# The Co-operative Bank plc
# Building the compelling co-operative alternative
Pillar 3 disclosures 2011

Part of The **co-operative** banking group

The **co-operative**
good with money

**Contents**

# Overview and context

For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

### Introduction

The Capital Requirements Directive (CRD), introduced on 1 January 2007, set out the new disclosure requirements for firms operating under 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 which is part of the wider Co-operative Banking Group.

### Frequency

This report will be published on an annual basis and will be based on the financial year end date in line with the financial statements announcement.

These disclosures are based on the reporting period ended 31 December 2011.

### Media and location

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

### Verification

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

# Scope of application

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

### Scope of application of disclosure requirements

The disclosure requirements of Pillar 3 as defined by BIPRU 11 are based on The Co-operative Bank. 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 year end financial statements directors' remuneration report.

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.

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

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

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;
- The Covered Bond LLPs; and
- Unity Trust Bank plc which being separately regulated needs to maintain a minimum prescribed level of capital.

The Group is defined as The Co-operative Bank consolidated with its subsidiaries.

### Scope of internal ratings based 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.

A number of portfolios are on rollout to foundation IRB approach and include corporates with total assets less than £350k, and housing associations. 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.

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

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 waiver was amended accordingly.

# Scope of application continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### 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 | Rollout to foundation IRB |
| | Business Banking | Corporates | Foundation IRB |
| | Public sector entities | Central governments and central banks | Standardised (immaterial portfolio) |
| | Registered social landlords (RSL)/housing associations | Corporates | Rollout to foundation IRB |
| | Leveraged finance | Corporates | Standardised (immaterial portfolio) |
| | Specialised lending | Corporates | Foundation IRB (slotting approach) |
| | Asset finance | Corporates | Standardised (immaterial portfolio) |
| | Overseas corporates | Corporates | Standardised (immaterial portfolio) |
| | Corporate lending to individuals | Corporates | Standardised (immaterial portfolio) |
| Treasury | Central governments and central banks | Central governments and central banks | Foundation IRB |
| | Financial institutions | Institutions | Foundation IRB |
| | Structured investments/credit trading funds | Corporates | Foundation IRB (securitisation ratings based approach) |
| | Securitisation | Corporates | Foundation IRB (securitisation ratings based approach) |
| Other | Equity shares | Equity shares | Standardised (immaterial portfolio) |
| Unity Trust Bank | | Institutions | Standardised (immaterial portfolio) |
| | | Corporates | Standardised (immaterial portfolio) |

### IRB model harmonisation
With effect from merger the capital requirements for wholesale risk have been determined using the Co-operative Banking Group rating system for all exposures. Early harmonisation was appropriate due to the large number of common exposures, and this has now been completed for the corporate income producing real estate (IPRE).

For prime retail mortgages the calculation of capital requirements is currently determined using standalone models. Harmonisation plans currently cover:

- The Co-operative Banking Group and Britannia secured rating systems will be merged on a phased basis.
- The first step to this will be harmonisation of the loss given default (LGD) models followed by exposure at default (EAD) models.
- Combined scorecards with long run probability of defaults (PD) and risk grade mapping will follow.
- Whilst models will be harmonised, the specific parameters they use will continue to reflect the differences in the respective portfolios where appropriate.

# Board and Risk Committee structure

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

The Co-operative Banking Group (the Banking Group) companies, including Co-operative Insurance Society Limited, CIS General Insurance Limited and The Co-operative Bank plc (the Bank) have a common Board composition.

The Banking Group has developed and implemented a common governance and organisation structure, which supports all the Boards within the Banking Group.

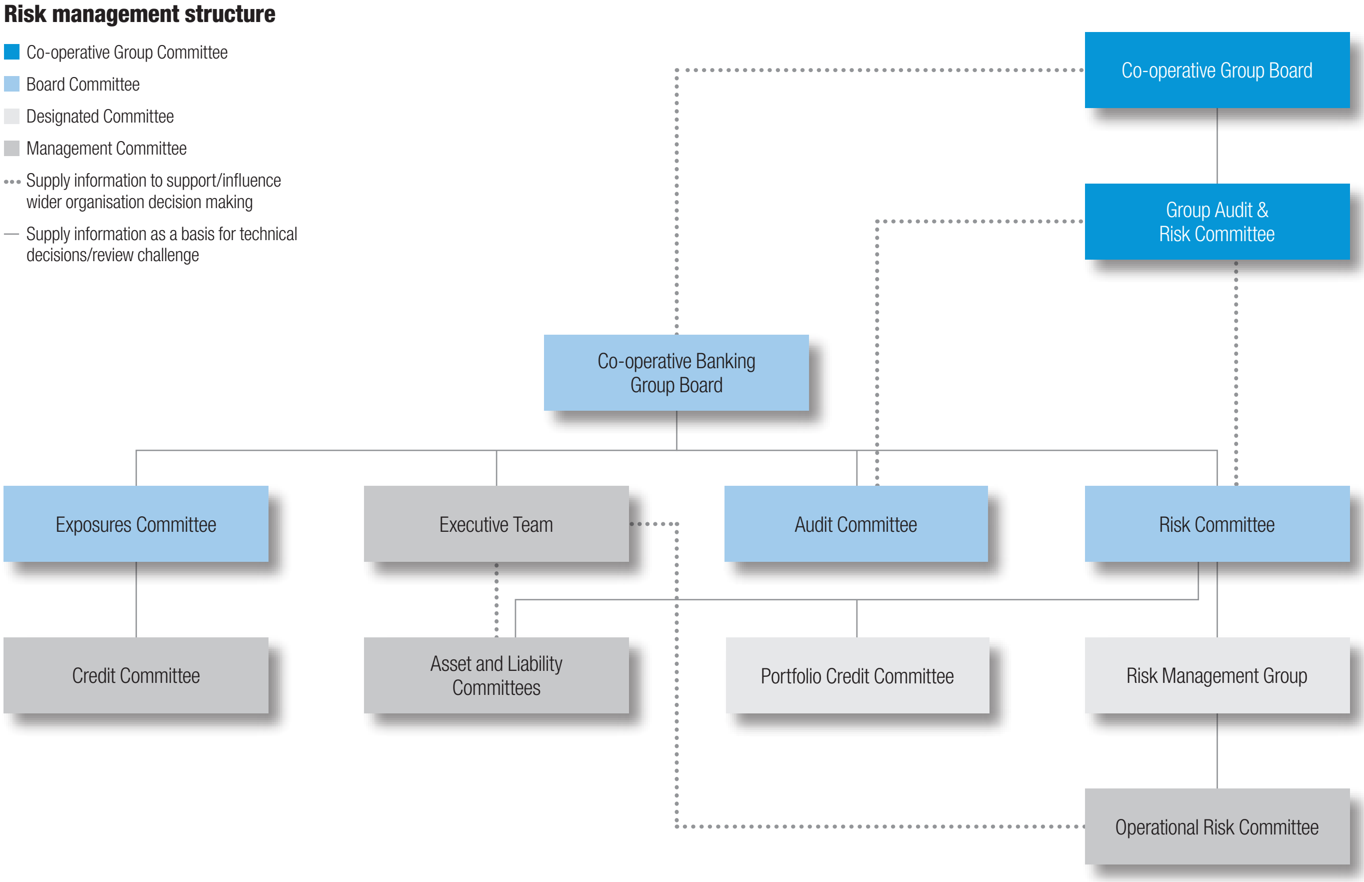
The Banking Group Board is responsible for approving the Banking Group strategy, its principal markets and the level of acceptable risks articulated through its statement of risk appetite. It is also responsible for overall corporate governance which includes ensuring that there is an adequate system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

The Board has established Board committees and senior management committees to:

- oversee the risk management process;
- identify the key risks facing the business; and
- assess the effectiveness of planned management actions.

Specific Board authority has been delegated to Board committees and the Chief Executive Officer who may, in turn, delegate elements of his discretions to appropriate executive directors and their senior line managers.

### Risk management structure



# Board and Risk Committee structure continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

**Risk and capital management committees**

The Banking Group's Board delegates authority to the Banking Group's Risk Committee for monitoring compliance with the Board approved risk appetite statements. This includes:

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

Risk Committee (RC): this committee is responsible for the oversight of the adequacy of capital for all risks (technical, operational and business model and external) across the Banking Group. This includes:

- operation of mandates and limits and any breaches thereof;
- risk management policy approval;
- risk management information reporting and integrity of relevant data;
- identification and measurement of risk;
- adequacy of the risk mitigation process;
- review and discussion of risk issues identified as a result of internal audit work; and
- review and challenge of the impact assessment of the strategic plan on the risk and capital profile.

Audit Committee (AC): this committee provides oversight on financial reporting, internal control, regulatory compliance, external and internal audit.

Exposures Committee: this committee ensures that non-executive directors are actively involved in major credit decisions (including sanctioning large counterparty transactions), monitors large exposures and problem loans as well as reviewing the adequacy of individual credit provisions.

Executive Team: the Executive Team manages the business in line with the Board risk appetite statement. It also maintains oversight of risk management processes and management information.

**Risk and capital management sub-committees**

Portfolio Credit Committee (PCC): this committee reports to RC and is chaired by the Banking Risk Officer. It is responsible for defining the Banking Group's credit risk appetite; providing oversight and timely action in relation to credit risk management; monitoring, challenging and approving changes to Basel rating systems; and reviewing lending and arrears policies.

Asset and Liability Committees (ALCO): these committees are management committees of the Board which are chaired by the Chief Financial Officer. They are primarily responsible for overseeing the management of market, liquidity and funding risks. They also advise on capital utilisation and the composition and sourcing of adequate capital.

Risk Management Group (RMG): this committee reports to RC and is chaired by the Chief Risk Officer. Its purpose is to provide a mechanism to ensure that the Banking Group's risk management is reviewed, challenged, approved (with escalation to RC where required) and embedded within the Banking Group. The committee also monitors all significant and emerging risks, and oversees the development and implementation of stress testing and risk appetite across the Banking Group.

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

Operational Risk Committee (ORC): this committee reports into RMG and is chaired by the Director of Specialist Risk Services. It monitors significant operational risks and controls as well as the management actions taken to mitigate them to an acceptable level or transfer them. This includes business continuity arrangements and insurance cover to protect the Banking Group's business. Capital requirements in relation to operational risk are monitored by the RC.

There is also a framework of sector specific management committees carrying out the following roles:

- supporting risk and capital management;
- implementing changes in business strategy;
- optimising performance;
- monitoring adherence to and setting of policy; and
- developing of management information and training.

# Risk management policies and objectives

For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

**Risk management framework**

A robust qualitative and quantitative risk and governance framework has been developed, and embedded, enterprise wide which is subject to regular ongoing review to ensure it is fit for purpose and benchmarks adequately. This framework:

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

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

- risk management vision, strategy, and principles;
- risk governance structure, and model;
- risk roles, accountabilities and responsibilities;
- risk categorisations and definitions (including the Co-operative Banking Group Risk Universe);
- risk appetite (definition and application);
- risk identification, evaluation, monitoring, assessment and control;
- significant risk reporting; and
- risk quantification methods and processes.

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

Risk initiatives being undertaken include:

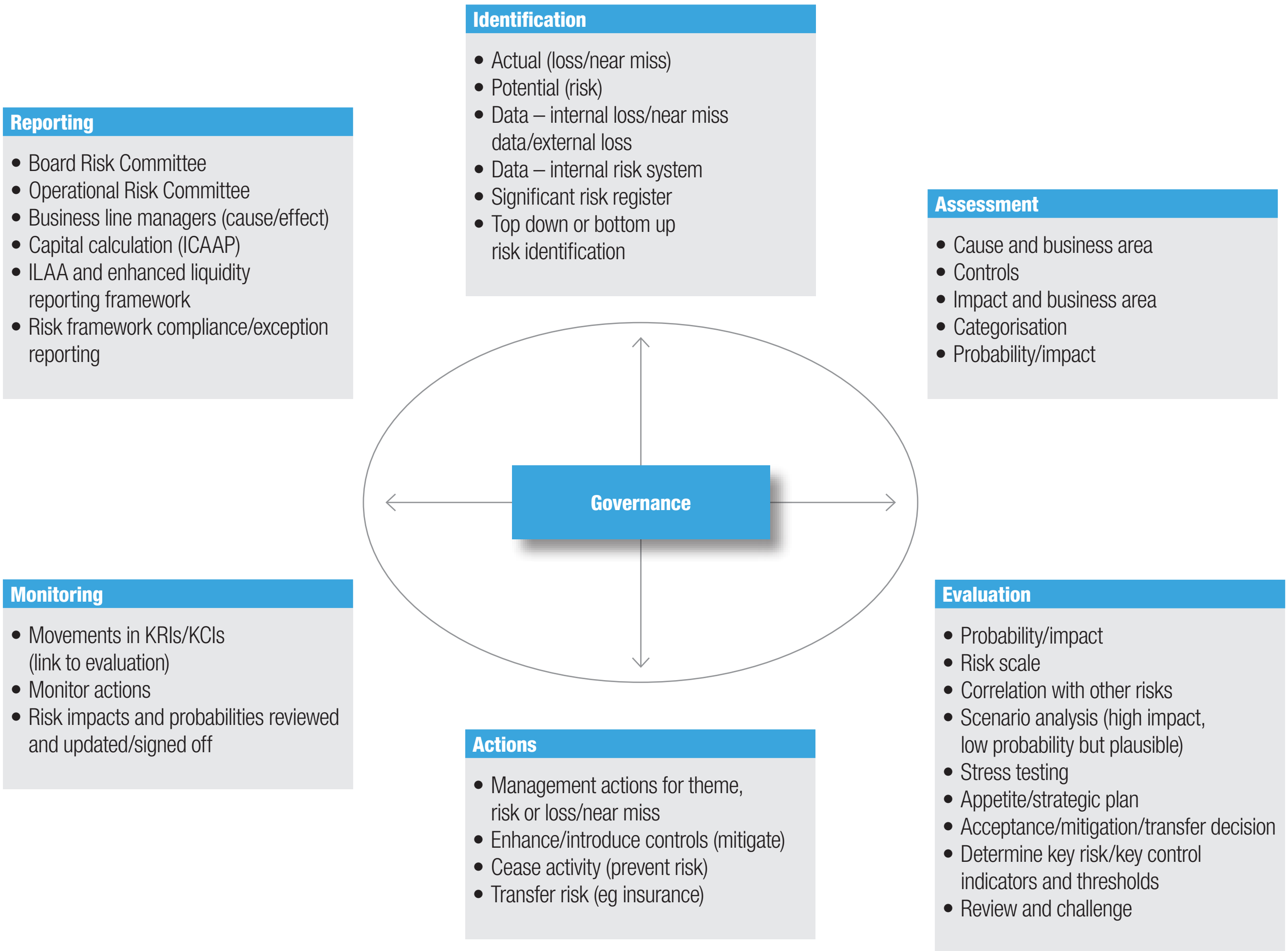
- finalising output from an external independent review of the Banking Group risk management framework including a benchmark against the current market and regulatory expectations which will lead to a number of changes in due course;
- construction of a robust risk management Target Operating Model for risk management to further articulate the types of risks and level of risk appetite we want to conduct which will match our vision and strategic objectives;
- ongoing enhancements to the integrated risk system to continue to capture and monitor all risks across the Group and the Banking Group;
- additional clarity and transparency of responsibility and accountability for risk management;
- improved processes to identify, quantify, monitor and report on emerging and actual risk losses;
- enhanced reporting of risk, risk appetite and return to inform senior management, Board and the strategic planning process;
- realignment of reporting lines and strengthening of the Chief Risk Officer (CRO) role to reinforce its independence and capacity for challenge. The CRO provides oversight and assurance across the overall Banking Group risk management framework for all the Co-operative Banking Group risks and related processes and controls. The CRO is independent from individual entities/business units, but there is common representation of both the CRO and Chief Financial Officer (CFO) at Board, Executive, Risk Committee (RC) and Audit Committee (AC). The CRO has the right of direct escalation to the chairs of the Board, RC and/or the AC; and
- development of key risk and control indicators to assess and challenge the adequacy of risk adjusted capital to meet risk appetite and strategic planning targets, with Board agreed overall risk appetite statements and tolerances for each category of risk within the Group's risk universe.

# **Risk management policies and objectives** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### Risk management monitoring and reporting
To ensure full understanding of the current and projected risk position:

- monitoring of all technical and operational risks, the adequacy of controls and of the capital required for these risks is undertaken on a regular basis;
- the Group monitors its liquidity position on a daily basis against a Board approved liquidity risk appetite and stress scenario. It also closely monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed, and regularly assesses its funding position;
- the Board monitors capital against a Board approved capital risk appetite and stress scenarios. It also closely monitors the adequacy of its controls to provide assurance that capital is being appropriately managed and assessed;
- technical risks are managed through appropriate tools and committees and are reported upon regularly;
- actual operational losses and near misses are reported and considered monthly by the Co-operative Banking Group Executive. In addition, the Banking Group operates a risk and control self assessment process; and
- on a regular basis, risk and risk appetite management information, liquidity monitoring, stress testing, and technical and operational significant risk reporting are undertaken.

The following diagram illustrates the monitoring and reporting functions described above:



# Risk categorisation

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

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

- credit risk;
- market risk;
- liquidity risk; and
- operational risk.

**Credit risk**

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

Credit risk is an integral part of our business activities and 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 credit risk policies are approved annually by the RC. The policies determine the criteria for the management of;

- credit risk associated with retail, corporate and wholesale segments (including securitisation, market exposures and credit management standards);
- country, sector and counterparty limits;
- risk appetites; and
- delegated authorities.

All authority to take credit risk derives from the Banking Group's Board. This authority is delegated to the Chief Executive Officer 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.

**Market risk**

Market risk is the risk relating to changes in market prices of financial instruments, execution of customer and interbank business and proprietary trading. The majority of the Group's market risk arises from changes in interest rates.

Interest rate risk policy statements, approved by the RC on behalf of the Board, specify the scope of the Group's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the ALCO. Its 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 ALCO reviews the balance sheet risk position and the utilisation of wholesale market risk limits.

# **Risk categorisation** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### 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.

#### 1. Value at Risk (VaR)
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 used is historical simulation using a time series of 1 year to latest day and was £0.35m at the 31 December 2011 for the Treasury traded portfolios. 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.

#### 2. PV100
This illustrates the change in valuation on a fixed income portfolio experienced given a 1% increase and decrease in interest rates for treasury, representing treasury banking book and trading book combined. PV100 is the effect on the net present value (NPV) of the wholesale portfolio to a parallel shift of 100 basis points upon the base yield curve.

The 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.

The effects of a 1% increase and a 1% decrease in interest rates are shown in the table below:

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

| | **2011** | | 2010 | |
|---|---|---|---|---|
| | **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** | **15.1** | **(16.0)** | (11.0) | 9.1 |
| **Split by currency:** | | | | |
| – GBP | **15.0** | **(15.9)** | (11.5) | 9.9 |
| – US Dollars | **0.2** | **(0.2)** | (0.3) | 0.1 |
| – Euros | **(0.1)** | **0.1** | 0.5 | (0.6) |
| – Others | **–** | **–** | 0.3 | (0.3) |
| **Treasury Trading Book** | **–** | **–** | – | – |
| **Total Treasury** | **15.1** | **(16.0)** | (11.0) | 9.1 |

### Currency risk
The Group's treasury foreign exchange activities primarily:

- provide a service in meeting the foreign exchange requirements of customers;
- maintain liquidity in euros and US dollars by raising funds and investing these to generate a return; and
- perform limited intraday trading and overnight positioning in major currencies to generate incremental income.

At 31 December 2011 the Group's open position was £0.4m (2010: £0.4m) representing a potential loss of £nil given a 3% depreciation in sterling (2010: £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.

### 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.

ALCO 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 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 (including non-maturity deposits) is no more than a set limit.

Risk limits are formally calculated at each month end. Interest rate risk and effectiveness of hedging is monitored daily using gap positions, incorporating new business requirements. Draw down risk, in particular for fixed rate mortgages, is managed through weekly balance sheet meetings. 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. This risk is managed by performing a future simulation of the balance sheet to establish what the Group's income volatility would be if the rates do not move in a one for one ratio. Cash placements are then undertaken with the treasury markets team to reduce the income volatility. The treasury markets team executes external trades as required.

# **Risk categorisation** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### Interest rate risk in the non-trading book
The exposure to interest rate risk in the retail non-trading book is measured using the Group's gap report. The calculation for interest rate risk assumes external rates on variable rate retail products and new fixed rate business changes by fixed amounts based on the Group's current view of pricing and margins.

Prepayment risk for fixed rate personal lending is modelled based on past behaviour observed by the Group.

The overall exposure to basis risk has remained a net base rate asset throughout 2011 as customers continue to favour variable rate mortgages where the introductory rate is linked to Bank of England base rate and fixed rate savings. Basis risk is monitored by ALCO monthly and action is taken as required, which includes pricing, new products or external hedging.

Non-maturity deposits which are non-interest bearing are separated into a stable 'core' element, based on a long run average, and the residual balance, which can fluctuate. In the gap report, the residual balance and interest bearing non-maturity deposits are deemed to reprice or mature within one month. The 'core' non-maturity deposits are within the non-sensitive balance on the gap report, along with non-dated capital and other non-sensitive balances. ALCO sets guidance around the treatment of non-sensitive balances to reinvest evenly in fixed rate assets in periods up to five years to smooth the income. In a low base rate environment the amounts of deposits which can no longer reprice (as a result of the interest rate being floored) increases leading to an increase in interest rate risk in the 'core' bank.

The 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 constructed 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 gap position would equate to the Group being exposed to income variation of £1m per annum if rates moved by 1%, so the maximum position equates to approximately £8m income exposure if rates moved by 1%.

| | **2011** | 2010 |
|---|---|---|
| | **Net greater than 12 month position £m** | Net greater than 12 month position £m |
| As at 31 December | **(279)** | (204) |
| Average during the period | **(330)** | (69) |
| Maximum sensitivity for the period | **806** | (867) |
| Minimum sensitivity for the period | **(51)** | 56 |

### Liquidity risk
Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed in line with policies developed by ALCO. The Group's liquidity management policies are reviewed and approved annually by the RC (on behalf of the Board) and compliance reviewed 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 Group operates within a robust liquidity risk framework of stress testing combined with a number of strategic and tactical measures which feed into an overall liquidity status score. This is supported with detailed contingency funding plans 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, including Institute of International Finance and Bank for International Settlements recommendations.

# **Risk categorisation** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

The Group manages liquidity risk by applying:

- a systematic control process embedded in the Group's operations; and
- controlled end to end liquidity management with:
  - net outflows monitored to ensure they are within FSA limits;
  - maintenance of a well diversified funding base;
  - management of liquid assets: high quality primary liquidity including cash, and secondary liquidity including certificates of deposit;
  - target strategic ratios; and
  - stress testing.

The three key strategic measures approved by the Board and monitored monthly by ALCO are:

- Wholesale borrowing ratio – amount of wholesale borrowing compared to total liabilities;
- Liquid asset ratio – amount of total assets that are liquid assets; and
- Customer loan/deposit ratio – the ratio of customer loans to customer deposits.

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

The Group monitors its liquidity position on a daily basis against the Board approved liquidity risk appetite and stress scenarios. Treasury holds a pool of liquid assets on behalf of the Group, and management actions are in place to provide additional liquidity when required. These sources of liquidity are held in order to be available to meet unexpected liquidity requirements.

Marketable assets are maintained as a liquidity pool against potential retail outflows; the liquidity pool is the highest quality debt and consists of high quality government issued debt, and cash at the Bank of England.

The Group has access to a variety of medium term wholesale funding sources: securitisations, covered bonds and Euro Medium Term Notes (EMTN). The Group will issue from the programmes as funding requirements and market conditions permit.

ALCO discusses 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 main liquidity risk measures used by the Group as at 31 December 2011 were as follows:

| | **2011** | 2010 |
|---|---|---|
| Wholesale borrowing ratio | **17.8%** | 17.2% |
| Liquid asset ratio | **15.5%** | 9.8% |
| Customer loan/deposit ratio | **93.9%** | 102.5% |

The Group has a high proportion of retail assets funded by retail deposits demonstrated by the loan/deposit ratio which averaged 99.3% during 2011, ensuring there is no over reliance on wholesale funding. There are customer funding and wholesale funding target ratios as described above which are set in line with the Board approved strategic plan. The Group's structural liquidity risk management is therefore retail based and is dependent on behavioural analysis of both customer demand and deposit and loan drawdown profiles by product category, based on experience over the last ten years. The behaviour of retail products is reviewed by ALCO and, in addition, the Group has maturity mismatch limits to control the exposure to longer term mismatches.

# Risk categorisation continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### Operational risk
Operational risk is defined within The Co-operative 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.

#### Objectives
As part of the Banking Group governance model (which deploys three lines of defence) the key objectives are as follows:

- the first line of defence (incorporating all areas of the business) is responsible for the identification and management of operational risks within their respective areas/processes, in line with policy[2];
- the Banking Group has a dedicated central operational risk team who are responsible for provision of a consistent operational risk framework and policy across the Banking Group in line with best practice and regulatory expectations. The team operates as a second line of defence, alongside other areas including compliance monitoring, legal and regulatory advice and financial crime management; and
- internal audit acts as the third line of defence, and have independent oversight of the appropriateness and effectiveness of the operational risk framework.

#### 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 and the associated capital requirements are regularly reported to the ORC, and the RC. These meet regularly to monitor the suitability of the risk management framework and management of significant risks within the Banking Group.

The Banking Group has a significant change agenda to transform the business. To support this agenda, a transformation risk category has been created to assure that the management of risks around the design, development and implementation of change is in line with risk appetite.

The framework is subject to regular internal audit review in line with the Banking Group's rolling risk based audit plan.

#### Business continuity framework
Business continuity is managed by the operational risk function and sets 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.

#### 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.

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

# **Risk categorisation** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### Responsibilities
Whilst the Board is ultimately responsible for operational risks across the Group and the wider Banking Group, this is delegated to the Chief Executive Officer and executive directors within the Banking Group who are responsible for controlling the operational risks in their direct areas of accountability and for compliance with the Banking Group policies.

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. Risk co-ordinators are supported from within their business 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; supports development and testing of business continuity arrangements for the business; and manages the corporate insurance programme.

### Operational risk themes
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:

#### Financial crime
This relates to the effectiveness of controls to minimise financial losses arising from the fraudulent activities of employees, customers and third parties[3].

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

#### 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 pro-actively manage legal issues in relation to commercial, contractual, employment and litigation activities.

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

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

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

#### 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 management information 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.

3 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.

# **Risk categorisation** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### Additional risks
In addition to the significant risks covered above, the following risks are also reported and managed in the Banking Group risk management framework:

- Co-operative group-wide risks, to include pensions, reputation, and contagion risk;
- business model and external risk;
- securitisation risk[4];and
- conduct risk.

### Co-operative group-wide risks
Pension risk: the risk of the Group being unable to meet its pension scheme commitments. Risks are identified at The Co-operative Group level, with the impact of any potential changes to contribution assessed under the Group's risk management framework.

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

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

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

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

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

Reputation risk: We define reputation risk as a failure to proactively develop, protect and optimise the value of the brands of the Co-operative Banking group of companies through inappropriate strategic decisions, poor business performance, operational failure or negative external perception.

As part of the assessment and control of this risk, our business performance and risk profile across all of our risk themes are closely monitored and reviewed. We also proactively monitor and manage media coverage, public and customer opinion and work closely with external rating agencies to ensure a fair and balanced representation. We believe this approach helps maintain member, customer and market confidence.

Contagion risk: Contagion risks are those risks that could originate from elsewhere in the Co-operative Group impacting upon entities within the Banking Group. The Risk Officer for the Group reports directly to the Chief Risk Officer (CRO) for The Co-operative Banking Group, who also acts as the Group Risk Director for the wider Co-operative Group. In addition to attending the Banking Group RC, the CRO also attends the Co-operative Group Risk and Audit Committee. This allows the CRO to have an independent and holistic view of the risk profile across the Co-operative Group.

### Business model and external risk
Business model and external 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.

The main challenges to the business plan and strategy are the uncertain economic environment, the changing regulatory environment and the significant internal 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.

### Conduct risk
Conduct risk is the failure to ensure the fair treatment of customers leading to poor outcomes for customers.

The environment could create new risks in different ways. New risks could arise through neglecting post sales service; and in not properly considering the intended audience in: complex new product design, development and sales processes.

The Banking Group mitigates and prevents emerging conduct risk through the application of appropriate risk management, controls and ongoing oversight and monitoring provided by established Risk and Compliance functions. Significant conduct risks are regularly monitored and reported up to and challenged by the RC.

4 Securitisation risk is defined within the Securitisations section.

# Capital resources

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

The Group's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. However, the Group 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 following table shows the capital resources of the Group as at 31 December 2011.**

| | **2011 £m** | 2010 £m |
|---|---|---|
| **Tier one capital[5]:** | | |
| **Core tier one capital** | | |
| Permanent share capital | **410.0** | 410.0 |
| Retained earnings | **1,716.2** | 1,610.5 |
| Share premium account | **8.8** | 8.8 |
| **Core tier one capital** | **2,135.0** | 2,029.3 |
| Perpetual non cumulative preference shares | **60.0** | 60.0 |
| **Total tier one capital before deductions** | **2,195.0** | 2,089.3 |
| Intangible assets | **(71.1)** | (69.0) |
| Expected loss shortfall | **(114.2)** | (50.9) |
| Securitisation positions | **(2.3)** | (34.4) |
| Material holdings and investments that are not material holdings | **(1.3)** | (1.3) |
| **Total tier one capital after deductions** | **2,006.1** | 1,933.7 |
| **Tier two capital:** | | |
| **Upper tier two[6]** | | |
| Upper tier two capital instruments | **256.5** | 262.5 |
| Revaluation reserves | **2.9** | 2.9 |
| Collective Provision | **0.7** | – |
| **Upper tier two capital** | **260.1** | 265.4 |
| Lower tier two capital instruments[7] | **827.5** | 622.1 |
| **Total tier two capital before deductions** | **1,087.6** | 887.5 |
| Expected loss shortfall | **(114.2)** | (50.9) |
| Securitisation positions | **(2.3)** | (34.4) |
| Material holdings and investments that are not material holdings | **(1.3)** | (1.3) |
| **Total tier two capital after deductions** | **969.8** | 800.9 |
| **Total capital resources** | **2,975.9** | 2,734.6 |

### Deductions

Intangible assets deducted from tier one capital represent capitalised software. Under the IRB approach a deduction is made for expected losses in excess of impairment provisions made on customer lending, 50% is deducted from tier one and 50% from tier two capital. The expected loss shortfall is shown net of tax. The lifetime expected loss has been treated in the same manner as impairment provisions and therefore included in the expected loss and securitisation position shortfall. The figures above are inclusive of the fair value adjustments on merger.

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

6 Upper tier two capital includes permanent interest bearing shares of Britannia 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.

7 Lower tier two capital includes subordinated debt. The lower tier two capital includes six subordinated debt issues: £150m Step Up Callable Subordinated notes 2019, fixed rate until 2014, then moving to a floating rate; £150m Callable Subordinated notes 2021 fixed rate until 2016, then moving to floating rate; £126m 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 fair value adjustment arising from the merger with Britannia. More information on these can be found in the Bank's annual financial statements.

# Capital and liquidity management framework

For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

The Group has a robust capital and liquidity management framework comprising:

- a strong well established and embedded asset liability management control programme;
- robust risk, capital and liquidity quantification and mitigation techniques and processes;
- management actions linked through to stress testing and capital and liquidity planning models, enabling a robust method of mitigating the effects of a severe but plausible economic stress;
- defined processes to invoke necessary management actions detailed in the Internal Capital Adequacy Assessment Process (ICAAP) submission document;
- clear articulation of how liquidity risk is identified, measured, monitored and managed in the Individual Liquidity Adequacy Assessment (ILAA) and procedures and governance in place to mitigate the risk;
- clearly defined risk appetite, controls and governance in the Group's capital and liquidity management policies; and
- detailed and documented ongoing development and embedding plans for capital adequacy, capital allocation and risk appetite development.

The Group is also progressing towards implementation of Basel III and other UK and EU risk and capital requirements. These include the Capital Requirements Directive IV and considerations resulting from the reports issued by the Independent Commission on Banking.

The capital and liquidity management meeting (CAL) is responsible for the further development of this framework including the FSA003 periodic Management Information (MI) submissions, overseeing the Group's capital and liquidity reporting processes, agreeing, reviewing and discussing the current and projected capital resources versus capital requirements for the Group, and for challenging and agreeing capital allocation assumptions and funding implications. The CAL also: monitor, review, and challenge the Group's risk appetite (with approval from Board), and regularly review, challenge and agree 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 meeting 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 Shareholder 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 risk appetite reflects the amount and type of risk that the Group is prepared to seek, accept or tolerate as defined in the following four capital objectives:

1. maintain capital quantity and quality adequate to cover existing and projected risks in the business;
2. maintain capital adequate to be confident of weathering extreme but plausible market scenarios;
3. maintain operations such that we are confident that our customer service and our reputation are sustained in extreme but plausible scenarios; and
4. generate good, stable returns for members.

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 cover all aspects of the liquidity risk the Group is exposed to.

The Group monitors its liquidity position on a daily basis against 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.

**Assessing 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 Internal Capital Adequacy Assessment Process (ICAAP) which has been constructed in two stages:

Stage 1 – initially assesses the capital adequacy of the Group'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, reputation risk, and contagion risk).

Stage 2 – models the Group's three year strategic plan earnings and balance sheet in order to ensure that its Pillar 1 and Pillar 2 capital requirements are met during a severe but plausible economic stress, over the plan period, utilising appropriate management actions, but without recourse to support from The Co-operative Group (except for specific event risks such as financial services compensation scheme levy for which capital is held by the Banking Group).

The Group's most material risk is credit risk. On this basis, the Group's principal stress in determining its Pillar 2 capital is that of credit quality deterioration as a result of a severe but plausible economic stress. The Group has defined its severe but plausible stress with reference to the FSA adverse anchor scenario in line with the guidance set out in PS09/20. Management actions that the Group would take to respond to the severe but plausible economic stress and their effect on the Group's internal capital adequacy are included within the model and reported in the ICAAP.

**Assessing adequacy of liquidity**

The Group's approach to assessing the adequacy of its liquid assets to support potential liquidity events is documented in the 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.

# Pillar 1 capital requirement

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

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

| IRB exposure class | 2011 £m | 2010 £m |
|---|---|---|
| Central government and central bank | **1.8** | 0.1 |
| Institutions | **74.8** | 85.6 |
| Corporates | **82.5** | 96.2 |
| Securitisations | **10.5** | 24.6 |
| Retail exposures secured by real estate collateral | **448.4** | 436.2 |
| Qualifying revolving | **56.2** | 62.2 |
| Other retail exposures | **50.9** | 59.4 |
| **Total IRB** | **725.1** | 764.3 |
| **Specialised lending** | **444.8** | 439.0 |
| **Standardised exposure class** | | |
| Central government and central bank | **–** | – |
| Regional governments or local authorities | **1.9** | 1.4 |
| Administrative bodies and non-commercial | **6.6** | 6.5 |
| Institutions | **5.0** | 5.7 |
| Corporates | **238.7** | 165.0 |
| Secured by mortgages on residential property | **0.3** | 0.1 |
| Secured by mortgages on commercial real estate | **0.1** | – |
| Retail | **–** | 2.7 |
| Past due | **16.1** | 8.6 |
| Other items[8] | **56.4** | 33.8 |
| **Total standardised** | **325.1** | 223.8 |
| **Total credit risk capital requirement** | **1,495.0** | 1,427.1 |
| **Trading book minimum capital requirements** | | |
| Interest rate position risk requirement | **1.5** | 2.0 |
| Counterparty risk capital component | **2.6** | 1.8 |
| Foreign currency position risk requirement | **–** | 0.1 |
| **Trading book minimum capital requirements** | **4.1** | 3.9 |
| **Operational risk capital requirement** | **121.7** | 128.3 |
| **Total Pillar 1 capital requirement** | **1,620.8** | 1,559.3 |

8 Other items within the standardised approach include equity shares with a balance sheet value of £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.

# Analysis of exposures

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

### Analysis of exposure (EAD) by residual maturity

The following table represents the Group's exposure analysed by approach, exposure class and residual maturity. The data is equivalent to exposure at default under the IRB approach (the exposure at default includes undrawn commitments after credit conversion factor). For the standardised approach the exposure includes drawn exposure plus undrawn commitments post credit conversion factor net of individual provisions.

**2011**

| Exposure class | Repay on demand £m | Up to 1 year £m | 1–5 years £m | 5–10 years £m | 10–20 years £m | Over 20 years £m | Total exposure £m | Average exposure £m |
|---|---|---|---|---|---|---|---|---|
| **IRB** | | | | | | | | |
| Central government and central bank | – | 6,435.6 | 375.6 | 819.1 | 461.3 | 111.9 | 8,203.5 | 5,972.6 |
| Institutions | – | 2,497.6 | 1,403.0 | 300.7 | 17.7 | 39.3 | 4,258.3 | 4,762.8 |
| Corporates | – | 349.4 | 585.0 | 168.5 | 161.6 | 26.2 | 1,290.7 | 1,316.4 |
| Securitisations | – | 349.0 | 315.7 | 170.2 | 57.3 | 10.2 | 902.4 | 1,080.7 |
| Retail mortgages | – | 134.0 | 1,115.1 | 2,683.4 | 11,878.3 | 9,307.3 | 25,118.1 | 25,697.5 |
| Qualifying revolving | 2,293.9 | – | – | – | – | – | 2,293.9 | 2,316.0 |
| Other retail exposures | 46.2 | 43.1 | 490.3 | 185.4 | – | – | 765.0 | 811.6 |
| **Total IRB** | 2,340.1 | 9,808.7 | 4,284.7 | 4,327.3 | 12,576.2 | 9,494.9 | 42,831.9 | 41,957.6 |
| **Specialised lending** | – | 948.2 | 1,957.2 | 875.9 | 846.3 | 1,083.7 | 5,711.3 | 5,716.5 |
| **Standardised** | | | | | | | | |
| Central government and central bank | – | – | – | – | – | – | – | – |
| Regional governments or local authorities | – | 52.1 | 13.2 | 7.2 | 40.6 | 4.1 | 117.2 | 105.8 |
| Administrative bodies and non-commercial | 2.9 | 22.0 | 13.2 | 46.3 | 3.7 | 2.1 | 90.2 | 94.2 |
| Institutions | – | 315.7 | 0.1 | – | – | – | 315.8 | 366.0 |
| Corporates | 1.2 | 236.5 | 852.1 | 457.4 | 660.3 | 778.2 | 2,985.7 | 2,808.5 |
| Secured by mortgages on residential property | – | 3.8 | 0.2 | 2.0 | – | 4.0 | 10.0 | 7.1 |
| Secured by mortgages on commercial real estate | – | 0.9 | – | – | – | – | 0.9 | 0.9 |
| Retail | 0.4 | – | – | – | – | – | 0.4 | 3.6 |
| Past due | – | 3.5 | 83.0 | 17.8 | – | – | 104.3 | 85.0 |
| Other items | 1,070.0 | – | – | – | – | – | 1,070.0 | 892.8 |
| **Total standardised** | 1,074.5 | 634.5 | 961.8 | 530.7 | 704.6 | 788.4 | 4,694.5 | 4,363.9 |
| **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 | 52,038.0 |

The Co-operative Bank Group is predominantly UK based with non-UK lending at immaterial levels.

# **Analysis of exposures** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

**2010**

| Exposure class | Repay on demand £m | Up to 1 year £m | 1–5 years £m | 5–10 years £m | 10–20 years £m | Over 20 years £m | Total exposure £m | Average exposure £m |
|---|---|---|---|---|---|---|---|---|
| **IRB** | | | | | | | | |
| Central government and central bank | – | 1,525.1 | 35.8 | 194.2 | 459.5 | 163.0 | 2,377.6 | 2,202.9 |
| Institutions | – | 4,024.0 | 1,130.9 | 76.3 | 11.6 | 21.9 | 5,264.7 | 5,368.3 |
| Corporates | – | 497.8 | 442.1 | 171.7 | 169.9 | 22.5 | 1,304.0 | 1,268.2 |
| Securitisation positions | – | 1,034.7 | 827.0 | 187.6 | 22.1 | 82.2 | 2,153.6 | 2,417.1 |
| Retail mortgages | – | 206.6 | 1,085.1 | 2,641.8 | 11,034.9 | 10,445.6 | 25,414.0 | 24,902.1 |
| Qualifying revolving | 2,387.6 | – | – | – | – | – | 2,387.6 | 2,425.7 |
| Other retail exposures | 40.3 | 38.6 | 558.9 | 217.8 | – | – | 855.6 | 861.3 |
| **Total IRB** | 2,427.9 | 7,326.8 | 4,079.8 | 3,489.4 | 11,698.0 | 10,735.2 | 39,757.1 | 39,445.6 |
| **Specialised lending** | – | 986.4 | 1,894.3 | 959.5 | 1,014.1 | 843.0 | 5,697.3 | 5,588.2 |
| **Standardised** | | | | | | | | |
| Central government and central bank | – | – | – | – | – | – | – | 543.5 |
| Regional governments or local authorities | – | 24.3 | 23.7 | 3.7 | 31.6 | 1.8 | 85.1 | 98.5 |
| Administrative bodies and non-commercial | 0.6 | 18.2 | 21.0 | 40.0 | 4.3 | 5.1 | 89.2 | 93.3 |
| Institutions | – | 352.7 | 0.1 | – | – | – | 352.8 | 412.3 |
| Corporates | 4.9 | 262.2 | 823.0 | 278.3 | 503.3 | 766.4 | 2,638.1 | 2,643.3 |
| Secured by mortgages on residential property | – | 0.9 | – | – | – | – | 0.9 | 1.0 |
| Secured by mortgaged on commercial real estate | – | – | – | – | – | – | – | – |
| Retail | 22.5 | 0.2 | 4.4 | 8.7 | 12.6 | 3.5 | 51.9 | 51.4 |
| Past due | – | 8.7 | 30.9 | 31.4 | – | 0.7 | 71.7 | 68.2 |
| Other items | 775.6 | – | – | – | – | – | 775.6 | 853.0 |
| **Total standardised** | 803.6 | 667.2 | 903.1 | 362.1 | 551.8 | 777.5 | 4,065.3 | 4,764.5 |
| **Total credit risk exposures** | 3,231.5 | 8,980.4 | 6,877.2 | 4,811.0 | 13,263.9 | 12,355.7 | 49,519.7 | 49,798.3 |

The Co-operative Bank Group is predominantly UK based with non-UK lending at immaterial levels.

# Analysis of exposures continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

**This table provides an analysis of exposures, impaired, past due, value adjustments and provisions and charges for value adjustments during the period by exposure class and rating approach.**

Total exposure is equivalent to exposure at default for the IRB approach (the exposure at default includes undrawn commitments after credit conversion factor). For the standardised approach the exposure includes drawn exposure plus undrawn commitments post credit conversion factor net of individual provisions.

For retail exposures loans are considered to be impaired where the loan is 90 days or more past due, irrespective of whether a provision is deemed necessary, and loans less than 90 days past due where a provision is required to cover an anticipated shortfall in the event of realisation of the collateral.

**2011**

| Exposure class | Total exposure £m | Of which: Impaired exposures £m | Of which: Past due exposures not impaired £m | Value adjustments and provisions held against impaired exposures £m | Charge for value adjustments in the period £m |
|---|---|---|---|---|---|
| **IRB** | | | | | |
| Central government and central bank | 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 |

Within the Pillar 3 disclosure, value adjustments are defined as being individual impairments and provisions are defined as collective impairments in line with British Bankers' Association (BBA) guidance.

Provisions are disclosed on a statutory basis and exclude those covered by fair value.

# **Analysis of exposures** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

**2010**

| **Exposure class** | Total exposure £m | Of which: Impaired exposures £m | Of which: Past due exposures not impaired £m | Value adjustments and provisions held against impaired exposures £m | Charge for value adjustments in the period £m |
|---|---|---|---|---|---|
| **IRB** | | | | | |
| Central government and central bank | 2,377.6 | – | – | – | – |
| Institutions | 5,264.7 | 123.8 | – | 4.5 | – |
| Corporates | 1,304.0 | 19.8 | – | 12.8 | 12.6 |
| Securitisations | 2,153.6 | 25.0 | – | 8.5 | – |
| Retail mortgages | 25,414.0 | 1,428.7 | 431.1 | 8.6 | 7.2 |
| Qualifying revolving | 2,387.6 | 151.0 | 1.9 | 111.4 | – |
| Other retail exposures | 855.6 | 59.5 | 3.8 | 46.3 | – |
| **Total IRB** | 39,757.1 | 1,807.8 | 436.8 | 192.1 | 19.8 |
| **Specialised lending** | 5,697.3 | 361.2 | 65.7 | 21.8 | 12.3 |
| **Standardised approach** | | | | | |
| Central government and central bank | – | – | – | – | – |
| Regional governments or local authorities | 85.1 | – | – | – | – |
| Administrative bodies and non-commercial | 89.2 | 0.6 | – | 0.9 | 0.4 |
| Institutions | 352.8 | – | – | – | – |
| Corporates | 2,638.1 | 13.1 | – | 5.5 | 4.1 |
| Secured by mortgages on residential property | 0.9 | – | – | – | – |
| Secured by mortgages on commercial real estate | – | – | – | – | – |
| Retail | 51.9 | – | 0.1 | – | – |
| Past due | 71.7 | 87.0 | – | 15.3 | 6.1 |
| Other items | 775.6 | – | – | – | – |
| **Total standardised** | 4,065.3 | 100.7 | 0.1 | 21.7 | 10.6 |
| **Total credit risk exposures** | 49,519.7 | 2,269.7 | 502.6 | 235.6 | 42.7 |

Within the Pillar 3 disclosure, value adjustments are defined as being individual impairments and provisions are defined as collective impairments in line with British Bankers' Association (BBA) guidance.

# **Analysis of exposures** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

**The table below provides an industrial analysis[9] of total exposures (equivalent to EAD) including undrawn commitments (after credit conversion factor) 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.

The 2010 analysis has been restated to reflect that i) The Co-operative Banking Group adopted the 'UK Standard Industrial Classification of Economic Activity 2007' at the beginning of 2011 for the purposes of Bank of England regulatory reporting, and ii) all PFI exposures are grouped under a single category.

**2011**

| Exposure class/industry | Total exposure £m | Of which: Impaired exposures £m | Value adjustments and provisions held against impaired exposures £m | Charge for value adjustments in the period £m |
|---|---|---|---|---|
| **Corporate exposure class** | | | | |
| 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** |
| **Analysed by approach** | | | | |
| IRB corporates | **1,290.7** | **38.6** | **15.9** | **3.8** |
| Specialised lending* | **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** |

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

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

# **Analysis of exposures** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

**2010**

| **Exposure class/industry** | Total exposure £m | Of which: Impaired exposures £m | Value adjustments and provisions held against impaired exposures £m | Charge for value adjustments in the period £m |
|---|---|---|---|---|
| **Corporate exposure class** | | | | |
| Accommodation Food & Licensed Services | 360.7 | 38.1 | 10.6 | 3.2 |
| Care | 142.3 | – | – | – |
| Education | 80.0 | – | – | – |
| Financial Services | 146.9 | 2.8 | 0.8 | 0.8 |
| Football clubs | 67.1 | 12.1 | 8.7 | 10.8 |
| Housing associations | 1,030.4 | – | – | – |
| Manufacturing | 184.6 | 9.1 | 1.5 | 0.2 |
| Motor Trade/Garages | 86.5 | 0.3 | – | 0.1 |
| PFI | 1,094.7 | – | – | – |
| Professional Services | 122.7 | 4.5 | 1.6 | 1.1 |
| Property and Construction | | | | |
| Commercial Investment | 3,598.6 | 265.1 | 10.5 | 7.7 |
| Residential Investment | 739.8 | 87.8 | 0.5 | 0.7 |
| Commercial Development | 288.2 | 25.4 | 6.2 | 3.2 |
| Residential Development | 118.3 | 2.2 | 0.4 | – |
| Public Sector Entities | – | – | – | 0.2 |
| Renewable Energy | 211.2 | – | – | – |
| Retail/Wholesale Trade | 506.9 | 0.3 | 0.1 | – |
| Services | 579.5 | 29.6 | 14.1 | 5.8 |
| Transport Storage & Communication | 261.4 | – | – | – |
| Utilities | 58.6 | 0.6 | – | – |
| Other | 32.7 | 2.8 | 0.1 | 0.7 |
| **Total** | 9,711.1 | 480.7 | 55.1 | 34.5 |
| | | | | |
| **Analysed by approach** | | | | |
| IRB corporates | 1,304.0 | 19.8 | 12.8 | 12.6 |
| Specialised lending* | 5,697.3 | 361.1 | 21.8 | 12.3 |
| Standardised corporates | 2,638.1 | 13.1 | 5.5 | 4.1 |
| Standardised past due corporates | 71.7 | 86.7 | 15.0 | 5.5 |
| **Total** | 9,711.1 | 480.7 | 55.1 | 34.5 |

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

# **Analysis of exposures** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### Impairment on loans and advances
The loan portfolios are reviewed on a periodic basis, usually once a month. A loan will be deemed to be impaired where there is objective evidence that a loss event has occurred after an asset has been recognised and prior to 31 December 2011.

Once a loan is defined as impaired the provision will be calculated as the difference between the current carrying value of the asset (including fair value adjustments) and the expected future recovery, discounted at the loan's effective interest rate, taking into account the expected charge off rate and any supporting collateral.

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

In Corporate Banking, collective provisions are raised in situations where losses have been incurred as at the balance sheet date but not yet specifically identified and provided against. As the recovery progresses, the collective provision will move across to a specific provision against the customer.

For retail mortgages, loans are described as collectively impaired where the evidence of a loss event having occurred is less certain and consequently the likelihood of a loss occurring is lower. This will include cases where a borrower has made a variation to the loan terms that may be indicative of an underlying financial difficulty, loans less than 90 days past due, and loans not currently past due but where external credit reference data indicates that the borrower's financial circumstances may have deteriorated.

### Individual provisions
Retail mortgages are identified as individually impaired when they are 90 days past due, or where we have commenced litigation proceedings to seek realisation of the collateral. Loans are deemed impaired even if the level of collateral is such that we do not expect to incur a loss. In addition roll-up mortgages are defined as impaired if the value of the underlying collateral is thought to have reduced to the extent that we expect to incur a loss when the loan is due for repayment.

The credit quality of all corporate counterparties is reviewed and allocated a 'risk grade' at least annually, supported in the interim by a suite of automated management reports to enable the Group to monitor the overall quality of its lending assets. Those of lesser quality, where the lending is potentially at risk and provisions for future loss may be required, are centrally monitored with specific management actions taken at each stage within laid down procedures and specific provisioning criteria. Provisions represent the likely net loss after realisation of any security or management actions.

### Past due but not impaired
Loans and securities are considered past due where the contractual interest or principal payment are in arrears, however there are certain mitigating circumstances that may deem it necessary not to raise a provision for past due accounts (eg where the amount of arrears or the number of days past due are immaterial or where the level of collateral on a secured loan is such that a loss is not expected).

### Fair value adjustments and provisions held against impaired exposures
When Britannia merged with The Co-operative Bank, the Britannia lending portfolios were carried into the newly merged entity at their fair value, taking account of future lifetime expected loss on the lending portfolios at 31 July 2009. The lifetime expected loss adjustment is offset against the heritage Britannia gross lending balances in the combined entity's financial statements. The utilisation and allocation of the Fair Value Adjustment is reviewed on a regular basis.

# Movement in value adjustments and provisions for impairment

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

### Allowance for impairments relating to loans and advances to customers

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

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

| | **Individual Mortgage £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** |

| | Individual Mortgage £m | Individual Corporate £m | Collective Retail £m | Collective Corporate £m | Total £m |
|---|---|---|---|---|---|
| **2010** | | | | | |
| At the beginning of the year | 2.3 | 51.3 | 139.8 | 0.6 | 194.0 |
| Charge against profits | 7.2 | 35.6 | 63.0 | 0.8 | 106.6 |
| Amounts written off | (0.9) | (30.5) | (43.9) | (1.0) | (76.3) |
| Unwind of discount allowance | – | (1.0) | (1.2) | – | (2.2) |
| Interest charged on impaired loans | – | 0.5 | – | – | 0.5 |
| **At the end of the year** | 8.6 | 55.9 | 157.7 | 0.4 | 222.6 |

### Allowance for impairments relating to debt securities

The provisions within the treasury portfolio relate to exposures to institutions and investment in securitisations. The impact of the ongoing financial crisis and associated reduction in liquidity within the wholesale markets have led to a loss of active markets or availability of traded prices for particular assets. A £4.5m collective provision previously held in respect of institutional debt securities has now been released given the imminent maturity of the underlying issues and their stable market price. A provision of £2.65m is retained relating to the securitisation position exposure class.

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

| | **2011 £m** | 2010 £m |
|---|---|---|
| Opening balance | **85.3** | 86.4 |
| Release for the year | **(5.6)** | (1.5) |
| Any other adjustments | **(34.5)** | 0.4 |
| **Closing balance** | **45.2** | 85.3 |

### Comparison of expected losses to accounting impairment losses

The table [on page 26] provides a comparison of expected losses on non-defaulted assets as at 31 December 2010 with the charge to the income statement for losses on loans and advances for the year to 31 December 2011.

Expected losses for exposures on the IRB approach are derived from underlying IRB models and are a function of PD, LGD and 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 are 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.

Expected loss is provided for all relevant exposures including heritage Britannia. Accounting impairment losses relate to heritage Bank lending portfolios, loss provisions on new business generated by the merged entity and loss provisions not covered by the lifetime expected loss calculation on heritage Britannia lending portfolios.

# **Movement in value adjustments and provisions for impairment** continued

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

| | Expected losses on non-defaulted assets as at 31 December 2010[10] £m | Impairment losses for 2011 £m |
|---|---|---|
| **Exposure class** | | |
| **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** |
| **Charge to the income statements** (loans and advances to customers and banks) | | **130.5** |

| | Expected losses on non-defaulted assets as at 31 December 2009 £m | Impairment losses for 2010 £m |
|---|---|---|
| **Exposure class** | | |
| **IRB** | | |
| Central government and central bank | – | – |
| Institutions | 2.6 | – |
| Corporates | 14.7 | 12.6 |
| Securitisations | – | – |
| Retail mortgages | 152.2 | 7.2 |
| Qualifying revolving | 41.4 | 37.8 |
| Other retail exposures | 23.4 | 25.2 |
| **Total IRB** | 234.3 | 82.8 |
| **Specialised lending** | 82.3 | 12.3 |
| **Total** | 316.6 | 95.1 |
| **Impairment losses on standardised portfolios** | | 11.5 |
| **Charge to the income statements** (loans and advances to customers and banks) | | 106.6 |

10 Expected loss forecasts losses for 12 months ahead

# Standardised approach

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

**Analysis of exposures calculated in accordance with the standardised approach**

For those exposures subject to the standardised approach a significant portion are unrated. There are some rated exposures to institutions within Basel defined immaterial portfolio. The nominated external credit assessment institutions (ECAIs) or export credit agency for these is Moody's. The Group complies with the credit quality assessment scale in allocating external credit ratings to the credit quality steps as defined by the FSA. There is no credit risk mitigation associated with the exposures on the standardised approach.

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

| | 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** |
| Secured by mortgages on residential property | – | – | – | – | – | – | **10.0** | **10.0** |
| Secured by mortgages on commercial real estate | – | – | – | – | – | – | **0.9** | **0.9** |
| Retail | – | – | – | – | – | – | **0.4** | **0.4** |
| 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** |

| | Credit Quality Step | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1 £m | 2 £m | 3 £m | 4 £m | 5 £m | 6 £m | Unrated £m | Total £m |
| **2010** | | | | | | | | |
| Central governments and central banks | – | – | – | – | – | – | – | – |
| Regional governments or local authorities | – | – | – | – | – | – | 85.1 | 85.1 |
| Administrative bodies and non-commercial | – | – | – | – | – | – | 89.2 | 89.2 |
| Institutions | 342.6 | 10.0 | – | – | – | – | 0.2 | 352.8 |
| Corporates | – | – | – | – | – | – | 2,638.1 | 2,638.1 |
| Secured by mortgages on residential property | – | – | – | – | – | – | 0.9 | 0.9 |
| Secured by mortgages on commercial real estate | – | – | – | – | – | – | – | – |
| Retail | – | – | – | – | – | – | 51.9 | 51.9 |
| Past due | – | – | – | – | – | – | 71.7 | 71.7 |
| Other items | – | – | – | – | – | – | 775.6 | 775.6 |
| **Total standardised approach** | 342.6 | 10.0 | – | – | – | – | 3,712.7 | 4,065.3 |

# Specialised lending

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

### Specialised lending analysis by slotting category

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.

### Specialist lending exposure by slotting category

| | 2011 £m | 2010 £m |
|---|---|---|
| **Slotting Category** | | |
| Strong | **242.6** | 316.0 |
| Good | **3,083.6** | 3,599.7 |
| Satisfactory | **1,020.4** | 618.0 |
| Weak | **651.3** | 609.3 |
| Default | **713.4** | 554.3 |
| **Total** | **5,711.3** | 5,697.3 |

# Securitisations

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

Securitisation risk is the residual credit risk arising from retaining an interest in the Group's securitisation companies through the provision of subordinated debt and/or start up expense loans and liquidity facilities where applicable.

**Asset backed securities (ABS)**

The Group has total ABS exposure of £0.9bn, down from £2.2bn in 2010. The overall exposure has been managed down during the year, with redemptions and sales of £1.2 billion being partly offset by approximately £0.1 billion of purchases. A profit of £37.2 million has been recognised in the year against the asset sales. During the period a provision of £2.7 million was placed against a Commercial MBS securitisation asset. This was due to a reduction in the value of the underlying collateral.

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 External Credit Assessment Institutions, 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. The performance of the portfolio is reported to the Exposures Committee on a monthly basis.

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.

**ABS securitisation exposures by risk band**

| | Credit quality step | Senior and granular £m | Non-senior and granular £m | Non-senior and non-granular £m |
|---|---|---|---|---|
| **2011** | | | | |
| **External Rating** | | | | |
| AAA or A1/P1 | **1** | **581.6** | **7.1** | **–** |
| AA | **2** | **33.3** | **77.4** | **5.2** |
| A+ | **3** | **–** | **16.8** | **14.6** |
| A or A2/P2 | **4** | **4.2** | **82.9** | **–** |
| A- | **5** | **5.1** | **3.0** | **–** |
| BBB+ | **6** | **–** | **5.3** | **–** |
| BBB | **7** | **9.6** | **41.5** | **–** |
| BBB- | **8** | **–** | **–** | **–** |
| BB+ | **9** | **–** | **–** | **–** |
| BB | **10** | **–** | **1.4** | **–** |
| BB- | **11** | **–** | **–** | **–** |
| Rated below BB- or A3/P3 | **12** | **–** | **–** | **6.9** |
| **Total** | | **633.8** | **235.4** | **26.7** |

| | Credit quality step | Senior and granular £m | Non-senior and granular £m | Non-senior and non-granular £m |
|---|---|---|---|---|
| **2010** | | | | |
| **External Rating** | | | | |
| AAA or A1/P1 | 1 | 1,607.1 | 27.7 | 18.0 |
| AA | 2 | 34.8 | 113.2 | 7.5 |
| A+ | 3 | – | 32.5 | 15.9 |
| A or A2/P2 | 4 | 16.5 | 121.6 | – |
| A- | 5 | – | 3.0 | – |
| BBB+ | 6 | 2.5 | 18.0 | – |
| BBB | 7 | – | 71.3 | – |
| BBB- | 8 | – | 25.0 | – |
| BB+ | 9 | – | 6.9 | – |
| BB | 10 | – | 1.4 | – |
| BB- | 11 | – | – | – |
| Rated below BB- or A3/P3 | 12 | 8.0 | 5.0 | 17.7 |
| **Total** | | 1,668.9 | 425.6 | 59.1 |

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.

# **Securitisations** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

**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 as 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. No outstanding securitisation affords the Group regulatory capital relief under BIPRU 9.

The table below shows the initial funded amount and value as at 31 December 2011 of subordinated and start up loans, and liquidity facilities in respect of securitisations sold to third party investors, subject to the qualifications documented in the following paragraphs.

**Originated securitisation exposures**

| | Initial funded amount £m | 2011 Value £m | 2010 Value £m |
|---|---|---|---|
| **Subordinated loans** | | | |
| Leek Finance Number Seventeen plc | **23** | **28** | – |
| Leek Finance Number Eighteen plc | **23** | **27** | 27 |
| Leek Finance Number Nineteen plc | **18** | **18** | 18 |
| **Total NOT protected by Dovedale** | **64** | **73** | 45 |
| **Start up loans** | | | |
| Leek Finance Number Nineteen plc | **3** | **–** | 1 |
| **Liquidity Facilities** | | | |
| Leek Finance Number Eighteen plc | **–** | **17** | – |
| Leek Finance Number Nineteen plc | **–** | **17** | – |
| **Total** | **67** | **107** | 46 |

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

| | Total notes issued £m | Date of issuance | 2011 Notes outstanding £m | 2010 Notes outstanding £m |
|---|---|---|---|---|
| **SPE Company** | | | | |
| Leek Finance Number Seventeen plc | **1,168** | **April 06** | **476** | 500 |
| Leek Finance Number Eighteen plc | **1,048** | **October 06** | **562** | 601 |
| Leek Finance Number Nineteen plc | **833** | **April 07** | **553** | 578 |
| Silk Road Finance Number One plc | **1,375** | **February 10** | **959** | 1,208 |
| Silk Road Finance Number Two plc | **728** | **July 11** | **688** | – |
| **Total** | **5,152** | | **3,238** | 2,887 |
| **Synthetic** | | | | |
| Dovedale Finance Number One plc | **102** | **June 06** | **–** | 27 |

# **Securitisations** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

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 the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU 9). Following the restructure of these transactions, initially announced in March 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 and in respect of future securitisations for the foreseeable future.

The Group executed Silk Road Finance Number Two ('Silk 2'), a Residential Mortgage Backed Security (RMBS), in July 2011, generating £728m equivalent of Euro and Sterling denominated notes. Silk 2 was the Group's second prime RMBS transaction following Silk Road Finance Number One ('Silk 1') issued in February 2010. Silk 2, as with Silk 1, is not subject to significant risk transfer rules under BIPRU 9. No outstanding securitisations afford the Group regulatory capital relief.

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 2011, £2.2bn of AAA Leek 20, Leek 21 and Leek 22 notes are outstanding, a proportion of which are deployed in bilateral funding arrangements.

For corporate planning purposes it is assumed that RMBS markets may be open to the Group during 2012 to diversify funding sources further in public markets and/or generate additional collateral for bilateral funding purposes. Detailed disclosures around each remaining active (and historic) securitisation are published each quarter on the Group website at the following address: **www.britannia.co.uk/bts.**

# Credit risk control

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

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

CRCU is responsible for procedures across both retail and corporate and performs the following tasks and responsibilities related to its role:

- design and implementation of risk assessment and rating systems;
- testing, validating, documenting and monitoring of risk assessment and rating systems;
- production and analysis of summary reports of risk assessment and rating systems;
- maintenance of lending policy and procedures and upkeep of various returns and reporting requirements;
- monitoring system decision overrides and exceptions;
- benchmarking against third party data and vendor model sources;
- reviewing the risk criteria to ensure they remain predictive of risk;
- oversight of independent validation;
- development and monitoring of risk appetite; and
- liaise with FSA regarding proposed changes to rating systems and forecast regulatory capital levels.

### Retail credit policy

The 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 the 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 historic data. Regular updates are provided to the PCC and RC on the performance of the portfolios.

### Credit approval and individual limit setting

#### 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. Different scorecards are used depending on which part of the Group receives the application. 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 on 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 2011, 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.

# **Credit risk control** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

### 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).

### Corporate lending – credit approval
The Co-operative Banking Group corporate banking customer engagement model is comprised of business development managers, relationship managers and support staff.

Corporate Banking is separate from the CRCU and is responsible for the development, recommendation and monitoring of risk appetite, lending policy, rating systems and lending procedures. The CRCU is, in turn, separate from the 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. The lending discretion of the Banking Risk Officer, Chief Executive Officer and Exposure Committees are operated 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.

### Corporate credit policy
The Group's corporate sector policy is to maintain a broad spread of exposures across sectors which reflect the Group's areas of expertise. Credit exposures to corporate and business banking customers are assessed individually. The quality of the overall portfolio is monitored using a credit grading system calibrated to expected loss. The PCC and RC receive regular reports on the performance of the portfolio. The Exposures Committee receives regular reports on new facilities, bad debt provisions and the management of problem loans.

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

### Wholesale credit policy
Teams of risk managers and the CRCU framework support the treasury business group.

The 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 RC receives regular reports on the performance of the portfolio. The Exposures Committee receives regular reports on changes in exposure limits, watchlist and problem counterparty information.

Limits on exposures to counterparties, 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.

# Scope and nature of credit risk reporting systems and processes

For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

### Risk reporting

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

1. RC is provided with credit risk MI within the Risk Report;
2. RMG receive, review and challenge, on a regular basis, key credit risk MI within the Risk Report;
3. PCC MI drills down to considerably greater depth, examples being by risk pool, campaign or key risk splits; and
4. CRCU receive and review, on a regular basis, credit risk MI by, for example, campaign or key characteristic.

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

### Risk Committee management information

The RC Risk Report includes the following key information:

- capital requirements versus capital availability for the Group;
- risk appetite – presenting current position with respect to each element of the risk appetite statement;
- a backdrop of key economic trends pertaining to the Group's credit risk experience;
- a combination of trend and 'point in time' information to illustrate both the current position and how each portfolio is changing; and
- high level credit risk performance.

### Risk Management Group management information

The Risk Report is presented regularly to RMG for review, challenge and approval prior to submission to the RC.

### Portfolio Credit Committee management information

The PCC MI is produced on a monthly basis, with different MI produced for each business area. The regular MI drills down to considerably greater depth than the executive packs with even further detail provided by exception. Reports include:

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

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

### Sector specific management information

MI for the wholesale sector is prepared for appropriate meetings on a monthly basis. Reports include:

- early warning signals, including sovereign and institutional CDS spreads and 10 year government bond yields;
- risk concentrations and investment portfolio analysis;
- trend analysis; and
- stress scenarios.

The identification of any exceptions and agreed mitigating action are included should they occur and are escalated as appropriate.

# Internal ratings process

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

### Retail models

#### Residential mortgages

Several PD models for both new to 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, or where we have commenced litigation to take possession of the borrower, or where the borrower is bankrupt.

Each account is assigned a Point in Time (PiT) PD by the models 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. This is done by either using historic internal and external information, or where this is not possible by modelling the various risk grades under different stressed macroeconomic scenarios. Different long run PDs are assigned depending on product type and business area.

The LGD models are also tailored towards each business area. These are all parameter based systems using a combination of statistical modelling of internal historic data and forward looking forecasts (eg downturn house price assumptions). The key components of the model are probability of possession given default (PPD) and expected shortfall. Any estimated 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 scorecard (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 LGD model – reducing future house price estimates, increasing time to sale parameters and increasing possession rates.

The regulatory LGD floor of 10% is applied where necessary at sector level, with a 5% floor being applied to individual mortgage accounts.

The models are applied to all residential mortgage accounts.

#### Qualifying revolving and other retail exposures

Rather than building bespoke Basel models the underlying business scorecards are calibrated to a Basel compliant definition of Default to provide a Probability of Default (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 Point in Time (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 homogenous LGD pools across the unsecured default portfolio, whereas the LGD (at development) was used for the up to date, arrears and charge off segments across the retail unsecured portfolio. These models directly estimate the average loss (percentage) of EAD over either a 24 (up to date and arrears) or a 36 (default and charge off) month recovery period for each pool. Economic impacts are then considered via assessment of key drivers and further truncations of the recoveries. Due to historical collections policies it was not possible to model LGD to write off and as such the estimates are inherently conservative.

Standard discounting principles are applied in conjunction with the cost of collections and further conservatism if required, to determine the ultimate LGD used for capital calculation.

Statistical techniques were used to develop EAD pools across segments of the unsecured portfolio whereby the exposure exceeded current drawings (credit cards and current accounts). In line with BIPRU requirements, where exposure does not exceed current drawings the current drawings are taken as the EAD (eg loans).

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

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

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

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

# **Internal ratings process** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

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

There are two externally developed PD models in use for grading and monitoring the IRB portion of the corporate asset class; namely, Moody's KMV RiskCalc version 3.1 (UK) for the unquoted corporate borrowers (total balance sheet assets >£0.35m) and CreditEdge version 8 (European) for non-financial UK quoted plcs. After assessing these two external models for their suitability to grade the Banking Group portfolio, the Moody's KMV expected default frequencies generated from the CreditEdge and RiskCalc PD models were calibrated in house to create a single master grading scale (grades 1–14 with the latter being default) and the results externally validated and approved by the RMG and RC.

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).

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.

The remainder of the corporate asset class portfolio is subject to a rollout to foundation IRB. The element of the portfolio that falls under the rollout to foundation IRB is subject to the same criteria for grading and closely monitoring higher risk (non-default) and default situations. Any situations that reach default will be graded on the master grading scale at grade 14 and are the subject of separate analysis to inform the development of the new models.

The Business Banking model was fully approved in December 2010 and was implemented in early 2011.

A housing associations model 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 is pending approval and is due to be implemented in 2012.

In addition to grade migration, arising either directly driven by the model or expert judgment overrides being applied, there is an additional watchlist marker that is applied to help identify where a situation has not reached the point of default but is one that the credit underwriting department has decided merits closer management. This element of the portfolio is subject to regular review by Credit Underwriting and Corporate Credit Function Leaders, and the Banking Risk Officer, together with their respective peers in corporate banking and the CRCU, as good risk practice and a means of informing future model refinement or development with key risk drivers.

The Corporate Bank applies a single 'definition of default' across its whole portfolio (foundation IRB, specialised lending, 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 Corporate and Business Banking committed exposure (EAD) across the different Basel exposure classes at the end of 2011 was £10.2bn. Of this figure, regulatory slotting models were used to analyse and grade £1.2bn PFI assets and £4.5bn real estate assets.

### Wholesale model
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, Standard & Poor's, and Fitch) based on fundamental credit analysis to assign an appropriate internal rating grade (IRG) 1–10. More conservative, judgmental adjustment to counterparties IRG (downward overrides) may be applied and the credit rationale is 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 £12.7bn at the reporting date.

The wholesale model is currently being re-developed to make use of an externally developed PD model from Standard & Poor's which is expected to develop further the existing ratings.

# Approach to validation

## For the year ended 31 December 2011

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, challenged by CRCU Model Review Forum, reviewed by CRCU Management Team and approved by PCC. Model changes are subject to pre or post implementation notification to the FSA depending upon capital impact.

The key forums for technical review and challenge of the IRB rating systems and/or models are the CRCU Model Review Forum and CRCU Management Team.

These forums are provided with sufficient information to understand:

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

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

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

The PCC hold overall responsibility and accountability for approval of rating models, approaches and their performance. Internal audit provide additional oversight and assurance to senior management, acting as the third line of defence. The AC approves the annual audit plan and copies of audit reports are circulated to the AC and/or the RC as appropriate.

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

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

All models are subject to annual reviews to ensure they continue to perform satisfactorily in line with the regulatory requirements and to identify any changes that are required to improve their ability to differentiate levels of credit risk. If the actual performance falls outside of expected criteria then this review process will be undertaken earlier. Annual model reviews are challenged by CRCU Model Review Forum prior to submission to CRCU management team and PCC.

# IRB approach

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

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

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

| | 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** |
| **2011** | | | | | | | | | | |
| **Exposure value** | | | | | | | | | | |
| **IRB Exposure class** | | | | | | | | | | |
| Central government and central banks | **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** |
| **RW %** | | | | | | | | | | |
| **IRB Exposure class** | | | | | | | | | | |
| Central government and central banks | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** |
| 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%** |

| | 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 |
| **2010** | | | | | | | | | | |
| **Exposure value** | | | | | | | | | | |
| **IRB Exposure class** | | | | | | | | | | |
| Central government and central banks | 2,377.6 | – | – | – | – | – | – | – | – | 2,377.6 |
| Institutions | 3,925.0 | 587.8 | 441.0 | 267.5 | 17.5 | – | – | – | 25.9 | 5,264.7 |
| Corporates | 22.5 | – | 130.0 | 463.9 | 453.3 | 135.5 | 79.1 | – | 19.7 | 1,304.0 |
| **Total foundation IRB** | 6,325.1 | 587.8 | 571.0 | 731.4 | 470.8 | 135.5 | 79.1 | – | 45.6 | 8,946.3 |
| **RW %** | | | | | | | | | | |
| **IRB Exposure class** | | | | | | | | | | |
| Central government and central banks | – | – | – | – | – | – | – | – | – | – |
| Institutions | 14% | 27% | 40% | 65% | 103% | – | – | – | – | 20% |
| Corporates | 31% | – | 57% | 66% | 103% | 136% | 211% | – | – | 92% |
| **Total foundation IRB** | 9% | 27% | 44% | 65% | 103% | 136% | 211% | – | – | 25% |

# **IRB approach** continued
## For the year ended 31 December 2011
All amounts are stated in £m unless otherwise indicated

**IRB approach: exposures values analysed by expected loss (EL) grades**
The table below analyses each retail IRB exposure class by EL grade, calculated as expected loss as percentage of EAD.

| | 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 Exposures 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 £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 |
|---|---|---|---|---|---|---|---|---|
| **2010** | | | | | | | | |
| **IRB Exposures class** | | | | | | | | |
| Residential mortgages | 15,349.7 | 1,357.7 | 2,789.2 | 1,230.8 | 2,558.0 | 1,219.2 | 909.4 | 25,414.0 |
| Qualifying revolving | 172.3 | 482.3 | 594.8 | 242.0 | 294.5 | 405.4 | 196.3 | 2,387.6 |
| Other retail | 48.3 | – | – | 161.8 | 333.3 | 243.4 | 68.8 | 855.6 |
| **Total retail IRB** | 15,570.3 | 1,840.0 | 3,384.0 | 1,634.6 | 3,185.8 | 1,868.0 | 1,174.5 | 28,657.2 |

EL grades are defined below:

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

EL = EAD * PD * LGD
EL% = EL/EAD

# Credit risk mitigation

## For the period ended 31 December 2011

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. Risk mitigation is not material to the treasury portfolio[11].

Policies are in place to manage collateral and valuation with daily monitoring undertaken within treasury operations. Repos and secured lending positions are revalued daily and whilst monitored daily, 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 include gilts held under reverse repo agreements, cash held under both repo agreements and collaterised 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 exposure values covered by eligible financial collateral by IRB exposure class.

| | **2011** | | 2010 | |
|---|---|---|---|---|
| | **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 government and central bank | **209.7** | **–** | – | – |
| Institutions | **1,023.8** | **144.8** | 1,324.3 | 192.7 |
| Corporates | **6.3** | **–** | 4.0 | – |

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

# Counterparty credit risk

## For the year ended 31 December 2011

All amounts are stated in £m unless otherwise indicated

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

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| **In relation to counterparty credit risk** | **Banking Book £m** | **Trading Book £m** | **Total £m** | Banking Book £m | Trading Book £m | Total £m |
| Gross positions fair value of contracts | **812.1** | **163.7** | **975.8** | 864.9 | 67.0 | 931.9 |

The counterparty credit risk mark to market method is used to measure exposure value for counterparty credit risk. The 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 internal rating grade (IRG) 1–10, and associated PD, based upon a limit matrix, which determines the Total Potential Limit (TPL) capacity for any single counterpart or counterparty group. Derivative limits are established, as for other traded products with reference to the limit matrix. The maximum term permitted for treasury products differs dependent upon the IRG shown on the limit matrix table. The provision of collateral can be used to extend term beyond that shown on the limit matrix.

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

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

There are three agreements in place where the 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 material to the treasury portfolio, however, it may occur. An example of conjectural wrong way risk is that fluctuations in the interest rate causes changes in the value of the derivative transactions but could also impact the creditworthiness of the counterparty, or, for instance, a macro factor wrong way risk, as an additional source of risk, is rightly of concern to banks and regulators. Such factors are taken into account when counterpart/country reviews are undertaken.

### Eurozone risk

All eurozone exposures continue to be closely monitored especially those financial institutions in Portugal, Ireland, Italy, Spain and Belgium. The Group has no exposure to Greece.

Underlying term assets are deemed to be in run off, with associated counterparty and country limits reducing as assets mature, and there is no new term exposure. All residual direct wholesale term exposure to these countries matures by mid 2012.

The Group's exposure to these eurozone countries (as valued for credit risk purposes) represents 0.96% of total Group exposures.

As at 31 December 2011 the Group had a £90m (2010: £nil) exposure to the Government of Finland, repayable in over one year. It held no other European sovereign debt.

# Glossary
## For the year ended 31 December 2011

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

| Item | Description |
|---|---|
| Application score | The credit score calculated on the application data alone. Typically, data provided on an application form and/or credit reference data. |
| Basel II | 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 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:<br>1. Cover letter requesting the approval;<br>2. Description of/approach to the control environment; IT infrastructure; validation; data standards; reconciliations/performance monitoring; IRB rating systems (including models); outputs;<br>3. Documentation of above;<br>4. Implementation plan (including roll-out);<br>5. Self-assessment. |
| Basel III | A strengthening of the requirements laid out in Basel II, to be phased into the Group gradually between 2013 and 2019 ahead of full implementation by 2023. |
| 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. |
| BIPRU | Part of Financial Services Authority (FSA) handbook setting out prudential requirements: The Prudential Sourcebook for Banks, Building Societies and Investment Firms. Available to view on www.fsa.gov.uk. |
| Collective Impairment | Impairment is measured collectively where a portfolio comprises assets with a homogenous risk and where appropriate statistical techniques are available. |
| Corporate and Business Banking (CABB) | The Group's operating segment which includes Corporate, Optimum and Platform. This includes lending to large corporate and commercial entities, acquired mortgage books and specialist mortgage team dealing with intermediary lending. |
| 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 Control Unit (CRCU) | This function provides an independent view of credit risk in order to support the business management function's decision making. CRCU does not directly benefit from decisions to extend credit. The CRCU provides risk oversight by virtue of its independence from the business management functions. The CRCU function is in house and is not outsourced. |
| CreditEdge version 8 (European) (also referred to as CreditEdge) | External supplier PD generation model used for analysis of quoted Corporate borrowers (UK based and non-financial plcs). |
| 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 (90 days past due for most borrowing) 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. |
| EAD | Exposure at default, a Basel II Pillar 1 parameter – the amount estimated to be outstanding at the time of default. |
| ECA | Export credit agencies are private or quasi-governmental institutions that act as intermediaries between national governments and exporters to issue export financing. The financing can take the form of credits (financial support) or credit insurance and guarantees (pure cover) or both, depending on the mandate the ECA has been given by its government. ECAs can also offer credit or cover on their own account. |
| ECAI | External Credit Assessment Institution is a credit rating agency 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. |

# **Glossary** continued
For the year ended 31 December 2011

| Item | Description |
|---|---|
| EL | Expected Loss, 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. |
| Eurozone | The geographical area containing countries whose economies function using the European single currency. |
| Exposure | The maximum loss the Group might suffer if:<br>(a) a customer (or counterparty) or a group of connected customers fail to meet their obligations; or<br>(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. |
| FSA | Financial Services Authority, an independent body that regulates the financial services industry in the UK. |
| FSA003 | Standard prudential report produced by banks providing capital resources and capital requirement information to the FSA on a regular basis. |
| ICAAP | Internal Capital Adequacy Assessment Process – capital assessment process stipulated within Basel II incorporating all risk exposures, effectively Pillar 2 element of Basel II framework. |
| ILAA | Individual Liquidity Adequacy Assessment – liquidity assessment process stipulated by FSA to the Group assessing the adequacy of its liquid assets to support potential liquidity events. |
| Individually Impaired | Impairment is measured individually for assets that are individually significant with risk. |
| 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. |
| 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.<br>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. |
| IRB Internal ratings based approach | Approach stipulated within Basel II allowing a more sophisticated and risk sensitive approach to calculate credit risk capital. |
| Leveraged Finance | Stems from lending to companies with a high ratio of debt to market value, or leverage, but has expanded to include a wide variety of borrowers whose debt is considered to be high risk, or non-investment grade, by rating agencies such as Standard & Poor's, Moody's and Fitch. |
| LGD | Loss Given Default is a Basel 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. |
| LRA PD | A long run average PD is reflective of the long run average default rates expected over a full economic cycle. Also referred to as long run PD. |
| LTV | Loan To Value is the ratio of current exposure value to the value of the asset held as security. |
| Master Grading Scale | Brings together the respective expected default frequency (EDF) from Moody's KMV RiskCalc and CreditEdge models to produce a Basel II compliant Corporate Banking PD. |
| Moody's KMV RiskCalc<br>version 3.1 (UK)<br>(Also referred to as RiskCalc) | External supplier PD generation model used for analysis of unquoted Corporate borrowers with total balance sheet assets greater than £0.35m. |
| 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. |
| PFI | Private Finance Initiative. |
| Pillar 1 | Pillar 1 Capital is a prescribed measure of capital required by a bank representing the minimum capital requirements. The Pillar 1 capital ratio is calculated using regulatory capital and risk weighted exposure amounts (RWEA). The total capital ratio must be no lower than 8%. |
| Pillar 2 | Pillar 2 is the Basel 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. |
| PIT | Point in time refers to Basel II modelling approach which assesses the risk of an account at a single point in time. |

# **Glossary** continued
## For the year ended 31 December 2011

| Item | Description |
|---|---|
| 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. |
| PPD | Probability of Possession Given Default is the probability that a proportion of mortgages (secured accounts) will to go to repossession. |
| 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, credit cards. |
| Rating systems | System for implementing scorecards and ranking customers/accounts by risk. May also include decision systems which use the ratings as a key input. |
| Retail SME | Loans extended to small businesses and managed as retail exposures are eligible for retail treatment under Basel II, provided the total exposure of the banking group to a small business borrower (on a consolidated basis where applicable) is less than €1 million. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold. |
| Retail | A division of the Group which is responsible for personal banking, and small business banking. Income streams include interest on unsecured lending and fees from ATMs, interest and fees on mortgages. |
| Retail IRB Approach | Internal Ratings Based approach for Retail customers stipulated within Basel II allowing a more sophisticated and risk sensitive approach to calculate credit risk. More advanced than Foundation IRB approach as PD, LGD and EAD parameters are 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. |
| RWEA | Risk weighted exposure amounts or risk weighted assets, amount of exposure deemed 'at risk' according to FSA prescribed calculation for Pillar 1 capital requirement. |
| Scorecard | A set of questions (called characteristics) that provide the most predictive information on future account performance. The account receives points (or weighting) for each question depending on the answer. These points are then added together to create a score. |
| 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. |
| SPEs | Special Purpose Entities<br>Entities that are created to accomplish a narrow and well defined objective. For the Group this includes:<br>– various securitisation transactions in which mortgages were sold to SPEs. The equity of these SPEs is not owned by the Group.<br>– 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:<br>1. the exposure is to an entity which was created specifically to finance and/or operate physical assets;<br>2. the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; and<br>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 stand alone entity. |
| the Banking Group | See 'The Co-operative Banking Group'. |

# **Glossary** continued
## For the year ended 31 December 2011

| Item | Description |
|---|---|
| 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.<br>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:<br>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<br>2. taken in order to hedge other elements of the trading book. |
| Value adjustments | Individual impairment balance. |
| VaR | Value at risk; a standard variance-covariance (VCV) methodology at a 95% confidence level (1 day holding period is used).<br>Procedure for estimating the probability of portfolio losses exceeding some specified proportion based on a statistical analysis of historical market price trends, correlations, and volatilities. |
| Wrong way risk | This type of risk occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty. |

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