3	56.7	26.6
Securitisations	422.8	6.2	–	6.2	–
Retail mortgages	24,539.3	1,442.1	17.5	14.2	8.5
Qualifying revolving	2,219.3	134.5	2.0	98.3	–
Other retail exposures	751.4	72.4	4.9	74.5	–
Total IRB	43,494.7	1,718.5	24.7	249.9	35.1
Specialised lending	5,615.6	1,682.3	1.3	321.8	305.9
Standardised approach					
Central government and central bank	–	–	–	–	–
Regional governments or local authorities	121.2	–	–	–	–
Administrative bodies and non-commercial	83.1	1.4	–	0.5	–
Institutions	225.7	–	–	–	–
Corporates	2,076.0	23.6	–	6.9	7.0
Secured by mortgages on residential property	16.5	–	–	–	–
Secured by mortgages on commercial real estate	0.9	–	–	–	–
Retail	0.4	–	–	–	–
Past due	149.0	250.8	–	70.6	40.1
Other items	1,036.0	–	–	–	–
Total standardised	3,708.8	275.8	–	78.0	47.1
Total credit risk exposures	52,819.1	3,676.6	26.0	649.7	388.1

8. Credit risk exposures continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

8.2 Analysis of exposures impaired and past due continued

Table 9 – Analysis of impaired and past due exposures continued

Exposure class	Exposure at default £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
2011					
IRB					
Central government and central bank	8,203.5	–	–	–	–
Institutions	4,258.3	25.9	–	4.9	–
Corporates	1,290.7	38.6	0.5	15.9	3.8
Securitisations	902.4	6.9	–	6.4	–
Retail mortgages	25,118.1	1,841.5	392.1	11.3	6.7
Qualifying revolving	2,293.9	146.0	2.0	101.7	–
Other retail exposures	765.0	74.0	4.4	61.7	–
Total IRB	42,831.9	2,132.9	399.0	201.9	10.5
Specialised lending	5,711.3	726.0	11.2	48.3	33.0
Standardised approach					
Central government and central bank	–	–	–	–	–
Regional governments or local authorities	117.2	–	–	–	–
Administrative bodies and non-commercial	90.2	0.7	–	0.3	–
Institutions	315.8	–	–	–	–
Corporates	2,985.7	37.4	–	6.5	1.7
Secured by mortgages on residential property	10.0	–	–	–	–
Secured by mortgages on commercial real estate	0.9	–	–	–	–
Retail	0.4	–	–	–	–
Past due	104.3	195.0	–	46.6	37.9
Other items	1,070.0	–	–	–	–
Total standardised	4,694.5	233.1	–	53.4	39.6
Total credit risk exposures	53,237.7	3,092.0	410.2	303.6	83.1

The increase in impaired exposures and value adjustments is driven by credit impairment primarily within Corporate portfolios (see section 3.1).

Within the Pillar 3 disclosure, value adjustments are defined as being individual impairments and provisions are defined as collective impairments in line with BBA guidance. Provisions are disclosed on a statutory basis and exclude those covered by fair value.

8. Credit risk exposures continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

8.2 Analysis of exposures impaired and past due continued

The table below provides an analysis by industry* of total exposure at default for the corporate exposure class.

Analysis is also provided showing the amount of the total exposure that is impaired, the value adjustment and provisions raised against the impaired assets and the charges for value adjustments made in the year. The prevailing collateral held against these exposures is not shown, however typical loan to value would provide adequate coverage.

Table 10 – Analysis of corporate exposure at default by industry class

Exposure class/industry	Exposure at default £m	Of which: impaired exposures £m	Value adjustments and provisions held against impaired exposures £m	Charge for value adjustments in the period £m
2012				
Corporate exposure class				
Accommodation Food & Licensed Services	**832.0**	**301.1**	**56.9**	**49.0**
Care	**279.8**	**2.1**	**1.8**	**1.0**
Education	**108.8**	**–**	**0.1**	**–**
Financial Services	**135.7**	**4.8**	**2.9**	**0.7**
Football clubs	**47.2**	**19.2**	**8.6**	**4.4**
Housing associations	**1,099.3**	**–**	**–**	**–**
Manufacturing	**166.2**	**9.5**	**8.7**	**7.1**
Motor Trade/Garages	**109.2**	**3.7**	**3.3**	**–**
PFI	**1,269.1**	**10.8**	**5.1**	**5.1**
Professional Services	**147.5**	**3.8**	**3.3**	**0.3**
Property and Construction				
Commercial Investment	**3,533.9**	**1,424.8**	**279.2**	**265.3**
Residential Investment	**460.2**	**120.5**	**24.5**	**12.9**
Commercial Development	**280.0**	**41.9**	**11.4**	**5.7**
Residential Development	**87.7**	**5.8**	**0.7**	**(0.2)**
Public Sector Entities	**1.0**	**–**	**–**	**–**
Renewable energy	**601.4**	**9.2**	**8.1**	**(1.2)**
Retail/Wholesale Trade	**517.3**	**19.3**	**10.8**	**9.8**
Services	**610.9**	**23.9**	**18.5**	**3.5**
Transport Storage & Communication	**183.3**	**15.2**	**10.3**	**15.6**
Utilities	**91.1**	**0.6**	**0.7**	**–**
Other	**79.1**	**3.9**	**1.1**	**0.6**
Total	**10,640.7**	**2,020.1**	**456.0**	**379.6**
IRB corporates	**2,800.1**	**63.3**	**56.7**	**26.6**
Specialised lending (1)	**5,615.6**	**1,682.4**	**321.8**	**305.9**
Standardised corporates	**2,076.0**	**23.6**	**6.9**	**7.0**
Standardised past due corporates	**149.0**	**250.8**	**70.6**	**40.1**
Total	**10,640.7**	**2,020.1**	**456.0**	**379.6**

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

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

8. Credit risk exposures continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

8.2 Analysis of exposures impaired and past due continued

Table 10 – Analysis of corporate exposure at default by industry class continued

Exposure class/industry	Exposure at default £m	Of which: impaired exposures £m	Value adjustments and provisions held against impaired exposures £m	Charge for value adjustments in the period £m
2011				
Corporate exposure class				
Accommodation Food & Licensed Services	578.3	132.5	6.3	1.4
Care	186.4	1.2	0.1	–
Education	100.0	–	–	–
Financial Services	134.5	3.7	2.1	–
Football clubs	57.6	20.8	4.3	(0.3)
Housing associations	1,022.7	–	–	–
Manufacturing	182.4	5.0	2.1	0.1
Motor Trade/Garages	98.2	4.5	3.0	2.9
PFI	1,237.5	–	–	–
Professional Services	111.6	4.5	2.8	1.5
Property and Construction				
Commercial Investment	3,507.1	561.5	37.4	18.7
Residential Investment	672.7	154.9	9.6	9.0
Commercial Development	258.0	29.8	5.9	3.9
Residential Development	114.6	3.9	0.9	0.5
Public Sector Entities	–	–	–	–
Renewable energy	389.8	10.3	9.4	9.3
Retail/Wholesale Trade	455.4	13.2	2.0	(0.1)
Services	593.0	21.9	17.3	15.7
Transport Storage & Communication	239.1	26.0	12.8	12.4
Utilities	76.4	0.6	0.7	0.6
Other	76.7	2.6	0.6	0.8
Total	10,092.0	996.9	117.3	76.4
IRB corporates	1,290.7	38.6	15.9	3.8
Specialised lending (1)	5,711.3	726.0	48.3	33.0
Standardised corporates	2,985.7	37.4	6.5	1.7
Standardised past due corporates	104.3	194.9	46.6	37.9
Total	10,092.0	996.9	117.3	76.4

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

9. Impairment

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The policy on impairment is detailed in the Risk Management section of the financial statement.

9.1 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. The provisions for retail exposures relate to retail exposures secured by real estate collateral exposure class, and the unsecured exposures within the 'qualifying revolving' and 'other retail' exposure classes. All retail exposures are treated under the retail IRB approach. In light of the continued deterioration in the revised economic outlook and also of our relatively significant exposure to corporate real estate, the directors have reassessed the carrying value of the loan portfolios of the Bank. This has resulted in a significant impairment charge principally relating to the non-core Corporate business as shown in the table below.

Table 11 – Allowance for impairment

	Individual Retail £m	**Individual Corporate £m**	**Collective Retail £m**	**Collective Corporate £m**	**Total £m**
2012					
At the beginning of the year	**9.0**	**105.1**	**165.7**	**12.2**	**292.0**
Charge against profits	**8.5**	**379.6**	**43.5**	**11.6**	**443.2**
Amounts written off	**(6.9)**	**(47.5)**	**(29.4)**	**(1.4)**	**(85.2)**
Unwind of discount allowance	**–**	**(3.7)**	**(3.4)**	**–**	**(7.1)**
Interest charged on impaired loans	**–**	**0.1**	**–**	**–**	**0.1**
At the end of the year	**10.6**	**433.6**	**176.4**	**22.4**	**643.0**

	Individual Retail £m	Individual Corporate £m	Collective Retail £m	Collective Corporate £m	Total £m
2011					
At the beginning of the year	8.6	55.8	157.8	0.4	222.6
Charge against profits	4.9	76.6	36.4	12.6	130.5
Amounts written off	(4.5)	(27.1)	(26.6)	(0.8)	(59.0)
Unwind of discount allowance	–	(0.5)	(1.9)	–	(2.4)
Interest charged on impaired loans	–	0.3	–	–	0.3
At the end of the year	9.0	105.1	165.7	12.2	292.0

9.2 Allowance for impairment relating to debt securities

The provisions within the treasury portfolio relate to exposures to institutions and investment in securitisations. The impact of the ongoing financial crisis and associated reduction in liquidity within the wholesale markets has led to a loss of active markets or availability of traded prices for particular assets.

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

Table 12 – Allowance for impairment relating to debt securities

	2012 £m	2011 £m
Opening balance	**45.2**	85.3
Charge against profits	**(5.4)**	(5.6)
Any other adjustments	**(0.8)**	(34.5)
Closing balance	**39.0**	45.2

9.3 Comparison of expected losses to accounting impairment losses

The following table provides a comparison of the expected losses on non-defaulted assets as at 31 December 2011 with the actual charge to the income statement for losses on loans and advances that materialised for the whole portfolio over the subsequent year ending on 31 December 2012. Expected losses for exposures on the IRB approach are derived from underlying IRB models and are a function of Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD) estimates. Expected losses for specialised lending are determined using pre-defined expected loss rates for each of the five FSA supervisory categories. Expected loss is not calculated for exposures on the standardised approach.

IRB models were developed following Basel II requirements and are not directly comparable with accounting impairment losses. In particular expected loss calculations are based on long-run estimates of PD and use economic downturn estimates of LGD. In addition LGD represents the loss expectation until finalisation of the workout period while account impairment losses correspond to a single year.

Although the 2012 impairments are higher for the Corporate IRB and Specialised Lending portfolios, these two portfolios were not undercapitalised in December 2011 as the total amount of capital (Expected Loss plus Pillar 1 credit risk capital requirements) held for non-defaulted customers at that point in time exceeded the amount of impairments raised during 2012 against the same customers.

9. Impairment continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

9.3 Comparison of expected losses to accounting impairment losses continued

Expected loss for defaulted assets is not disclosed within this table, therefore if there is subsequent impairment on defaulted assets, the expected loss will not be captured in this table, potentially resulting in higher impairment than expected loss.

Table 13 – Comparison of expected losses to impairment losses

Exposure class	Expected losses on non-defaulted assets as at 31 December 2011 £m	Impairment losses for 2012 £m
IRB		
Central government and central bank	–	–
Institutions	14.6	–
Corporates	12.0	42.4
Securitisations	–	–
Retail mortgages	128.6	22.3
Qualifying revolving	31.9	29.7
Other retail exposures	28.1	–
Total IRB	215.2	94.4
Specialised lending	102.8	300.2
Total	318.0	394.6
Impairment losses on standardised portfolios	–	48.6
Net charge to the income statements (loans and advances to customers and banks)	–	443.2

Exposure class	Expected losses on non-defaulted assets as at 31 December 2010 £m	Impairment losses for 2011 £m
IRB		
Central government and central bank	–	–
Institutions	4.0	–
Corporates	14.1	5.7
Securitisations	–	–
Retail mortgages	153.9	7.2
Qualifying revolving	40.0	19.9
Other retail exposures	28.1	14.2
Total IRB	240.1	47.0
Specialised lending	92.1	41.7
Total	332.2	88.7
Impairment losses on standardised portfolios	–	41.8
Net charge to the income statements (loans and advances to customers and banks)	–	130.5

10. Standardised approach

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

Analysis of exposures calculated in accordance with the standardised approach

For those exposures at default subject to the standardised approach a significant portion are unrated. There are some rated exposures to institutions within the, Basel defined, immaterial portfolio. For standardised exposures that are rated, the nominated external credit assessment institution (ECAI) or export credit agency for these is Moody's. The Group complies with the credit quality assessments 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.

Table 14 – Exposures at default calculated under the standardised approach

	Credit Quality Step							
	1 £m	**2 £m**	**3 £m**	**4 £m**	**5 £m**	**6 £m**	**Unrated £m**	**Total £m**
2012								
Central governments and central banks	–	–	–	–	–	–	–	–
Regional governments or local authorities	–	–	–	–	–	–	**121.2**	**121.2**
Administrative bodies and non-commercial	–	–	–	–	–	–	**83.1**	**83.1**
Institutions	**120.3**	**105.2**	–	–	–	–	**0.2**	**225.7**
Corporates	–	–	–	–	–	–	**2,076.0**	**2,076.0**
Retail	–	–	–	–	–	–	**0.4**	**0.4**
Secured by mortgages on residential property	–	–	–	–	–	–	**16.5**	**16.5**
Secured by mortgages on commercial real estate	–	–	–	–	–	–	**0.9**	**0.9**
Past due	–	–	–	–	–	–	**149.0**	**149.0**
Other items	–	–	–	–	–	–	**1,036.0**	**1,036.0**
Total standardised approach	**120.3**	**105.2**	–	–	–	–	**3,483.3**	**3,708.8**

	Credit Quality Step							
	1 £m	2 £m	3 £m	4 £m	5 £m	6 £m	Unrated £m	Total £m
2011								
Central governments and central banks	–	–	–	–	–	–	–	–
Regional governments or local authorities	–	–	–	–	–	–	117.2	117.2
Administrative bodies and non-commercial	–	–	–	–	–	–	90.2	90.2
Institutions	235.5	80.1	–	–	–	–	0.2	315.8
Corporates	–	–	–	–	–	–	2,985.7	2,985.7
Retail	–	–	–	–	–	–	0.4	0.4
Secured by mortgages on residential property	–	–	–	–	–	–	10.0	10.0
Secured by mortgages on commercial real estate	–	–	–	–	–	–	0.9	0.9
Past due	–	–	–	–	–	–	104.3	104.3
Other items	–	–	–	–	–	–	1,070.0	1,070.0
Total standardised approach	235.5	80.1	–	–	–	–	4,378.9	4,694.5

Corporate standardised exposures have decreased since last year primarily as a result of the implementation of the RSL PD model.

11. Specialised lending

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

The corporate sector includes a specialised lending portfolio, consisting of lending to PFI and property investment and development. For the specialised lending portfolio, the slotting approach is used. The table analyses exposure (EAD) (including undrawn commitments after credit conversion factor) by slotting category. The collateral held is excluded from the analysis.

Table 15 – Specialised lending by slotting category

	2012 £m	2011 £m
Slotting category		
Strong	**95.1**	242.6
Good	**3,161.1**	3,083.6
Satisfactory	**463.6**	1,020.4
Weak	**214.6**	651.3
Default	**1,681.2**	713.4
Total	**5,615.6**	5,711.3

Slotting models are used to analyse and monitor specialised lending exposures to property which are assigned to FSA supervisory categories with predefined risk weights. A significant proportion of loans have been downgraded with many moving into default (see section 3.1).

12. Securitisations

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

12.1 Asset backed securities (ABS)

The Group has total ABS exposure of £0.4bn, down from £0.9bn in 2011. The overall exposure at default has been managed down during the year, with redemptions and sales of £0.5bn. A profit of £25.0m has been recognised in the year against the asset sales. During the period no provisions were placed against the portfolio. The assets 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 Group has no direct exposure to US sub-prime assets or US retail mortgage-backed securities. 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. The assets are independently rated by ECAI, the majority having a rating from at least two of Fitch, Moody's and Standard & Poor's. The treasury credit risk team acts as first line of defence in monitoring changes in the credit and market risk of our ABS exposure, with external market analysis being supplemented by discussions with the portfolio manager. ABS are assessed using the ratings based approach, under foundation IRB, where risk weight percentages are applied to each deal depending on the external rating, seniority and granularity of the instrument. Notwithstanding the risk banding allocation, all transactions where no value adjustment is held continue to meet their payment obligations. There were no securitised revolving exposures held during the reporting period.

Table 16 – ABS securitisation exposure at default by risk band

		Senior and granular		Non-senior and granular		Non-senior and non-granular		Resecuritisation	
	Credit quality step	Exposure £m	Capital requirement £m	Exposure £m	Capital requirement £m	Exposure £m	Capital requirement £m	Exposure £m	Capital requirement £m
2012									
AAA or A1/P1	**1**	**221.8**	**1.4**	–	–	–	–	–	–
AA	**2**	**32.2**	**0.2**	**54.2**	**0.7**	**1.6**	–	–	–
A+	**3**	**3.3**	–	**6.6**	**0.1**	–	–	–	–
A or A2/P2	**4**	**2.8**	–	**25.8**	**0.4**	**1.9**	**0.1**	–	–
A –	**5**	**10.8**	**0.2**	**5.0**	**0.1**	–	–	–	–
BBB+	**6**	–	–	**5.1**	**0.2**	–	–	–	–
BBB	**7**	–	–	**20.2**	**1.4**	**7.9**	**0.5**	–	–
BBB-	**8**	–	–	**13.1**	**1.1**	–	–	–	–
BB+	**9**	–	–	–	–	–	–	–	–
BB	**10**	–	–	–	–	–	–	–	–
BB-	**11**	–	–	**3.0**	**1.7**	–	–	–	–
Rated below BB – or A3/P3	**12**	–	–	**1.4**	**1.4**	–	–	**6.1**	**6.1**
Total		**270.9**	**1.8**	**134.4**	**7.1**	**11.4**	**0.6**	**6.1**	**6.1**

		Senior and granular		Non-senior and granular		Non-senior and non-granular		Resecuritisation	
	Credit quality step	Exposure £m	Capital requirement £m	Exposure £m	Capital requirement £m	Exposure £m	Capital requirement £m	Exposure £m	Capital requirement £m
2011									
AAA or A1/P1	1	581.6	3.5	7.1	0.1	–	–	–	–
AA	2	33.3	0.2	77.4	1.0	5.2	0.1	–	–
A+	3	–	–	16.8	0.3	14.6	0.5	–	–
A or A2/P2	4	4.2	–	82.9	1.4	–	–	–	–
A-	5	5.1	0.1	3.0	0.1	–	–	–	–
BBB+	6	–	–	5.3	0.2	–	–	–	–
BBB	7	9.6	0.5	41.5	2.6	–	–	–	–
BBB-	8	–	–	–	–	–	–	–	–
BB+	9	–	–	–	–	–	–	–	–
BB	10	–	–	1.4	0.5	–	–	–	–
BB-	11	–	–	–	–	–	–	–	–
Rated below BB – or A3/P3	12	–	–	–	–	6.9	6.9	6.5	6.5
Total		633.8	4.3	235.4	6.2	26.7	7.5	6.5	6.5

12. Securitisations continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

12.2 Originated securitisations

Securitisation is the process by which a group of assets, usually loans, are aggregated into a pool, and sold to bankruptcy remote special purpose entities (SPEs). The pool of mortgage loans is used to back the issuance of new securities, allowing the credit rating of the securities to be separated from the credit rating of the original company. The Group has established securitisation structures as part of its funding activities, using residential mortgage loans as the underlying asset pool. Securitisations provide a diverse source of funding for the Group. However, the majority of the risks and rewards in respect of the underlying mortgage loan pools are retained by the Group. SPEs are included as subsidiaries in the consolidated financial statements with the Group continuing to recognise securitised assets as loans and advances to customers on the balance sheet, and income from the securitised assets being recognised as income.

The Group has experience of issuing securitisations under various programmes, and has built up a depth of knowledge, processes and management information to deal effectively with these funding vehicles. Securitisation has historically been used to increase the diversification of funding sources, manage maturity mismatch risk, and assist overall credit risk management.

The Group has only acted as mortgage originator, servicing agent and liquidity facility provider (in Leek Finance Number Eighteen plc and Leek Finance Number Nineteen plc only) in respect of its own securitisations. The Group does not provide bridging loans nor does it act as underwriter or dealer in its securitisations. All transactions are approved at Board level and benefit from relevant accounting and legal advice to ensure compliance with regulatory/statutory rules.

Other than in connection with the transaction announced by the Group on 18 January 2013, the Group will continue to be ineligible to receive any regulatory capital relief in respect of any future residential mortgage backed security (RMBS) securitisation transactions for the period determined by the FSA as previously announced in the RNS of 21 May 2010.

The table below shows the initial funded amount and value, as at 31 December 2012, of the first loss pieces and liquidity facilities in respect of securitisations sold to third party investors, subject to the qualifications documented in the following paragraphs.

This table discloses 'First Loss Pieces' which represent subordinated loans advanced by the Bank (in respect of Leek Seventeen, Eighteen, and Nineteen), or Variable Funding Notes ('VFNs') subscribed to by the Bank (in respect of Silk Road One, Two, and Three).

Table 17 – Originated securitisation exposures

	Retained notes initial percentage (1)	**Initial funded amount £m**	**2012 value £m**	2011 value £m
First Loss Piece				
Leek Finance Number Seventeen plc		**23**	**28**	28
Leek Finance Number Eighteen plc		**23**	**27**	27
Leek Finance Number Nineteen plc		**18**	**18**	18
Silk Road Finance Number One plc	**45%**	**116**	**116**	116
Silk Road Finance Number Two plc		**22**	**22**	22
Silk Road Finance Number Three plc		**19**	**19**	–
Liquidity Facilities				
Leek Finance Number Eighteen plc		**–**	**17**	17
Leek Finance Number Nineteen plc		**–**	**17**	17
Total		**221**	**264**	245

(1) Other than Silk Road Finance Number One, the initial retained note percentage for other originated securitisations sold to third party investors is 0%.

12. Securitisations continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

The table below shows the value of securitised notes sold to third party investors issued and outstanding.

Table 18 – Securitised notes sold to third party investors

	Total notes issued £m	Date of issuance	2012 Notes outstanding £m	2011 Notes outstanding £m
SPE Company				
Leek Finance Number Seventeen plc	**1,168**	**April 06**	**456**	476
Leek Finance Number Eighteen plc	**1,048**	**October 06**	**540**	562
Leek Finance Number Nineteen plc	**833**	**April 07**	**529**	553
Silk Road Finance Number One plc	**1,375**	**February 10**	**755**	959
Silk Road Finance Number Two plc	**728**	**July 11**	**562**	688
Silk Road Finance Number Three plc	**650**	**August 12**	**591**	–
Total	**5,802**		**3,433**	3,238

The Group executed Silk Road Finance Number Three ('Silk 3'), a RMBS, in August 2012, generating £650m AAA Sterling denominated notes. Silk 3 was the Group's third prime RMBS, since merger with Britannia, transaction following Silk Road Finance Number One ('Silk 1') issued in February 2010 and Silk Road Finance Number Two ('Silk 2') issued in July 2011. Silk 3, as with Silk 1 and Silk 2, is not subject to significant risk transfer rules under BIPRU 9.

Leek Finance Number Twenty plc (Leek 20), Leek Finance Number Twenty One plc (Leek 21) and Leek Finance Number Twenty Two plc (Leek 22) notes issued in July 2008, October 2008 and January 2009 respectively were fully retained by the Group. At 31 December 2012, an aggregate amount of £2.0bn of AAA Leek 20, Leek 21 and Leek 22 notes are outstanding, a proportion of which are deployed in bilateral funding arrangements. Furthermore, the Bank retained £1.5bn of AAA notes issued by Cambric Finance Number One plc (Cambric) in December 2012. For corporate planning purposes it is assumed that RMBS markets may be open to the Group during 2013 to diversify funding sources further in public markets and/or generate additional collateral for bilateral funding purposes. Detailed disclosures around each remaining active securitisation are published each quarter on the Banking Group website at the following address: www.britannia.co.uk/bts.

The Group had previously claimed regulatory capital relief in relation to Leek Finance Number Eighteen (Leek 18) and Leek Finance Number Nineteen (Leek 19) in accordance with the terms of BIPRU 9. Following the restructure of these transactions, in June 2011, the Group was regarded as providing non-contractual support to each of Leek 18 and Leek 19 respectively. Regulatory capital relief for Leek 18 and Leek 19 was therefore discontinued from June 2011.

In January 2013 the Bank transferred a portion of the risk in its portfolio of specialist Platform/Optimum mortgages to third party investors via the issuance of £116m of funded notes issued by Calico Finance Number One (Calico). The Bank received funded credit protection from third party investors on a residential mortgage portfolio of approximately £1.8bn. The structure conforms to all relevant provisions of the current FSA Handbook for significant risk transfer (GENPRU/ BIPRU 9). A capital improvement is generated principally from a reduction in the total calculated risk weighted assets as a result of the risk transfer.

Other than in respect of Calico, no outstanding securitisation affords the Group regulatory capital relief.

13. Credit risk control

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The Credit Risk Management Committee (CRMC) reviews credit risk MI in considerable depth, for example by risk pool, campaign or key risk splits. In addition, the credit risk second line receive and review credit risk MI on a regular basis split by campaign or key characteristic. The CRMC MI is produced on a monthly basis, with different MI produced for each business area. The regular MI covers a broader scope than that provided to the ERC. Reports include:

- performance against agreed Risk Appetite limits and tolerances;
- sector and obligor concentrations and risk segmentation;
- monitoring of exposures at risk and in arrears and Impairment levels;
- monitoring of loans under forbearance; and
- monitoring of IRB model performance.

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

13.1 Retail credit policy

There is an overarching principal credit risk policy, which covers retail, corporate and wholesale credit risk.

13.1.1 Retail credit approval and individual limit setting

The Banking Group's policy on retail secured and unsecured credit is to establish credit criteria that determine the balance between volume growth (generating higher income) and higher arrears and losses, so as to ensure the return is commensurate with the Banking Group's risk appetite and strategic objectives. Retail credit risk related decisions are based on a combination of defined lending policies and the use of bespoke scorecards derived from historical data. Regular updates are provided to senior management on the performance of the portfolios.

Unsecured lending

Application and behavioural scorecards are used to support new lending decisions and ongoing portfolio management. These scores are used, in combination with policy criteria and an assessment of affordability, to determine whether we will lend to an individual borrower and to set individual limits on the amount we will lend. Application scorecards are used to determine lending decisions to those customers with no existing relationship with the Group. Behavioural scorecards are used to make lending decisions for existing customers, including credit limit increases/decreases, authorisation decisions, and card reissue.

Decisions are generally fully automated with manual intervention only required in the event of referrals being triggered or customer appeal. The application and behavioural scorecards used for lending decisions form the main components of the IRB models.

Mortgage lending – credit approval

Scorecards are also used to assess new mortgage applications. 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 external credit reference data and information collected as part of the application process.

The calculation of the application scores is fully automated within the application processing system. The score is used in association with lending policy and affordability checks to make a decision on whether an application will be approved. Higher risk applications or those outside of standard lending policy are referred to more senior underwriters to ensure compliance with policy and to allow expert judgment, within agreed levels of authority.

Retail individual and portfolio limit setting

For the period ended 31 December 2012, portfolio limits were agreed for specific lending sectors based on an overall assessment of our appetite for exposure to that sector. This included an assessment of risk based on the capital requirement of each sector based on the IRB models.

Retail pricing and profitability

The IRB models, or the underlying credit-risk models upon which the IRB models are based, are used as inputs to pricing/profitability models across the retail lending portfolios (both secured and unsecured).

13. Credit risk control continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

13.2 Corporate credit policy

The Banking Group's policy on new corporate lending is to consider relatively low risk and senior (not subordinated) exposures from UK customers provided they meet the criteria contained in the corresponding sector strategy, while avoiding excess single-name or sector concentrations. Individual cases which show signs of unsatisfactory performance are managed through a specialist Corporate Business Support team who are engaged with the customers to restore them to good health or wherever this is not possible management actions are taken to effect recovery. The CRMC and ERC (and by exception BRC) receive regular reports on the performance of the portfolio.

13.2.1 Corporate lending and credit approval

The Banking Group corporate banking customer engagement model is comprised of business development managers, relationship managers and support staff. Corporate Banking is separate from the second line corporate credit risk team which is responsible for the development, recommendation and monitoring of risk appetite, lending policy, rating systems and lending procedures. The second line of defence is, in turn, separate from the credit 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 credit 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. Only the Senior Corporate Banking Officer, Chief Finance Officer, Chief Executive Officer and Credit Approvals Committee have authority to sanction the largest credit applications.

The credit 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.

13.3 Wholesale credit policy

Teams of risk managers and treasury second line support the treasury business group. The Banking Group's credit risk framework for wholesale markets has, 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, dependent on Internal Rating Grade (IRG) and associated PD, to approve limits to individual counterparties within the parameters established by the credit risk policy. The ERC receives regular reports on the performance of the portfolio. The CRMC receives regular reports on changes to the watchlist and problem counterparty information. Limits on exposures to counterparties, known as Total Potential Limits (TPL), are established within the operating internal rating grades 1–9 (IRG 10 representing the default state), each having an associated PD using a counterparty limit matrix.

14. Retail models

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

Residential mortgages

Several PD models for both new-to-the-Group 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, where we have commenced litigation to take possession of the borrowers assets, or where the borrower is bankrupt. Each account is assigned a Point in Time (PiT) PD and is allocated a risk grade accordingly. Long run PDs for each risk grade have been developed by incorporating these PiT PDs with estimates of how these grades would perform over an economic cycle – different long run PDs are assigned depending on product type and business area.

LGD models are all parameter based systems using a combination of statistical modelling of internal historical data and forward looking forecasts (eg downturn house price assumptions). The key components are probability of possession given default (PPD) and expected shortfall. Any post sale recoveries are excluded from the loss estimate. The core component of the PPD 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 forced sale discount (the difference between actual and forecasted house prices) and projected balances and costs, along with time to possession and sale parameters and standard discounting principles. In calculating capital, a downturn LGD is used. This is achieved by flexing the key components of the 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.

Qualifying revolving and other retail exposures

Underlying business scorecards are calibrated to a Basel compliant definition of default to provide a PD for each loan – 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 mortgage exposures. The application credit score is used for new lending to determine PD up until sufficient internal account performance data is available at which time the behaviour score will be used to determine PD. 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 estimate of default rate to which conservatism is applied to ensure that it is compliant and reflective of the 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 homogeneous LGD values across the unsecured default portfolio. Scorecards were developed on the default and charge off segments across the retail unsecured portfolio, subsets of the scored populations were used to derive non-default estimations. These models directly estimate the average loss (percentage) of snapshot balance over a 36 month recovery period. Standard discounting principles are applied in conjunction with the cost of collections and further conservatism (if required) is applied in order to estimate a 48 month position. Economic stresses are derived based on an assessment of the key drivers, payment percentages, which are then applied to infer the total economic loss in a downturn. Due to historical collections policies it was not possible to model LGD to write off and as such the estimates are inherently conservative. A floor value LGD is derived based on analysis of the predicted loss over the development sample and is calculated based on the maximum value over the sample for the default and charge off segments or, for the non-default models, an average loss from the subsets of the scored populations. This floor value is used for capital calculation and effectively stabilises capital. Statistical techniques were used to develop EAD pools across segments of the unsecured portfolio whereby the exposure exceeded current drawings (credit cards and current accounts). In line with BIPRU requirements, for loans the current drawings are taken as the EAD.

15. Corporate models

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

Corporate exposures are rated with a combination of models and approaches as outlined in the table in section 2.2.

There are two externally developed PD models in use for grading and monitoring the IRB portion of the corporate asset class. PD models were calibrated in house to create a single master grading scale (grades 1–14 with the last grade being default).

The ratings philosophy of these PD models is defined as 'near point in time models'. This approach 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.

Slotting models are used to analyse and monitor the specialised lending exposures to PFIs and property. The PFI and property investment and development 'slotting models' are based on BIPRU criteria, which map to five FSA supervisory categories with predefined risk weights from strong to default (slotting model categories 1–5 respectively). Whilst the prescribed FSA slotting approach is used to calculate capital, internally developed property PD models are used for internal risk assessment with the same key risk drivers informing both the slotting and the PD model.

The master grading scale and slotting grades can only be overridden by credit 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.

A housing associations model for Registered Social Landlords (defined as Registered Providers in England) has been built using an expert judgment model as the portfolio has such low levels of default that traditional model building techniques could not 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. This model has been implemented in 2012 following regulatory approval from the FSA.

Arising from either 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 credit underwriting department has decided merits closer management. This element of the portfolio is subject to regular review by Credit Underwriting and Heads of Corporate Credit, and the Credit Risk Director, together with their respective peers in corporate banking and the second line team, 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, foundation IRB rollout and immaterial). This definition is taken as being one or more of the following:

- where the Group considers that the borrower is unlikely to repay its credit obligations without recourse by the Group 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; ie bankruptcy, filing for administration, liquidation etc.

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 CABB committed exposure (EAD) across the different Basel exposure classes at the end of 2012 was £10.8bn. Of this figure, regulatory slotting models were used to analyse and grade £1.3bn PFI assets and £4.5bn real estate assets.

16. Wholesale model

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The wholesale model is used for all treasury counterparties, which are largely institutions but also include central governments, central banks, supranationals, multilateral development banks and qualifying money market funds. Credit ratings are derived from a variety of information sources including external credit assessment institutions (Moody's and Fitch) based on fundamental credit analysis to assign an appropriate internal rating grade (IRG) 1–10. More conservative, judgmental adjustment to counterparty's IRG (downward overrides) may be applied with the supporting credit rationale clearly stated in the appropriate credit review. The PD methodology is based upon annual corporate bond default statistics sourced from Moody's and Standard & Poor's. PDs are deemed to be conservative for the mainly bank/sovereign wholesale portfolio for regulatory capital purposes. These models are used across the wholesale portfolio representing exposures of £13.8bn at the reporting date. The wholesale model is currently being assessed alongside an external PD model developed by Standard & Poor's.

17. Approach to validation

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The independent validation of the rating models is undertaken using a combination of suitably skilled internal and external resource.

All model developments and material adjustments are subject to assessment against a comprehensive validation framework, which incorporates all relevant requirements from BIPRU.

For each rating system, the outcome of the validation process is fully documented, and then challenged by the second line of defence and approved by the CRMC. Model changes are subject to pre or post implementation notification to the FSA depending upon capital impact.

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

The second line of defence, staffed with appropriately qualified and experienced professionals, play a key role in the ongoing oversight of the IRB systems/models.

Internal audit provide additional oversight and assurance to senior management, acting as the third line of defence. The Audit Committee approves the annual audit plan and copies of audit reports are circulated to them and/or the BRC as appropriate.

All models are reviewed annually 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 actual performance falls outside of expected criteria then this review process will be undertaken earlier.

As a result of the changes being driven by the wide ranging review of the Banking Group risk management framework, the approach to model validation has evolved in the last quarter of the year to reflect the new organisational design and governance structure. This revised approach includes the creation of a MRC that reports directly to the ERC. The coordination of all model risk will sit with the MRC.

18. IRB approach

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

IRB approach: exposure at default values and exposure weighted average risk weight for each exposure class by PD band for foundation IRB

The table below analyses exposure default, and risk weight percentage for each IRB exposure class by PD band for exposures subject to the foundation IRB approach.

Table 19 – Foundation IRB exposures at default by 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
2012										
Exposure value IRB Exposure class										
Central government and central bank	**7,330.0**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**7,330.0**
Institutions	**3,798.7**	**921.5**	**627.6**	**83.9**	**0.1**	**–**	**–**	**–**	**–**	**5,431.8**
Corporates	**145.9**	**744.5**	**586.8**	**984.9**	**169.9**	**62.6**	**42.9**	**–**	**62.6**	**2,800.1**
Total foundation IRB	**11,274.6**	**1,666.0**	**1,214.4**	**1,068.8**	**170.0**	**62.6**	**42.9**	**–**	**62.6**	**15,561.9**

	0.00–0.10%	0.11–0.20%	0.21–0.30%	0.31–1.00%	1–5%	5–10%	10–50%	50–99%	Default	Total
RW % IRB Exposure class										
Central government and central bank	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Institutions	**12%**	**20%**	**52%**	**67%**	**102%**	**–**	**–**	**–**	**–**	**19%**
Corporates	**24%**	**41%**	**51%**	**68%**	**99%**	**127%**	**188%**	**–**	**–**	**59%**
Total foundation IRB	**4%**	**29%**	**52%**	**68%**	**99%**	**127%**	**188%**	**–**	**–**	**17%**

	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
2011										
Exposure value IRB Exposure class										
Central government and central bank	8,203.5	–	–	–	–	–	–	–	–	8,203.5
Institutions	2,276.8	1,616.3	148.1	46.0	140.2	5.0	–	–	25.9	4,258.3
Corporates	99.8	31.4	162.3	599.1	211.4	84.7	83.7	–	18.3	1,290.7
Total foundation IRB	10,580.1	1,647.7	310.4	645.1	351.6	89.7	83.7	–	44.2	13,752.5

	0.00–0.10%	0.11–0.20%	0.21–0.30%	0.31–1.00%	1–5%	5–10%	10–50%	50–99%	Default	Total
RW % IRB Exposure class										
Central government and central bank	–	–	–	–	–	–	–	–	–	–
Institutions	15%	22%	45%	56%	102%	164%	–	–	–	22%
Corporates	28%	38%	44%	68%	103%	125%	222%	–	–	80%
Total foundation IRB	4%	22%	45%	68%	103%	127%	222%	–	–	14%

Corporate IRB exposures have increased substantially since last year primarily as a result of the implementation of the RSL PD model, which resulted in Housing Associations being rated almost exclusively with PDs less than 0.35%. The increase in exposures to institutions is driven by new bond positions. The reduction in exposures to central governments and central banks is due to the maturity of positions with the Bank of England.

18. IRB approach continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

IRB approach: exposure at default analysed by expected loss (EL) grades

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

Table 20 – Retail IRB exposure at default by EL grade

	EL grade 1 £m	EL grade 2 £m	EL grade 3 £m	EL grade 4 £m	EL grade 5 £m	EL grade 6 £m	Default £m	Total £m
2012								
IRB Exposure class								
Residential mortgages	**14,857.0**	**1,342.4**	**2,646.1**	**1,432.7**	**2,387.6**	**1,053.5**	**820.0**	**24,539.3**
Qualifying revolving	**160.3**	**562.1**	**360.8**	**205.4**	**399.3**	**357.4**	**174.0**	**2,219.3**
Other retail	**72.7**	**–**	**–**	**123.3**	**193.0**	**273.1**	**89.3**	**751.4**
Total retail IRB	**15,090.0**	**1,904.5**	**3,006.9**	**1,761.4**	**2,979.9**	**1,684.0**	**1,083.3**	**27,510.0**

	EL grade 1 £m	EL grade 2 £m	EL grade 3 £m	EL grade 4 £m	EL grade 5 £m	EL grade 6 £m	Default £m	Total £m
2011								
IRB Exposure class								
Residential mortgages	15,052.6	1,091.0	2,632.1	1,487.9	2,686.7	1,280.8	887.0	25,118.1
Qualifying revolving	140.0	410.0	604.5	251.1	335.2	380.0	173.1	2,293.9
Other retail	60.2	–	–	145.6	180.9	300.6	77.7	765.0
Total retail IRB	15,252.8	1,501.0	3,236.6	1,884.6	3,202.8	1,961.4	1,137.8	28,177.0

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

EL = EAD x PD x LGD

EL% = EL ÷ EAD

The table below analyses retail IRB RWAs by exposure class and EL grade.

Table 21 – Retail IRB RWA by EL grade

	EL grade 1 £m	EL grade 2 £m	EL grade 3 £m	EL grade 4 £m	EL grade 5 £m	EL grade 6 £m	Default £m	Total £m
2012								
IRB Exposure class								
Residential mortgages	**353.7**	**115.8**	**426.8**	**460.5**	**1,476.3**	**1,184.9**	**1,104.6**	**5,122.6**
Qualifying revolving	**3.5**	**25.3**	**28.7**	**30.8**	**139.8**	**421.3**	**117.7**	**767.1**
Other retail	**6.2**	**–**	**–**	**65.3**	**196.1**	**362.3**	**72.9**	**702.8**
Total retail IRB	**363.4**	**141.1**	**455.5**	**556.6**	**1,812.2**	**1,968.5**	**1,295.2**	**6,592.5**

	EL grade 1 £m	EL grade 2 £m	EL grade 3 £m	EL grade 4 £m	EL grade 5 £m	EL grade 6 £m	Default £m	Total £m
2011								
IRB Exposure class								
Residential mortgages	373.1	95.5	412.9	458.4	1,685.4	1,401.4	1,177.8	5,604.5
Qualifying revolving	3.3	15.6	33.9	39.4	117.6	452.0	40.8	702.6
Other retail	–	–	–	68.0	169.0	383.1	16.7	636.8
Total retail IRB	376.4	111.1	446.8	565.8	1,972.0	2,236.5	1,235.3	6,943.9

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

EL = EAD x PD x LGD

EL% = EL ÷ EAD

19. Credit risk mitigation

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The Group 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 residential real estate collateral for retail mortgages and either residential or commercial real estate collateral held against corporate lending.

Property collateral for corporate lending is categorised as security for property development or investment customers (ie 'property' lending) or owner occupied premises to secure mainstream loan and overdraft facilities. For general lending, in addition to taking charges over property assets owned by the company, other security is taken in modest proportion to the total portfolio. This includes debentures or floating charges (supported by tangible security, where appropriate, including property, life policies and stocks and shares) and cash cover. 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. Any shortfall of security for an exposure is regarded as unsecured and assessment includes this element of residual risk.

Policies are in place to manage collateral and valuation with daily monitoring undertaken within treasury operations. Repos and secured lending positions are revalued with margin calls on collateralised swaps predominantly made daily save for several arrangements which permit calls on a weekly basis. Eligible financial collateral for Basel reporting includes gilts held under reverse repo agreements, cash held under both repo agreements and collateralised swap arrangements or against corporate lending. The guarantees relied upon are either parental guarantees held against subsidiary exposures within bank groups or sovereign guarantees. The table below analyses balance sheet exposure values covered by eligible financial collateral by IRB exposure class.

Table 22 – IRB exposures covered by collateral

	2012		2011	
	Exposure value covered by collateral after haircut £m	**Exposure value covered by guarantee after haircut £m**	Exposure value covered by collateral after haircut £m	Exposure value covered by guarantee after haircut £m
Central governments and central banks	**–**	**–**	209.7	–
Institutions	**835.2**	**30.6**	1,023.8	144.8
Corporates	**3.0**	**–**	6.3	–
Totals	**838.2**	**30.6**	1,239.8	144.8

The reduction in exposures covered by collateral to central governments and central banks is due to the maturity of a repo position with the Bank of England.

20. Counterparty credit risk

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The table shows the Group's balance sheet exposure to over the counter (OTC) derivatives in relation to counterparty credit risk.

Table 23 – Exposure to OTC derivatives

	2012			2011		
	Banking Book £m	**Trading Book £m**	**Total £m**	Banking Book £m	Trading Book £m	Total £m
Gross positions fair value of contracts	**621.5**	**197.3**	**818.8**	812.1	163.7	975.8

The decrease in banking book derivatives is primarily driven by exchange rates, fall in London Interbank Offered Rate (LIBOR) and maturity of positions.

The counterparty credit risk mark to market method is used to measure exposure value for counterparty credit risk. The Banking Group 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 Group assigns an appropriate IRG 1–10, and associated PD, based upon a limit matrix, which determines the TPL capacity for any single counterparty 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 counterparties 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 several agreements in place where the Group 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 Group.

Wrong way risk is not deemed material to the treasury portfolio, though it may occur. An example of conjectural wrong way risk is where fluctuations in interest rates cause an increase in the value of derivative transactions with a counterparty whose creditworthiness is reduced as a result. Such factors are taken into account when counterpart/country reviews are undertaken.

21. Eurozone risk

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

The Group monitors developments daily across all countries as they affect the Treasury portfolio. Proactive management actions have been taken to reduce risk within the Treasury portfolio with an underlying theme of reducing exposure to the south (peripheral eurozone) and increasing exposure to the north (eg Germany, the Netherlands, Finland and Sweden) where economies are more robust.

Credit quality and liquidity within the Treasury portfolio have been enhanced through concentrating asset purchases in the shorter dated debt securities issued by AAA rated supranational financial institutions, government agencies and sovereign or state owned banks. Credit risk mitigation as at year end 2012 stood at 54% of total exposure to eurozone financial institutions compared with 21% as at year end 2011.

Ongoing exposure to counterparties within the 'peripheral' eurozone (Portugal, Ireland, Italy, Greece and Spain) is, with the exception of ABS/MBS exposure of £10.8m to Spain, primarily restricted to selective short dated money market lending or balances held on nostro accounts. A £13.4m exposure to an Irish subsidiary of a major American bank group was outstanding as at 31 December 2012, this exposure being fully guaranteed by the group holding company. Other than a £25k exposure to the London subsidiary of a Greek bank, the Group has no direct exposure to Greek financial institutions or any other counterparty types.

The Group's exposure to these eurozone countries (as valued for credit risk purposes) represents 0.27% of total Group exposures.

Other than the ABS/MBS exposure above, all residual wholesale term exposure to counterparties within peripheral eurozone countries reached final maturity by mid 2012 and was repaid in full. These exposures had previously contributed to watchlist red exposures totalling £277m as at 31 December 2011 and comprising holdings in FRNs issued by German (£75m), Spanish (£138m), Irish (£30m) and Portuguese (£34m) financial institutions. No watchlist red exposures remain as at 31 December 2012.

As at 2012 the Group had direct exposure of £306.7m (2011: £90.0m) to the Government of Finland, £89.9m (2011: £nil) to Swedish Export Credit Corporation and £12.3m (2011: £nil) to the Government of the Netherlands all repayable in over one year. It held no other non-UK European sovereign debt.

22. Glossary

For the year ended 31 December 2012

The following glossary defines terminology used within the Group's Pillar 3 disclosures to assist the reader and to facilitate comparison with publications by other financial institutions:

Item	Description
Asset Backed Security (ABS)	Securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows but are commonly pools of residential or commercial mortgages but could also include leases, credit card receivables, motor vehicles, student loans.
Application score	The credit score calculated on the application data alone. Typically, data provided on an application form and/or credit reference data.
Audit Committee (AC)	The committee which provides oversight in relation to financial reporting, internal control, regulatory compliance, external and internal audit across the Banking Group.
Asset and Liability Committee (ALCO)	This committee is chaired by the Chief Executive Officer and is primarily responsible for overseeing the management of market, liquidity and funding risks. Its responsibilities include identifying, managing and controlling the Bank balance sheet risks in executing its chosen business strategy, overseeing and monitoring relevant risk control frameworks and recommending to CEO and ERC relevant risk policies and detailed risk appetite limits for approval.
Basel II	A statement of best practice issued by the Basel Committee on Banking Supervision, that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive, and was implemented in the UK via the FSA Handbook.
Basel III	A strengthening of the requirements laid out in Basel II, initially required to be phased into the Group gradually between 2013 and 2019 ahead of full implementation by 2023. This phased implementation is now expected to commence in the UK from 2014.
Basis Points (bps)	One hundredth of a per cent (0.01%), so 100 basis points is 1%. Used in quoting movements in interest rates or yields on securities.
Behaviour score (behavioural scorecard)	A credit risk scoring system for retail customers assessing the performance of an existing customer's account. Typically using data from previous performance of a customer's account and/or credit reference data.
Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)	Part of the Financial Services Authority (FSA) handbook setting out prudential requirements: The Prudential Sourcebook for Banks, Building Societies and Investment Firms. Available to view on www.fsa.gov.uk.
Board Risk Committee (BRC)	This committee provides oversight and advice to the Banking Group Board on current and potential risks and the overall risk framework, including risk appetite, risk tolerance and management strategies.
Corporate and Business Banking (CABB)	The Group's operating segment which includes Corporate and Optimum and Illius. This includes lending to large corporate and commercial entities, acquired mortgage books and specialist mortgage team dealing with intermediary lending.
Capital Management Committee (CMC)	This committee reviews, challenges and monitors the capital adequacy of the Banking Group, in line with capital policy and within risk appetite.
Co-operative Financial Services Management Services (CFSMS)	CFSMS provides supplies and services on behalf of fellow subsidiary undertakings within the Co-operative Banking Group.
Collective Impairment	Impairment is measured collectively where a portfolio comprises assets with a homogenous risk and where appropriate statistical techniques are available.
Credit Approvals Committee	The Credit Approvals Committee supports the Chief Executive Officer carrying out his responsibilities including, but not limited to, sanctioning large counterparty transactions and managing large exposure positions.
Credit Default Swap (CDS)	An arrangement whereby the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of protection. A credit default swap is a contract where the protection seller receives premium or interest related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a credit rating agency.
Credit quality assessment scale	Published by the FSA in accordance with the Capital Requirements Regulations 2006 which maps the external credit rating provided by eligible ECAIs and ECAs to credit quality steps.
Credit quality steps	A credit quality step in a credit quality assessment scale as set out in BIPRU 3.4 (Risk weights under the standardised approach to credit risk) and BIPRU 9 (Securitisation).
Credit Risk Management Committee (CRMC)	This committee advises and supports the Credit Risk Director. It designs the credit risk control implementation approach and risk control framework. It reviews the CBG credit risk policy and credit measurement methodologies, defines and recommends the credit risk appetite and limits and reviews and challenges the CBG credit risk processes and procedures.

22.Glossary continued

For the year ended 31 December 2012

Item	Description
Default	Circumstances in which probability of default is taken as 100% for the purposes of the calculation of regulatory capital and compliance with Basel II. This is defined as where the customer reaches a predefined arrears status or where the Group may consider the borrower is unlikely to repay its credit obligation in full without recourse by the Group to actions such as realising security.
Draw down risk	The risk to a lender that a customer will withdraw additional funds up to their maximum facility limit.
Exposure at default (EAD)	A Basel II Pillar 1 parameter – the amount estimated to be outstanding at the time of default. Exposure at default calculated under the standardised approach is always reported post credit conversion factors and provisions. Under the IRB approach the exposure at default includes undrawn commitments after credit conversion factors.
Export credit agencies (ECA)	Export credit agencies are private or quasi-governmental institutions that act as intermediaries between national governments and exporters to issue export financing. The financing can take the form of credits (financial support) or credit insurance and guarantees (pure cover) or both, depending on the mandate the ECA has been given by its government. ECAs can also offer credit or cover on their own account.
External Credit Assessment Institution (ECAI)	An external Credit Assessment Institution is a credit rating agency eg Moody's, Standard and Poor's, and Fitch. A credit rating agency (CRA) is a company that assigns credit ratings for issuers of certain types of debt obligations as well as the debt instruments themselves.
Expected Loss (EL)	A Basel II Pillar 1 calculation – The amount estimated under the IRB approach to be lost on current exposures due to potential defaults on existing and committed lending over a one year time horizon.
Encumbrance	Encumbrance is an impediment to use of assets, for example a claim against a property by another party. Encumbrance usually impacts the transferability of the asset and can restrict its free use until the encumbrance is removed.
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.
Executive Risk Committee (ERC)	ERC provides a mechanism to ensure that the Banking Group's risk management is reviewed, challenged, approved and embedded within the Banking Group.
Eurozone	The geographical area containing countries whose economies function using the European single currency.
Exposure	The maximum loss the Group might suffer if: (a) a customer (or counterparty) or a group of connected customers fails to meet its obligations; or (b) it realises assets or off-balance sheet positions.
Foundation IRB	Foundation internal ratings based approach (see IRB), uses standard LGD and EAD parameters but PD is estimated by the Group.
Financial Services Authority (FSA)	An independent body that regulates the financial services industry in the UK.
FSA003	Standard prudential report produced by banks providing capital resources and capital requirement information to the FSA on a regular basis.
Internal Capital Adequacy Assessment Process (ICAAP)	The Bank's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events.
Individual Liquidity Adequacy Assessment (ILAA)	The Bank's assessment of its liquidity risks, controls and quantification of liquid assets required to survive severe financial shocks through the use of stress tests prescribed by the FSA (see 'Liquidity risk').
Individual Liquidity Guidance	The regulatory minimum amount of liquidity that the Bank is required to hold.
Individually Impaired	Impairment is measured individually for assets that are individually significant with risk.
Liquidity Coverage Ratio	Liquidity ratio that will be introduced under Basel III, measuring highly liquid assets against stressed net cash outflows over a 30 day period.
Institute of International Finance	A worldwide association of financial institutions. Provides analysis and research on central issues including regulatory, financial and economic policy issues and advocates best practice and industry standards.
Integration and Transformation Committee	This committee provides oversight by in depth review of transformation activity within the Group in order to give assurance on progress.
Internal Rating Grade	For Corporate exposures the Group has adopted an Internal Rating Based approach in accordance with Basel II guidelines. Exposures are sanctioned based on an assessment of the risks and are allocated a Risk Grade or Rating extracted from a suite of Basel compliant models. These models have been implemented with outputs calibrated to reflect the Corporate portfolio or FSA slotting standards as appropriate. For Treasury exposures individual counterparties may be allocated credit ratings obtained from External Credit Assessment Institutions. These ratings combined with expert judgment drive the formulation of internal rating grades ranging from 0 to 10 and associated probability of default (PDs). These internal rating grades form the basis of the Treasury Counterparty Limit Matrix.

22. Glossary continued

For the year ended 31 December 2012

Item	Description
IRB Internal ratings based approach	A Basel II approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk sensitive than the Standardised Approach and may be Foundation or Advanced. IRB approaches may only be used with FSA permission.
Leveraged Finance	Stems from lending to companies with a high ratio of debt to market value, or leverage, but has expanded to include a wide variety of borrowers whose debt is considered to be high risk, or non-investment grade, by rating agencies such as Standard & Poor's, Moody's and Fitch.
Loss Given Default (LGD)	A Basel II Pillar 1 parameter – an estimate of the actual loss that would occur in the event of default expressed as a percentage of the EAD.
London Interbank Offered Rate (LIBOR)	The interest rate participating banks offer to other banks for loans on the London market.
Liquidity Management Committee (LMC)	This committee enables more detailed discussion on all aspects of Bank liquidity risk management, monitoring and control including operational issues in respect of covered bond and residential mortgage backed security funding activities. It also recommends actions to ensure the Bank's liquidity position remains in line with agreed levels.
Long run average probability of default (LRA PD)	A long run average PD is reflective of the long run average default rates expected over a full economic cycle. Also referred to as long run PD.
Loan To Value (LTV)	A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Bank calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a quarterly basis to reflect changes in the house price index (HPI)).
Master Grading Scale	Brings together the respective expected default frequency (EDF) from Moody's KMV RiskCalc and Moody's KMV CreditEdge models to produce a Basel II compliant Corporate Banking PD.
Mortgage Backed Security (MBS)	Securities that represent interests in a group of mortgages. Investors in these securities have the right to cash received from future interest and/or principal mortgage payments.
Model Review Committee (MRC)	This committee provides oversight and challenge of model governance across the Banking Group in support of the Enterprise Risk Director.
Net Stable Funding Ratio	Liquidity ratio that will be introduced under Basel III, measuring the proportion of long-term assets which are funded by long term or stable funding.
Net Present Value (NPV)	The present value of the expected future cash in and out flows on an asset or liability.
Operational Risk Committee (ORC)	This committee is chaired by the Operational Risk Director. 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.
Basel II IRB Permission Application Pack (PAP)	A financial institution planning to use the IRB approach for calculation of its credit risk capital requirement needs to apply for permission from the FSA. The information submitted should at least include: 1. Cover letter requesting the approval; 2. Description of/approach to the control environment; IT infrastructure; validation; data standards; reconciliations/performance monitoring; IRB rating systems (including models); outputs; 3. Documentation of above; 4. Implementation plan (including roll-out); 5. Self-assessment.
Probability of Default (PD)	Probability of Default, a Basel II Pillar 1 parameter under IRB approach, estimate of the probability that a borrower will default in next 12 months.
Pillar 1	Pillar 1 Capital is a prescribed measure of capital required by a bank representing the minimum capital requirements. The Pillar 1 capital ratio is calculated using regulatory capital and risk weighted asset (RWA). The total capital ratio must be no lower than 8%.
Pillar 2	Pillar 2 is the Basel II terminology for the internal capital adequacy assessment process, which reviews the capital calculation derived within the Pillar 1 work and calculates the additional capital required through various economic cycles, in addition to other risks not covered under Pillar 1.
Pillar 3	Under Basel II Pillar 3 covers market discipline. Market discipline takes the form of standard disclosure requirements that are intended to provide information about a bank's exposure to risks and risk assessment processes. The aim is to provide a means of disclosure comparable between banks.
Point in time (PiT)	Point in time refers to Basel II modelling approach which assesses the risk of an account at a single point in time.
Prepayment risk	The risk to a lender that part or all the principal of a loan will be paid prior to the scheduled maturity. For a bondholder, prepayment risk refers to the possibility the issuer will redeem a callable bond prior to maturity. Prepayments generally occur when market rates of interest decline following the loan origination. Prepayment generally results in reduced cash flow for a bondholder when proceeds from the redemption are reinvested at a reduced interest rate.
Provisions	Collective provision balance.
Probability of Possession Given Default (PPD)	Probability of Possession Given Default is the probability that a proportion of mortgages (secured accounts) will to go to repossession.

22. Glossary continued

For the year ended 31 December 2012

Item	**Description**
Perpetual Subordinated Bonds (PSBs)	Bonds with no maturity date that do not require the issuer to redeem.
PV100	Daily calculation of the effect on the net present value (NPV) of Treasury portfolios to both parallel and specific point of yield curve stress testing (ie non-linear yield curve shifts). Analysis includes daily parallel shifts in yield curve rates of +/ – 100 bps with the resultant change in NPVs representing the potential change in portfolio values.
Qualifying revolving	Qualifying Revolving Retail Exposure eg overdraft or credit cards.
Rating systems	System for implementing scorecards and ranking customers/accounts by risk. May also include decision systems which use the ratings as a key input.
Remuneration and Appointments Committee (REMCO)	REMCO determines the policy on remuneration and other terms and conditions of employment of senior executives. It makes recommendations on senior executive appointments and the related terms and conditions. It reviews and agrees remuneration policy for staff under the FSA remuneration code. In addition it reviews and approves incentive schemes and decides on issues surrounding the retirement benefit schemes.
Retail SME	Loans extended to small businesses and managed as retail exposures are eligible for retail treatment under Basel II, provided the total exposure of the Group to a small business borrower (on a consolidated basis where applicable) is less than €1m. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold.
Retail	The segment that comprises customer focused products and services for individuals, sole traders and small partnerships. This includes mortgages, credit cards, consumer loans, current accounts and savings products.
Retail IRB Approach	Internal Ratings Based approach for Retail customers stipulated within Basel II allowing a more sophisticated and risk sensitive approach to calculate credit risk. More advanced than Foundation IRB approach as PD, LGD and EAD parameters are derived by the Group.
Risk grade	Credit risk score or output from a rating system or Basel II Pillar 1 model.
Roll out to Foundation IRB	Portfolios where PD models are being developed by the Group which will allow use of Foundation IRB Approach. The Pillar 1 capital requirement for these portfolios is currently calculated using the standardised approach.
Regulatory Review Committee (RRC)	RRC maintains the appropriate authorisations for the regulated entities within The Co-operative Banking Group, oversees the Approved Persons regime, regulatory reporting requirements and ongoing regulatory engagement.
Risk weighted asset (RWA)	Risk weighted asset or risk weighted assets, amount of exposure deemed 'at risk' according to FSA prescribed calculation for Pillar 1 capital requirement.
Scorecard	A set of questions (called characteristics) that provide the most predictive information on future account performance. The account receives points (or weighting) for each question depending on the answer. These points are then added together to create a score.
Slotting approach	An approach applied to specialised lending exposures to calculate Pillar 1 capital requirement and EL. For each of five risk categories that may be assigned to a specialised lending customer, a set percentage based on the slotting category is applied to the account exposure value to derive capital requirement and expected loss.
Special Purpose Entities (SPE)	Entities that are created to accomplish a narrow and well defined objective. For the Group this includes: – various securitisation transactions in which mortgages were sold to SPEs. The equity of these SPEs is not owned by the Group; – Covered Bond Limited Liability Partnerships created in order to act as guarantors for issues of covered bonds.
Specialised lending	A specific Basel portfolio type which are Corporate exposures which possess the following characteristics: 1. the exposure is to an entity which was created specifically to finance and/or operate physical assets; 2. the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; and 3. the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.
Standardised approach	Under Basel II, the basic method of calculating Pillar 1 capital requirements based on supervisory defined factors which are applied to exposure values based on external credit ratings of the customer.
Stress testing	Assessing the risk of a portfolio using a what-if approach to represent various economic changes, for example, a rise in unemployment.
the Bank	The Co-operative Bank as a standalone entity.

22. Glossary continued
For the year ended 31 December 2012

Item	Description
the Banking Group	See 'The Co-operative Banking Group'.
The Board	The Board of Directors. They manage the Banking Group's business performance in line with its purpose, givens, vision and values.
The Co-operative Banking Group	An internal brand, which is a consolidation of the following entities: CFS Management Services Ltd, CFS Services Ltd, CIS General Insurance Ltd, Co-operative Insurance Society Ltd, Co-operative Asset Management Ltd and Co-operative Bank plc.
The Co-operative Group	The ultimate parent company.
The Group	The Co-operative Bank consolidated with its subsidiaries.
Total Potential Limit (TPL)	For Treasury exposures – the maximum aggregate exposure (Total Potential Limit) extended to any single counterparty. For Retail/Corporate customers – the total exposure up to and including any shadow limits which a customer could utilise.
Trading book	In relation to the Group's business or exposures, means its proprietary positions in financial instruments: 1. which are held for resale and/or are taken on by the firm with the intention of benefiting in the short term from actual and/or expected differences between their buying and selling prices or from other price or interest-rate variations; and 2. taken in order to hedge other elements of the trading book.
Treasury Market Risk Committee (TMRC)	This committee reviews, challenges and monitors the market risk profile for the Banking Group, in line with policy and within the risk appetite.
Value adjustments	Individual impairment balance.
Value at risk (VaR)	VaR measures the daily maximum potential gain or loss due to past market volatility. The VaR methodology employed is historical simulation using a time series of 1 year to latest day. Confidence level of 95% with a one day holding period.
Wrong way risk	This type of risk occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty.

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