# Tesco Personal Finance plc

## Basel II Pillar 3 Disclosures
## 28th February 2011

# 1. Overview

## 1.1. Background

The European Union Capital Requirements Directive (Basel II) came into force on 1st January 2007, replacing the original Basel Accord (Basel I) agreed in 1988 by the Basel Committee on Banking Supervision. Implementation of Basel II in the UK has been achieved through a series of rules introduced by the Financial Services Authority (FSA). The Basel II framework consists of three "pillars":

**Pillar 1** - sets out the minimum capital requirements firms are required to meet for credit, market and operational risk.

**Pillar 2** - requires firms and supervisors to take a view on whether a firm should hold additional capital against risks considered under Pillar 1 that are not fully captured by the Pillar 1 process (e.g. credit concentration risk); those factors not taken into account by the Pillar 1 process (e.g. interest rate risk in the banking book, business and strategic risk); and factors external to the bank (e.g. business cycle effects).

**Pillar 3** – aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment process and hence the capital adequacy of the institution.

## 1.2. Scope of Application

This document represents the Pillar 3 disclosures of Tesco Personal Finance plc ("TPF plc") and is based on disclosure and accounting data for the 12 month period to 28th February 2011.

Tesco Personal Finance Group Limited ("TPFG" or "TPF Group") is a UK based retail financial services organisation wholly owned by Tesco plc.

Tesco Personal Finance plc, trading as Tesco Bank, is a wholly owned subsidiary of TPFG, which provides a range of financial services and products to personal customers under the Tesco Bank brand, mainly through telephony and on-line sales channels, and through a small number of in-store branches.

The products currently offered by Tesco Bank include general insurance products, travel money, unsecured personal loans, savings accounts and credit cards. Tesco Bank also operates an ATM estate primarily located in Tesco stores. TPF plc has limited international exposure in Ireland.

Tesco Personal Finance Compare Limited ("Tesco Compare"), an internet based price comparison business, is also a wholly owned subsidiary of TPFG.

There are no material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities among the parent and subsidiary members of the TPFG.

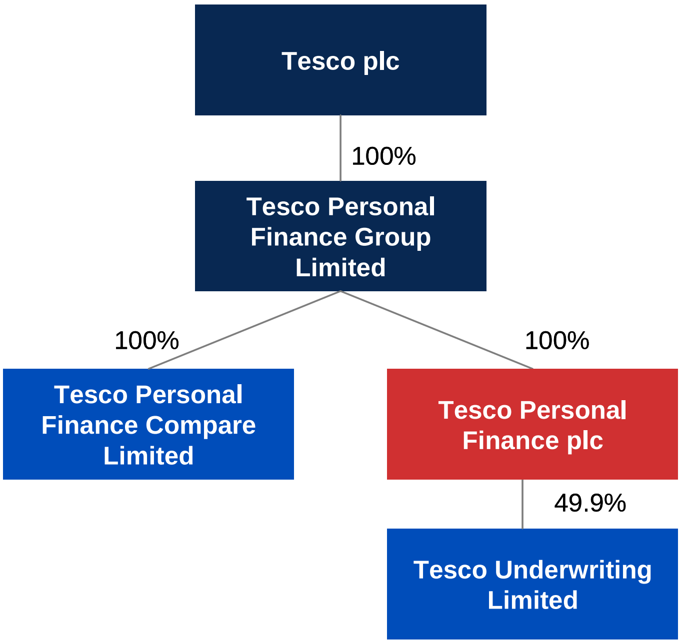
Tesco Underwriting Limited ("TU") is 49.9% owned by TPF plc and 50.1% owned by Ageas Insurance Limited. TU underwrites household and motor insurance and provides claims management for policies sold under the Tesco Bank brand.

### 1.2.1. Accounting Consolidation

TPFG operates as a holding company with 100% ownership of TPF plc and Tesco Compare with TPF plc holding 49.9% ownership of TU, as illustrated in Figure 1 below. Financial Statements are produced annually for TPF plc and TPFG as well as Tesco Compare and TU.

TU is treated as an associate and is proportionally consolidated using the equity method of accounting.

**Figure 1: TPF Group Limited: Accounting Consolidation Structure**




### 1.2.2. Prudential Consolidation

TPF plc does not form part of a Consolidation Group for Regulatory Reporting purposes and does not make use of the solo consolidation waiver provisions.

The TPF plc investments in TU and Royal Bank of Scotland Insurance Group Limited ("RBSI") are treated as a deduction from total capital resources as shown in Table 1: Capital Resources.

### 1.2.3. Comparison of Pillar 3 Disclosures with the Directors' Report & Financial Statements

These disclosures have been prepared in accordance with Basel II, Pillar 3 regulatory reporting requirements. There are a number of significant differences between accounting disclosure requirements and Pillar 3 disclosure requirements which means that information may not be directly comparable with the Directors' Report and Financial Statements. The main differences for TPF plc are summarised below:

- Pillar 3 exposure values are reported on the basis of Balance Sheet values, net of provisions, with off Balance Sheet exposures assigned credit conversion factors based on prescribed regulatory values which vary according to risk categories;
- Regulatory reporting rules require that TPF plc make certain deductions from capital resources, the most material of which relate to subordinated loans in favour of RBSI and TU and TPF plc's holdings in its TU insurance associate.

## *1.3. Disclosure Policy*

The following sets out TPF plc's Disclosure Policy as applied to Basel II Pillar 3 Disclosures, including the information to be disclosed, frequency, media, location and verification.

### 1.3.1. Information to be disclosed

TPF plc policy is to meet all required Pillar 3 disclosure requirements as detailed in Section 11 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms ("BIPRU"). TPF plc does not seek any exemption from disclosure on the basis of materiality or on the basis of proprietary or confidential information.

Remuneration disclosures will be published in accordance with FSA guidance for Proportionality Tier 2 firms and will be approved by the TPFG Remuneration Committee and the TPFG Board. TPF plc has been brought into scope of the revised Remuneration Code with effect from 1st January 2011 and is working to ensure full compliance in advance of 1st July 2011, in accordance with the transitional guidance set out by the FSA. The Remuneration disclosures required under Pillar 3 will be published on the Tesco plc corporate website (http://www.tescoplc.com) during the second half of 2011.

#### 1.3.2. Frequency

TPF plc policy is to publish the disclosures required on an annual basis. The information is published as soon as practical with reporting aligned with the publication of the annual Directors' Report and Financial Statements.

#### 1.3.3. Medium and location of publication

TPF plc Pillar 3 disclosures are published in the Investor Centre section of the Tesco plc corporate website: www.tescoplc.com/investors/results-and-events/.

#### 1.3.4. Verification

These disclosures have been reviewed by the TPFG Audit Committee and approved by the TPFG Board. The disclosures are not subject to audit except where they are equivalent to those prepared under accounting requirements and disclosed in the TPFG / TPF plc annual Directors' Report and Financial Statements.

The TPF plc Disclosure Policy, which forms part of these disclosures, is reviewed by the TPFG Audit Committee and approved by the TPFG Board as part of the annual Pillar 3 Disclosure review and approval process.

## 2. Document Structure

The document is structured to provide details of Risk Management Objectives and Policy in Section 3. This section is supplemented by a discussion of Tesco Bank "Risk Types" in Sections 6, 8, 9, 11 and 12 with Market Risk discussed in Section 7. Capital Resources and Compliance with BIPRU and the overall Pillar 2 rule are considered in Sections 4 and 5 respectively. Non Trading Book Exposures in Equities are discussed in Section 10 with Securitisation disclosures published in Section 13. Remuneration disclosures will be published in the second half of 2011 and this is noted in Section 14.

## 3. Risk Management Objectives and Policy

### *3.1. Approach to Risk Management*

Risk management is a strategic priority for TPF plc with monitoring and actively managing the risk profile and conservatively managing the Balance Sheet being key objectives in the strategic plan. TPF plc is focussed on developing a stable, cautious enterprise with a modest risk appetite and a conservative liquidity and funding profile.

The TPFG Board has overall responsibility for strategy and management of the business, including approval of TPF plc's risk appetite, approval of the risk and control framework and monitoring of the risk and capital adequacy profile.

TPF plc's risk appetite reflects the amount of risk that the bank is willing to accept in delivering its strategic objectives. Risk appetite provides a key link between strategic objectives and the risk management framework acting as a key reference point for decision-making and planning across the business. TPF plc measures risk appetite in both quantitative and qualitative terms with performance reported frequently to the TPFG Board Risk Committee ("BRC") and the TPFG Board.

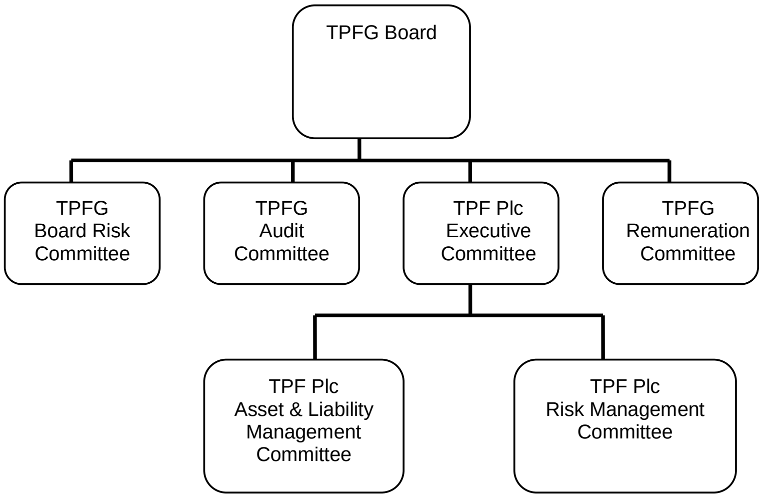
TPF plc has a framework of internal risk controls as more fully described in Section 3.3 below. The Policy Framework provides the structure, standards and mechanisms for policy development, approval and maintenance and for monitoring adherence to policy standards. The key objective of the Policy Framework is to ensure that an appropriate and complete set of clearly defined policies are available to staff to communicate the standards that must be adhered to and to provide the direction required to identify, prioritise and manage risk in the business.

The Risk Management Committee ("RMC") and the Asset & Liability Management Committee ("ALCO") monitor and track performance against Risk Appetite at a detailed product and functional level.  The BRC is responsible for reporting to the TPFG Board on overall risk appetite, tolerance and strategy, taking into account the current and prospective macroeconomic and financial environment, relevant and authoritative financial stability assessments and economic analysis; and capital and liquidity and its prospective adequacy over the cycle in light of TPF plc's overall strategy and risk appetite.  Reporting to BRC and the TPFG Board includes stress testing and scenario analysis which is designed to inform senior management of required levels of capital and other financial resources, including liquidity, under various economic and business stressed scenarios.

## *3.2. Risk Management and Governance*

The Chief Executive has executive responsibility for oversight of risk management and governance.  The TPFG Board has ultimate responsibility for all material risk matters, but has delegated responsibility for the day to day identification of risks and managing them effectively to the Executive Committee ("EC"), RMC and ALCO.  A committee structure including the TPFG Board, EC, TPFG BRC, RMC, ALCO, TPFG Audit Committee and TPFG Remuneration Committee operated throughout the year as described below.

**Figure 2: TPFG and TPF plc Risk Management Governance**




## TPFG Board

The TPFG Board has overall responsibility for the management of the business and acts as the main decision making forum for TPF plc.  It agrees the strategy for the business, approves TPF plc's risk appetite and its policies, authorisations and the risk and control process.  The TPFG Board monitors the risk management profile and capital adequacy position.

## Executive Committee

The TPFG Board has delegated the day to day running of the business of the TPFG to the Chief Executive, who has chosen to manage day to day matters through an Executive Committee and a series of specialised sub committees.

The EC assists the Chief Executive in the performance of his duties, provides general executive management of the business and facilitates cross-functional communication and liaison. The operational management of the TPF plc business has been delegated to the EC which reviews and directs the ongoing operations of the business within the strategic framework, business plan, policies and risk appetite agreed by the TPFG Board. It monitors trade and financial performance on a regular basis and oversees risks and controls across the business.

## TPFG Board Risk Committee

The BRC operates under delegated authority from the TPFG Board and is comprised of no less than three independent Non-executive Directors.

The role of the BRC is forward looking to anticipate future risks and also to align the business strategy (including new products) with risk appetite and to satisfy itself that adequate policies and processes are in place to promptly identify, assess and control the risks. The BRC considers issues escalated by RMC and ALCO and it seeks to encourage the embedding of a supportive risk culture so that all employees are alert to the wider impact on the whole organisation of their actions and decisions.

## Risk Management Committee

The RMC operates as a sub-committee of the EC. The main responsibility of the RMC is to oversee the management of key risks and issues in the business; to monitor and track performance against risk appetite at product and function level; to oversee the risk management framework; to seek to ensure that key risks are identified and managed; and to review and challenge the Regulatory, Operational, Credit and Insurance Risk disciplines regarding risks affecting or likely to affect TPF plc.

The RMC approves policies and procedures that have been delegated by the TPFG Board, to enable the effective management of risk for TPF plc.

The remit of the RMC includes all credit, operational (including fraud), regulatory and insurance risks affecting or likely to affect TPF plc.

## Asset & Liability Management Committee

The ALCO operates as a sub-committee of the EC. The role of the ALCO is to optimise TPF plc's Balance Sheet structure and identify, manage and control TPF plc's Balance Sheet risks in the execution of its chosen business strategy. The main areas of responsibility include: capital management, liquidity and funding risk management, large exposures, interest rate risk in the banking book, non trading foreign exchange risk management and intra group limits. ALCO approves those policies delegated by the TPFG Board in these areas.

ALCO provides policy and direction to the Treasury function for managing TPF plc's Balance Sheet.

## TPFG Audit Committee

The role of the TPFG Audit Committee is to review the financial statements and to monitor accounting policies and practices for compliance with relevant standards. The Audit Committee examines arrangements in place to enable management to ensure compliance with requirements and standards under the regulatory system. The Audit Committee oversees the internal audit function and the internal and external audit programme, as well as managing the relationship with the external auditor.

## TPFG Remuneration Committee (RemCo)

The role of the TPFG Remuneration Committee is to determine and approve remuneration arrangements for the TPF Group Leadership, including TPF plc, and to approve a remuneration framework for all employees below leadership level. The TPFG Remuneration Committee will seek to ensure that the levels and structures of remuneration are designed to attract, retain and motivate the management talent needed to run the business of the TPFG in a way which is consistent with the risk appetite and ongoing sustainability of the business and to be compliant with all applicable legislation and regulation.

## *3.3. Risk Management Framework*

The TPF plc Risk Management Framework consists of a number of inter-linking elements which support the embedding of risk management across the business. The framework is driven at a strategic level by TPF plc's overall risk appetite and comprises a series of activities that, when implemented together, sets out how risk is identified, measured, managed, controlled and reported across the TPF plc business.

The Risk Framework recognises five primary risk types:

- Regulatory Risk;
- Operational Risk;
- Credit Risk;
- Insurance Risk;
- Treasury Risk (including Capital Management, Interest Rate Risk in the Banking Book, Funding Liquidity Risk, Foreign Exchange Risk and Large Exposures and Intra Group Limits).

Further detail is provided on each of these risk types in Sections 6, 8, 9, 11 and 12.

Risk Management Framework activities are set out in 6 segments:

### 3.3.1. Policy and Standards

Policy and Standards forms the basis for defining risk management and sets the requirements to be adhered to across the business. Policy and Standards are endorsed by the relevant executive bodies with risk policies being formally approved at Risk Management Committee. Policy and Standards make clear what the requirements are on all staff, both in the business and in the risk community.

Risk appetite is a cornerstone of the Risk Management Framework. Policies and Standards are designed to support the management of the business in line with risk appetite.

### 3.3.2. Organisation and Structure

Organisation and Structure describes the responsibilities for the management and oversight of risk both in terms of the Risk team structure and the spread of responsibilities in the wider business.

The TPF plc Risk Management Framework is structured according to the Three Lines of Defence model described in Section 3.4 below.

### 3.3.3. Methodology and Processes

This describes the core processes applied across the business to manage risk. The Risk function carries the responsibility to decide whether in their opinion, the processes are 'fit for purpose'. This is informed through a range of risk activities including assurance reviews, risks and issues tracking, stress testing and the ICAAP exercise.

This segment also recognises the authorities and decision making protocols that support sound governance over such processes.

### 3.3.4. Analysis, Monitoring and Reporting

This describes the means by which Risk 'quantify' the level of risk being run by the business, how they track risk exposures and their oversight and monitoring responsibilities.

The outputs of this analysis and monitoring form the basis for internal and external reporting that support management and control processes.

### 3.3.5. Technology and Data

This refers to the functionality, security, process control, access and technical standards applicable to the software, applications and systems used by TPF plc Risk in support of its deliverables. Such systems and applications include risk registers, alert systems and credit models. At the heart of this is the provision of data to supplement risk management activities.

This segment also recognises the importance of effective information security policies and procedures to ensure that information is protected against unauthorised access or disclosure.

### 3.3.6. Communications, Internal and External Liaison

This segment recognises the importance of ensuring that there is appropriate awareness and understanding across the business in order that business decisions are informed by risk insight. This requires the use of both formal and informal channels.

This segment also recognises the importance of meeting the expectations of stakeholders (including regulators) as well as establishing relationships in the external risk and business community to benchmark against peers and understand emerging trends.

## *3.4. Risk Model*

The TPF plc Risk Management Framework is structured according to a 'Three Lines of Defence' model where:

- **First line of defence** - is the business which has primary responsibility for the identification, management and control of risk.
- **Second line of defence** - is the independent Risk function led by the Chief Risk Officer who reports directly to the Chief Executive Officer. The function comprises Credit, Operational, Insurance and Regulatory Risk teams which provide oversight and assurance in relation to risk profiles.
- **Third line of defence** - is the Internal Audit function which is responsible for the independent assessment of risk management and determining whether the internal control systems are effective both in design and practice.

## *3.5. Risk Assurance*

Risk assurance is undertaken at a number of levels within TPF plc, reflecting the 3 lines of defence risk management approach. The objective of risk assurance activity is to provide comfort internally that risks are being managed in line with the Risk Framework and in line with TPF plc's agreed risk appetite.

The core components of risk assurance undertaken within TPF plc include:

- Assessments of risk and controls undertaken by the business areas and functional units;
- Risk Assurance (including compliance monitoring) undertaken by the TPF plc Risk function. This is captured within the annual risk based Risk Assurance Plan which is agreed by the Chief Risk Officer and reported to RMC and Audit Committee. This covers thematic, desk based and face to face assurance activity across all business areas and key processes across all risk disciplines; and
- Internal Audit Assurance – The Audit Committee will obtain assurance about the internal control and risk management environment through an agreed programme of audits carried out by TPF plc Internal Audit. This is set out in the annual Audit Plan, which is reported to and agreed by the TPFG Audit Committee.

To assess the effectiveness of the TPF plc control environment, the TPFG Board reviews the reports of the TPFG Audit Committee. Certain responsibilities are delegated to the TPFG Audit Committee, including ensuring that there is regular review of the adequacy and efficiency of internal systems and controls.

### *3.6. Internal Audit*

The Internal Audit function supports the TPFG Audit Committee in providing an independent assessment of the adequacy and effectiveness of internal controls. Responsibility for Internal Audit within TPF plc lies with the Audit Director.

The role of Internal Audit in TPF plc is to assess the adequacy and effectiveness of internal systems and controls, procedures and policies. Internal Audit has the following responsibilities:

- to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of TPF plc's systems, internal control mechanisms and arrangements;
- to report control weaknesses identified as a result of work carried out;
- to verify that actions are taken to address the reported control weaknesses; and
- to report to the TPFG Audit Committee in relation to internal audit matters.

An Audit Plan is submitted to the TPFG Audit Committee for approval on an annual basis. The Audit Director makes regular reports to the TPFG Audit Committee on progress against the Audit Plan and key audit findings. The scope of work of Internal Audit covers the whole of the TPF Group. The annual Audit Plan is risk based, focusing on the areas of highest risk.

### *3.7. Hedging and Mitigating Risk*

The TPF plc Risk Management Framework sets out how risk is managed across the business. Further information in relation to policies, strategies and processes for hedging and mitigating risk are discussed in Sections 6, 8, 9, 11 and 12 in relation to each of the primary risk types.

## 4. Capital Resources

The TPFG Board has ultimate responsibility for capital resources within TPF plc (and in Tesco Compare). The TPFG Board reviews and approves the Capital Management Policy on an annual basis. Day to day responsibility for capital planning and other aspects of capital management are delegated to the Treasurer. The ALCO (chaired by the CEO) is the main body responsible for monitoring all aspects of capital planning and has delegated authority to approve capital injections into subsidiaries of TPFG. The TPFG Board is kept informed via a monthly update on the capital plan.

The Financial Services Authority, in its capacity as supervisor sets targets for, and monitors, the capital adequacy of TPF plc. Capital adequacy returns are submitted quarterly to the FSA.

During the 12 month accounting period to 28th February 2011 TPF plc complied with the capital requirements determined by the FSA. Table 1 shows TPF plc capital resources as at 28th February 2011.

**Table 1: Capital Resources**

| Total Capital Resources | February 2011 (£k) | February 2010 (£k) |
|---|---|---|
| **Tier 1 Capital** | | |
| Equity Capital | 923,400 | 477,900 |
| Verified Reserves | 52,626 | 152,952 |
| Intangible Assets | (215,275) | (60,328) |
| **Total Tier 1** | **760,751** | **570,524** |
| | | |
| **Tier 2** | | |
| **Upper Tier 2** | | |
| Undated Subordinated Debt | 45,000 | 45,000 |
| Collective Provisions | 17,626 | 20,650 |
| **Lower Tier 2** | | |
| Dated Subordinated Debt | 190,000 | 190,000 |
| **Total Tier 2** | **252,626** | **255,650** |
| | | |
| Deductions from Total Capital Resources | (364,863) | (262,721) |
| **Total Capital Resources** | **648,514** | **563,453** |
| | | |
| **Risk Weighted Assets** | **4,787,753** | **4,410,000** |
| | | |
| **Core Tier 1 Ratio** | **15.89%** | **12.94%** |
| **Total Capital Ratio** | **13.55%** | **12.78%** |

Information on TPF plc's capital resources is provided below:

## 4.1. Core Tier 1 Capital

TPF plc Tier 1 capital is wholly comprised of Core Tier 1 capital resources. Equity capital comprises share capital and the share premium account, as detailed in Table 2 below. Verified reserves include previously audited Profit and Loss Account reserves and interim verified profits less dividends paid.

**Table 2: Share Capital and Share Premium**

| Share Capital & Share Premium | February 2011 Number | February 2010 Number |
|---|---|---|
| **Authorised** | | |
| Ordinary shares of 10p each | Unlimited | Unlimited |

| Share Capital & Share Premium | February 2011 (£k) | February 2010 (£k) |
|---|---|---|
| **Allotted, Called up & Fully Paid** | | |
| Ordinary shares of 10p each | 92,340 | 47,790 |
| | | |
| Share Premium Account | 831,060 | 430,110 |
| **Total** | **923,400** | **477,900** |

During the year TPF plc issued 445,500,000 (2010: 230,000,000) Ordinary shares to the parent company, TPFG, for a total consideration of £445,500k (2010: £230,000k).

## 4.2. Hybrid Capital

TPF plc does not have any forms of hybrid capital.

### 4.3. Deductions from Tier 1 Capital Resources

Intangible assets relate to Computer Software and "Work in Progress" which relates primarily to the internal development of IT software assets as part of the migration to a new infrastructure from the Royal Bank of Scotland Group.

### 4.4. Tier 2 Capital Resources

All dated and undated subordinated debt is issued to TPFG who, in turn, have issued the same amount to Tesco plc. Details of subordinated liabilities are provided in Table 3: below. Collective provisions are included as Upper Tier 2 capital resources in accordance with GENPRU 2.2.187 to 2.2.189.

**Table 3: Subordinated Liabilities**

| Subordinated Liabilities | February 2011 (£k) | February 2010 (£k) |
|---|---|---|
| Undated floating rate notes | 45,000 | 45,000 |
| Floating rate subordinated loan maturing 2017 | 30,000 | 30,000 |
| Floating rate subordinated loan maturing 2018 | 35,000 | 35,000 |
| Floating rate subordinated loan maturing 2020 | 30,000 | 30,000 |
| Floating rate subordinated loan maturing 2022 | 95,000 | 95,000 |
| | 235,000 | 235,000 |

### 4.5. Capital Resources that provide for an incentive to be redeemed

The undated floating rate notes have no fixed maturity date and may not be repaid except under certain conditions such as the winding up of the Company. The dated floating rate subordinated loans are repayable, in whole or in part, at the option of the issuer, prior to maturity, on conditions governing the debt obligation. Interest payable is based on 3 month LIBOR plus a range of 60 to 175 basis points.

### 4.6. Innovative Tier 1 Capital Resources

TPF plc does not have any forms of innovative Tier 1 capital resources.

### 4.7. Deductions from Tier 2 Capital Resources

There are no deductions from Tier 2 capital resources.

### 4.8. Deductions from Total Capital Resources

The deductions from total capital resources relate to capital deducted loans and the investment in associate.

### 4.9. Tier 3 Capital Resources

TPF plc does not have any Tier 3 capital resources.

## 5. Compliance with BIPRU and the overall Pillar 2 Rule

### 5.1. Approach to assessing adequacy of Internal Capital

TPF plc has adopted the Standardised Approaches to the calculation of Pillar 1 minimum capital requirements for Credit and Operational Risk. TPF plc does not currently have a Trading Book and does not calculate a Market Risk capital requirement. The FSA sets Individual Capital Guidance ("ICG") for each bank following completion of the Internal Capital Adequacy Assessment Process (ICAAP) which is TPF plc's internal assessment of capital adequacy designed to address the requirements under Pillar 2 of the Basel II framework. TPF plc has continued to maintain capital resources in excess of its ICG.

Capital is held to provide sufficient resources to absorb losses. TPF plc has minimal risk appetite for all Treasury activities, including capital management. The TPFG Board has determined that TPF plc will maintain capital in excess of its ICG at all times.

Capital adequacy is monitored daily by Treasury with monthly reporting provided to the TPFG Board and to the ALCO. In addition, capital planning forms a key element of the TPF plc Budgeting and Long Term Plan (LTP) processes. As part of the LTP, the Treasury function prepare a forward looking capital plan covering the current financial year and a further four years which is approved by ALCO and the TPFG Board. The first year of the plan is revised for each reforecast and reported to ALCO and the TPFG Board. The capital plan is a living process with the latest iteration submitted monthly to the TPFG Board for noting. The capital plan forecasts for TPF plc show that sufficient capital resources continue to be available to support delivery of business and strategic objectives, including under stressed conditions.

An integrated part of the capital planning process is the stress testing framework that explores the resilience of the bank in the face of adverse scenarios. This framework covers both capital and liquidity stress testing with results presented to ALCO, RMC, BRC and the TPFG Board for challenge and approval. The Stress Testing Policy is reviewed and approved by the TPFG Board on an annual basis.

The ICAAP process considers all of the risks faced by TPF plc, how these risks are mitigated and the amount of capital that requires to be held both currently and in the future. TPF plc performs a full ICAAP at least annually with approval provided by the TPFG Board. The ICAAP process forms a key part of the capital adequacy assessment and to complement the full ICAAP process a monthly ICAAP Monitor is produced and presented to the EC, the TPFG Board and the BRC detailing the current risk profile and directional movements in the profile together with supporting commentary.

## *5.2. Pillar 1 Capital Requirements*

Table 4 shows the overall Pillar 1 minimum capital requirements and risk weighted assets for TPF plc under the Standardised Approaches to Credit and Operational Risk. TPF plc does not have any exposure to Trading Book Market Risk.

**Table 4: Pillar 1 Capital Requirements and Risk Weighted Assets**

| Minimum Capital Requirements 28 February 2011 (£k) | | |
|---|---|---|
| Exposure Class | Capital Requirement | Risk Weighted Assets |
| Central Government and Central Banks | - | - |
| Multilateral Development Banks | - | - |
| Institutions | 4,342 | 54,272 |
| Corporates | 8,951 | 111,881 |
| Retail | 282,431 | 3,530,387 |
| Past due | 1,700 | 21,249 |
| Securitisation Positions | 1,175 | 14,689 |
| Collective Investment Undertakings | 4,995 | 62,441 |
| Other Assets | 17,003 | 212,540 |
| **Total Credit Risk Minimum Capital Requirement under Pillar 1** | **320,597** | **4,007,459** |
| **Total Operational Risk Minimum Capital Requirement under Pillar 1** | **62,423** | **780,293** |
| **Total Pillar 1 Capital Requirements** | **383,020** | **4,787,753** |

| Minimum Capital Requirements 28 February 2010 (£k) | | |
|---|---|---|
| Exposure Class | Capital Requirement | Risk Weighted Assets |
| Central Government and Central Banks | - | - |
| Multilateral Development Banks | - | - |
| Institutions | 4,472 | 55,902 |
| Corporates | 11,694 | 146,180 |
| Retail | 252,501 | 3,156,262 |
| Past due | 5,974 | 74,677 |
| Securitisation Positions | 1,550 | 19,380 |
| Collective Investment Undertakings | 7 | 82 |
| Other Assets | 12,052 | 150,652 |
| **Total Credit Risk Minimum Capital Requirement under Pillar 1** | **288,250** | **3,603,136** |
| **Total Operational Risk Minimum Capital Requirement under Pillar 1** | **64,549** | **806,864** |
| **Total Pillar 1 Capital Requirements** | **352,799** | **4,410,000** |

### *5.3. Counterparty Credit Risk*

Counterparty Credit Risk ("CCR") may be defined as the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. Such transactions relate to contracts for financial derivative instruments, securities financing transactions and long settlement transactions. All financial derivative transactions are governed by industry standard ISDA agreements. Information relating to policies used in management of Counterparty Credit Risk is provided in Section 6.1.2.

As at 28th February 2011 TPF plc has no credit rating and no ISDA Credit Support Annexes that contain downgrade triggers and therefore has no requirement to post additional collateral in the event of a ratings downgrade. There is also no exposure to credit derivative transactions.

TPF plc in its ordinary course of business uses over the counter (OTC) derivatives and forward foreign exchange transactions to hedge exposures, i.e. interest rate and foreign exchange risk. The CCR mark to market method is used to measure exposure value and details of exposures are provided in Table 5 below.

**Table 5: Measure for exposure value under the CCR Mark to Market Method**

| Counterparty Credit Risk Exposures: CCR Mark to Market Method | February 2011 (£k) | February 2010 (£k) |
|---|---|---|
| Interest-rate contracts | 26,810 | 7,516 |
| Contracts concerning foreign currency rates and gold | 7,125 | 6,180 |
| Contracts concerning equities | - | - |
| Contracts concerning precious metals except gold | - | - |
| Contracts concerning commodities other than precious metals | - | - |
| **Total** | **33,935** | **13,696** |

Regulatory capital calculations do not incorporate netting benefits and there is no use of collateral in calculating net derivatives credit exposure. This is demonstrated in Table 6 below.

**Table 6: Net Derivative Credit Exposure**

| Net Derivative Credit Exposure | February 2011 (£k) | February 2010 (£k) |
|---|---|---|
| Gross Positive Fair Value of Contracts[1] | 16,378 | 1,547 |
| Less: Netting benefits | - | - |
| Netted current credit exposure | 16,378 | 1,547 |
| Less: Collateral Held | - | - |
| Net Derivatives Credit Exposure | 16,378 | 1,547 |

[1] Excludes add-on for Potential Future Credit Exposure

# 6. Credit Risk and Dilution Risk

## *6.1. Credit Risk*

Credit risk arises from the potential that the business incurs losses from the failure of a customer or any other counterparty to meet its financial obligations. Credit risk arises principally from TPF plc's retail lending activities but also from placement of surplus funds with other banks and money market funds, investments in transferable securities, interest rate derivatives and foreign exchange. Credit risk may also arise when an adverse change in an entity's credit rating causes a fall in the fair value of TPF plc's investment in that entity's financial instrument. TPF plc has a low appetite for credit risk seeking to lend responsibly and maintain a credit risk profile better than the industry average.

The Chief Risk Officer and his direct report, the Head of Credit Risk, are responsible for the development and oversight of the credit risk management framework within TPF plc, in line with credit risk appetite, as well as supporting the business in the implementation of policies and processes.

The scope of TPF plc credit risk policies includes Credit Risk and Minimum Standards, Treasury & Corporate Counterparties, Model Development, Problem Debt Management and Provisioning. All credit risk policies are subject to annual review by the RMC.

Polices are supported through limits and standards, including decisioning parameters, and detailed process manuals governing key credit risk activities. These are tracked through a suite of key indicators reported through the RMC and to the TPFG Board.

### 6.1.1. Retail Credit Risk

TPF plc's credit policy is defined via the credit risk policy framework. Through this standards and limits are defined at all stages of the customer lifecycle, including new account sanctioning, customer management and collections and recoveries activity. Customer credit decisions are managed principally through the deployment of bespoke credit scorecard models and credit policy rules, which exclude specific areas of lending, and an affordability assessment which determines a customer's ability to repay an outstanding credit amount. Credit management policy is governed by and agreed through the RMC.

A dedicated credit risk management team have the day to day responsibility for managing the credit quality of the lending portfolio. As at 28th February 2011, the deployment and execution of credit strategies sat within The Royal Bank of Scotland Group plc infrastructure, managed through the relevant Commercial Services Agreement; however, TPF plc has full ownership of its credit risk appetite and its credit policy. Responsibility for setting scorecard parameters, and the process for dealing with exceptions, lies with the Head of Credit Risk, reporting to the Chief Risk Officer. Regular reporting to the RMC, EC, BRC and the TPFG Board ensures that TPF plc has adequate oversight of this activity and sufficient insight to the performance of the portfolio.

### 6.1.2. Wholesale Credit Risk

Credit Risk is also responsible for setting wholesale counterparty credit risk limits. These limits are set out in credit policy and approved by the RMC. The Treasurer is responsible for ensuring that Treasury complies with counterparty credit risk limits, with Credit Risk providing independent oversight that these limits are adhered to.

TPF plc operates a control framework relating to the placement of funds with approved counterparty and instrument types. Approved counterparties generally include investment grade financial institutions, sovereigns and multilateral development banks with approved instrument types including cash, certificates of deposit, bonds, treasury bills, gilts, repurchase agreements, money market funds and asset backed securities. Interest rate and foreign exchange derivatives are also used to hedge exposures.

The framework sets limits on the amounts that can be lent, relative to the TPF plc capital base, based on counterparty credit-worthiness and instrument type. As part of the credit assessment process for Treasury credit risk exposures, TPF plc continues to use Fitch, Moody's and Standard & Poor's as External Credit Assessment Institutions (ECAIs) with Fitch ratings used to determine regulatory capital requirements under the Standardised Approach to Credit Risk. All limits are approved via the RMC and any exceptions or overrides to the TPF plc policy must be explicitly agreed by the RMC.

As at 28th February 2011 TPF plc has not recognised any impairment losses in connection with these financial assets. There is therefore no requirement to establish credit reserves for wholesale credit risk exposures.

The Treasury & Corporate Counterparty Credit Risk Policy provides for the use of credit risk mitigation to reduce credit risk exposure. Industry standard ISDA Master Agreements are in place with all derivative counterparties. Use is also made of Delivery Versus Payment (DVP) arrangements when settling transactions. As at the end of February 2011 no additional credit risk mitigation has been taken.

## Wrong Way Risk

Wrong way risk is defined as the risk that occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty. Examples of wrong way risk include:

- Purchasing credit protection from financial guarantors, such as monoline insurers, on an asset type, such as sub-prime mortgages, where the guarantor has concentrated exposure to that asset type;
- Reverse repurchase agreements where the counterparty and issuer of the collateral are the same;
- Purchase of put options from a counterparty whose shares are subject to that option or are highly correlated with that option.

TPF plc has no exposure to wrong-way risk.

## External Credit Assessment Institutions' Assessments

Issue credit assessments are used for investments in specific obligations, mainly Asset Backed Securities and Government Guaranteed Bonds, where there are adjustments to the issuer's general rating that reflect factors specific to the investment. Issuer credit assessments are generally used for other forms of lending where the assessment concerns the general capacity and willingness of the counterparty to meet their obligations. Ratings are obtained from market sources with processes in place to assign appropriate ratings to exposures and to monitor rating actions. TPF plc complies with the credit quality assessment scale with the appropriate issue or issuer rating used to determine the risk weights applied under the Standardised Approach to Credit Risk. Capital is assigned according to BIPRU requirements as explained in Section 5 above.

The exposure values, excluding undrawn commitments and derivative exposures, associated with each credit quality step are shown by exposure class in Table 7 below. Undrawn credit card commitments, which attract a zero per cent credit conversion factor, were £7,127,334k as at 28th February 2011 (2010 £6,464,509k).

**Table 7: Analysis of Exposures by Credit Quality Step**

| Exposure Values 2011 | Credit Quality Step 1 (£k) | Credit Quality Step 2 (£k) | Credit Quality Step 3 (£k) | Credit Quality Step 4 (£k) | Credit Quality Step 5 (£k) | Credit Quality Step 6 (£k) | Unrated (£k) | Total (£k) |
|---|---|---|---|---|---|---|---|---|
| **Fitch Assessment** | **AAA to AA-** | **A+ to A-** | **BBB+ to BBB-** | **BB+ to BB-** | **B+ to B-** | **CCC+ and below** | | |
| Central Governments or Central Banks | 510,585 | - | - | - | - | - | - | 510,585 |
| Multilateral Development Banks | 228,641 | - | - | - | - | - | - | 228,641 |
| Institutions | 251,861 | 10,814 | - | - | - | - | - | 262,675 |
| Corporates | - | 982 | 154 | - | - | - | 111,236 | 112,372 |
| Retail Claims | - | - | - | - | - | - | 4,707,183 | 4,707,183 |
| Past Due Items | - | - | - | - | - | - | 21,249 | 21,249 |
| Securitisation Positions | 73,444 | - | - | - | - | - | | 73,444 |
| Collective Investment Undertaking | 312,207 | - | - | - | - | - | | 312,207 |
| Other | - | - | - | - | - | - | 220,890 | 220,890 |
| **Total exposures pre mitigation** | **1,376,738** | **11,796** | **154** | **-** | **-** | **-** | **5,060,558** | **6,449,246** |
| **Total exposures post mitigation** | **1,376,738** | **11,796** | **154** | **-** | **-** | **-** | **5,060,558** | **6,449,246** |

| Exposure Values 2010 | Credit Quality Step 1 (£k) | Credit Quality Step 2 (£k) | Credit Quality Step 3 (£k) | Credit Quality Step 4 (£k) | Credit Quality Step 5 (£k) | Credit Quality Step 6 (£k) | Unrated (£k) | Total (£k) |
|---|---|---|---|---|---|---|---|---|
| **Fitch Assessment** | **AAA to AA-** | **A+ to A-** | **BBB+ to BBB-** | **BB+ to BB-** | **B+ to B-** | **CCC+ and below** | | |
| Central Governments or Central Banks | 478,045 | - | - | - | - | - | - | 478,045 |
| Multilateral Development Banks | 98,796 | - | - | - | - | - | - | 98,796 |
| Institutions | 147,423 | 52,876 | - | - | - | - | - | 200,299 |
| Corporates | - | - | 460 | - | - | - | 145,720 | 146,180 |
| Retail Claims | - | - | - | - | - | - | 4,208,350 | 4,208,350 |
| Past Due Items | - | - | - | - | - | - | 74,677 | 74,677 |
| Securitisation Positions | 96,901 | - | - | - | - | - | - | 96,901 |
| Collective Investment Undertaking | 411 | - | - | - | - | - | - | 411 |
| Other | - | - | - | - | - | - | 150,652 | 150,652 |
| **Total exposures pre mitigation** | **821,576** | **52,876** | **460** | **-** | **-** | **-** | **4,579,399** | **5,454,311** |
| **Total exposures post mitigation** | **821,576** | **52,876** | **460** | **-** | **-** | **-** | **4,579,399** | **5,454,311** |

### 6.1.3. Credit Risk: Past Due and Impaired Assets

TPF plc considers exposures to be past due where a customer does not make their minimum contractual monthly payment. For accounting purposes, an asset is considered to be impaired where the customer is more than 90 calendar days past due in interest or principal payments or where there is earlier objective evidence of impairment (for example, bankruptcy, insolvency or a declaration of financial hardship). For regulatory reporting purposes, BIPRU defines the Past Due Exposure Class as items that are past due more than 90 days.

Details of past due and impaired exposures (gross of provisions), value adjustments and provisions and the net charge for the period, by industry type are provided in Table 8. Similar information for past due and impaired exposures by geography is provided in Table 9 below.

## Table 8: Past Due and Impaired Exposures by Industry

| | Past Due and Impaired exposures by Industry Type 28 February 2011 | | | | |
|---|---|---|---|---|---|
| | Financial Institutions (£k) | Governments (£k) | Individuals (£k) | Wholesale and retail trade (£k) | Total (£k) |
| **Past Due not Impaired** | | | | | |
| 1-29 days | - | - | 53,642 | - | 53,642 |
| 30-59 days | - | - | 12,663 | - | 12,663 |
| 60-89 days | - | - | 6,474 | - | 6,474 |
| 90 days or more | - | - | - | - | - |
| Total | - | - | 72,779 | - | 72,779 |
| | | | | | - |
| **Impaired Exposures** | - | - | 185,571 | - | 185,571 |
| | | | | | - |
| **Impairment Provisions** | - | - | 181,948 | - | 181,948 |
| | | | | | - |
| **Net Impairment Charge** | - | - | 131,356 | - | 131,356 |

| | Past Due and Impaired exposures by Industry Type 28 February 2010 | | | | |
|---|---|---|---|---|---|
| | Financial Institutions (£k) | Governments (£k) | Individuals (£k) | Wholesale and retail trade (£k) | Total (£k) |
| **Past Due not Impaired** | | | | | |
| 1-29 days | - | - | 57,140 | - | 57,140 |
| 30-59 days | - | - | 13,872 | - | 13,872 |
| 60-89 days | - | - | 7,458 | - | 7,458 |
| 90 days or more | - | - | - | - | - |
| Total | - | - | 78,470 | - | 78,470 |
| | | | | | - |
| **Impaired Exposures** | - | - | 368,018 | - | 368,018 |
| | | | | | - |
| **Impairment Provisions** | - | - | 313,991 | - | 313,991 |
| | | | | | - |
| **Net Impairment Charge** | - | - | 176,633 | - | 176,633 |

## Table 9: Past Due and Impaired Exposures by Geography

| | Past Due and Impaired exposures by Geography 28 February 2011 | | | |
|---|---|---|---|---|
| | Uk (£k) | Europe (£k) | Other (£k) | Total (£k) |
| **Past Due not Impaired** | | | | |
| 1-29 days | 50,858 | 2,784 | - | 53,642 |
| 30-59 days | 12,207 | 456 | - | 12,663 |
| 60-89 days | 6,407 | 67 | - | 6,474 |
| 90 days or more | - | - | - | - |
| Total | 69,472 | 3,307 | - | 72,779 |
| **Impaired Exposures** | 182,743 | 2,827 | - | 185,571 |
| **Impairment Provisions** | 178,666 | 3,282 | - | 181,948 |
| **Net Impairment Charge** | 129,661 | 1,695 | - | 131,356 |

| | Past Due and Impaired exposures by Geography 28 February 2010 | | | |
|---|---|---|---|---|
| | Uk (£k) | Europe (£k) | Other (£k) | Total (£k) |
| **Past Due not Impaired** | | | | |
| 1-29 days | 53,974 | 3,166 | - | 57,140 |
| 30-59 days | 13,336 | 536 | - | 13,872 |
| 60-89 days | 7,388 | 70 | - | 7,458 |
| 90 days or more | - | - | - | - |
| Total | 74,698 | 3,772 | - | 78,470 |
| **Impaired Exposures** | 365,298 | 2,720 | - | 368,018 |
| **Impairment Provisions** | 310,962 | 3,029 | - | 313,991 |
| **Net Impairment Charge** | 174,278 | 2,355 | - | 176,633 |

During the year TPF plc has amended its methodology for charging off loans and advances to customers. The impact of this is that loans balances are now manually charged off in the financial statements at an earlier date than in prior periods. This has resulted in an increase of £158,027k in uncollectible amounts written off within the provision movement in the current year (refer to Table 10) and a corresponding decrease of £158,027k being recorded in the gross loans and advances to customers balance. Had a similar exercise been carried out last year, the effect on the prior year would have been to increase uncollectible amounts written off within the provision movement by £123,626k and to decrease gross loans and advances to customers balance by the same amount. There is no change to the carrying value of loans and advances to customers and no impact on the income statement in either the current or prior year.

### 6.1.4. Credit Risk: Value Adjustments and Provisions

Credit risk provisioning and impairment is the responsibility of the TPFG Board. Day to day responsibility for impairment provisions is delegated to the Finance Director based on the policy agreed by the TPFG Board and RMC.

In managing credit risk provisioning and impairment TPF plc apply IFRS, specifically International Accounting Standard 39: Financial Instruments (IAS 39) which requires that financial assets are assessed for impairment. Loan impairment provisions are established to recognise incurred impairment losses. A loan is impaired when there is objective evidence that events since the loan was granted have affected expected cash flows from the loan. The impairment loss is the difference between the carrying value of the loan and the present value of estimated future cash flows discounted at the loan's original effective interest rate.

TPF plc applies a collective impairment provisioning model that segments provisions into the latent (good) book and the bad (impaired) book based upon the approved definition of default operated on both the credit card and loans portfolios. Good book provisions are held where there is objective evidence of impairment on an account (e.g. missed payments) but the account does not yet meet the TPF plc definition of default. Impairment provisions are established on a portfolio basis taking into account the level of arrears, security, past loss experience and defaults based on portfolio trends. The most significant factors in establishing these provisions are the expected loss rates.

Table 10 shows the reconciliation of changes in provisions for loans and advances. This table excludes impairment losses of £414k arising on amounts due from the insurance business.

**Table 10: Analysis of Impairment provisions for loans and advances**

| Impairment Provisions for Loans & Advances | February 2011 (£k) | February 2010 (£k) |
|---|---|---|
| Opening Balance | 313,991 | 249,578 |
| Amounts written off | (268,252) | (118,394) |
| Recoveries of amounts previously written off | 8,636 | 10,430 |
| New impairment provisions less releases charged to the income statement | 130,942 | 176,633 |
| Unwind of discount | (3,496) | (4,256) |
| Provisions as at 28 February | 181,821 | 313,991 |

Provisions for impaired loans and advances at 28th February 2011 were £164,276k (2010: £293,341k).

There are no further value adjustments in relation to credit risk. Non-credit risk value adjustments are disclosed in Note 18 of the Directors' Report and Financial Statements.

### 6.1.5. Credit Risk: Analysis by Exposure Class

Table 11 shows the credit risk exposure, excluding off Balance Sheet exposures and the derivative exposures detailed in Section 5.3 above, as at the financial year end together with average credit risk exposure values across the financial year from 1st March to 28th February. The exposure is shown gross before taking into account the effects of credit risk mitigation but is reported net of impairment provisions.

Off-Balance sheet exposures relate to undrawn credit card commitments and have an exposure value as at 28 February 2011 of £7,127,334k (2010 £6,464,509k). Average undrawn exposure values for March 2010 to February 2011 were £6,840,049k (March 2009 to February 2010 £6,188,987k).

**Table 11: Credit Risk: Analysis by Exposure Class**

| Exposure Class | Maximum Exposure Value | | Average Exposure Value | |
|---|---|---|---|---|
| | February 2011 (£k) | February 2010 (£k) | Mar 10 - Feb 11 (£k) | Mar 09 - Feb 10 (£k) |
| Central Governments or Central Banks | 510,585 | 478,045 | 494,347 | 268,340 |
| Multilateral Development Banks | 228,641 | 98,796 | 150,555 | 8,233 |
| Institutions | 262,675 | 200,299 | 265,757 | 615,605 |
| Corporates | 112,372 | 146,180 | 202,606 | 139,934 |
| Retail Claims | 4,707,183 | 4,208,350 | 4,475,666 | 3,964,463 |
| Past Due Items | 21,249 | 74,677 | 62,520 | 93,051 |
| Securitisation Positions | 73,444 | 96,901 | 83,934 | 51,771 |
| Collective Investment Undertaking | 312,207 | 411 | 137,449 | 321,650 |
| Other | 220,890 | 150,652 | 177,990 | 95,004 |
| Total | 6,449,246 | 5,454,311 | 6,050,824 | 5,558,051 |

### 6.1.6. Credit Risk: Analysis by Geography

Table 12 provides the geographic distribution of TPF plc exposures by asset class. TPF plc is primarily focussed on providing financial services and products to UK personal customers although there is limited exposure in the Republic of Ireland. TPF plc sells credit cards into the Republic of Ireland where it is an authorised 'credit institution' under Irish law and is directly regulated by the Irish Financial Regulator in respect of this activity.

**Table 12: Credit Risk: Analysis by Geography**

| Exposure Class | Geographic Location (28 February 2011) | | | |
|---|---|---|---|---|
| | UK (£k) | Europe (ex. UK) (£k) | Other (£k) | Total (£k) |
| Central Governments or Central Banks | 396,933 | 113,652 | - | 510,585 |
| Multilateral Development Banks | - | 181,375 | 47,266 | 228,641 |
| Institutions | 262,675 | - | - | 262,675 |
| Corporates | 110,460 | 1,772 | 140 | 112,372 |
| Retail Claims | 4,674,180 | 33,003 | - | 4,707,183 |
| Past Due Items | 21,249 | - | - | 21,249 |
| Securitisation Positions | 73,444 | - | - | 73,444 |
| Collective Investment Undertaking | 50,028 | 262,179 | - | 312,207 |
| Other | 220,890 | - | - | 220,890 |
| **Total** | **5,809,859** | **591,981** | **47,406** | **6,449,246** |

| Exposure Class | | Geographic Location (28 February 2010) | | |
|---|---|---|---|---|
| | UK (£k) | Europe (ex. UK) (£k) | Other (£k) | Total (£k) |
| Central Governments or Central Banks | 329,951 | 148,094 | - | 478,045 |
| Multilateral Development Banks | - | 98,796 | - | 98,796 |
| Institutions | 200,299 | - | - | 200,299 |
| Corporates | 145,944 | 236 | - | 146,180 |
| Retail Claims | 4,175,781 | 32,568 | - | 4,208,350 |
| Past Due Items | 74,677 | - | - | 74,677 |
| Securitisation Positions | 96,901 | - | - | 96,901 |
| Collective Investment Undertaking | - | 411 | - | 411 |
| Other | 150,652 | - | - | 150,652 |
| **Total** | **5,174,205** | **280,105** | **-** | **5,454,311** |

### 6.1.7. Credit Risk: Analysis by Industry type

The distribution of exposures by industry type is provided in Table 13. TPF plc is primarily focussed on providing financial services and products to UK personal customers although it also has exposure to wholesale counterparties as detailed in Section 6.1.2 above.

**Table 13: Credit Risk: Analysis by Industry Type**

| Exposure Class | | | Industry Type (28 February 2011) | | |
|---|---|---|---|---|---|
| | Financial Institutions (£k) | Government (£k) | Individuals (£k) | Wholesale and retail trade (£k) | Total (£k) |
| Central Governments or Central Banks | - | 510,585 | - | - | 510,585 |
| Multilateral Development Banks | 228,641 | - | - | - | 228,641 |
| Institutions | 262,675 | - | - | - | 262,675 |
| Corporates | - | - | - | 112,372 | 112,372 |
| Retail Claims | - | - | 4,707,183 | - | 4,707,183 |
| Past Due Items | - | - | 21,249 | - | 21,249 |
| Securitisation Positions | 73,444 | - | - | - | 73,444 |
| Collective Investment Undertaking | 312,207 | - | - | - | 312,207 |
| **Total** | **876,967** | **510,585** | **4,728,432** | **112,372** | **6,228,356** |

| Exposure Class | | | Industry Type (28 February 2010) | | |
|---|---|---|---|---|---|
| | Financial Institutions (£k) | Government (£k) | Individuals (£k) | Wholesale and retail trade (£k) | Total (£k) |
| Central Governments or Central Banks | 0 | 478,045 | - | - | 478,045 |
| Multilateral Development Banks | 98,796 | - | - | - | 98,796 |
| Institutions | 200,299 | - | - | - | 200,299 |
| Corporates | - | - | - | 146,180 | 146,180 |
| Retail Claims | - | - | 4,208,350 | - | 4,208,350 |
| Past Due Items | - | - | 74,677 | - | 74,677 |
| Securitisation Positions | 96,901 | - | - | - | 96,901 |
| Collective Investment Undertaking | 411 | - | - | - | 411 |
| **Total** | **396,407** | **478,045** | **4,283,027** | **146,180** | **5,303,659** |

Note that Other Assets have been excluded from these tables.

### 6.1.8. Credit Risk: Exposure by Residual Maturity

An analysis of residual maturity of exposures, on a contractual basis, is provided in Table 14.

**Table 14: Credit Risk exposure by residual maturity**

| Exposure Class | Residual Maturity (Contractual) (28 February 2011) | | | | | | |
|---|---|---|---|---|---|---|---|
| | On Demand (£k) | Repayable in 3 months or less (£k) | Repayable between 3 months and 1 year (£k) | Repayable between 1 and 5 years (£k) | Repayable over 5 years (£k) | Undated (£k) | Total (£k) |
| Central Governments or Central Banks | 120,854 | 4,513 | 25,095 | 222,366 | 133,517 | 4,240 | 510,585 |
| Multilateral Development Banks | - | 3,106 | - | 166,196 | 59,339 | - | 228,641 |
| Institutions | - | 64,282 | 165,211 | 18,893 | 14,289 | - | 262,675 |
| Corporates | - | 112,372 | - | - | - | - | 112,372 |
| Retail Claims | 2,453,107 | 155,312 | 461,558 | 1,475,090 | 162,116 | - | 4,707,183 |
| Past Due Items | 7,930 | 4,390 | 3,164 | 5,391 | 374 | - | 21,249 |
| Securitisation Positions | - | 183 | 7,193 | 48,735 | 17,333 | - | 73,444 |
| Collective Investment Undertaking | 312,122 | 85 | - | - | - | - | 312,207 |
| Other | 3,060 | 112,027 | 16,706 | 89,097 | - | - | 220,890 |
| **Total** | **2,897,073** | **456,270** | **678,927** | **2,025,768** | **386,968** | **4,240** | **6,449,246** |

| Exposure Class | Residual Maturity (Contractual) (28 February 2010) | | | | | | |
|---|---|---|---|---|---|---|---|
| | On Demand (£k) | Repayable in 3 months or less (£k) | Repayable between 3 months and 1 year (£k) | Repayable between 1 and 5 years (£k) | Repayable over 5 years (£k) | Undated (£k) | Total (£k) |
| Central Governments or Central Banks | 178,418 | 1,554 | 80,044 | 214,699 | - | 3,330 | 478,045 |
| Multilateral Development Banks | - | 1,111 | - | 97,685 | - | - | 98,796 |
| Institutions | - | 22,004 | 90,702 | 86,783 | 810 | - | 200,299 |
| Corporates | - | 146,180 | - | | - | - | 146,180 |
| Retail Claims | 2,282,354 | 132,819 | 393,689 | 1,254,189 | 145,299 | - | 4,208,350 |
| Past Due Items | 6,292 | 20,661 | 17,304 | 28,411 | 2,009 | - | 74,677 |
| Securitisation Positions | - | 73 | 28,920 | 57,996 | 9,912 | - | 96,901 |
| Collective Investment Undertaking | 392 | 19 | - | | - | - | 411 |
| Other | - | 92,583 | 9,169 | 48,900 | - | - | 150,652 |
| **Total** | **2,467,456** | **417,004** | **619,828** | **1,788,663** | **158,030** | **3,330** | **5,454,311** |

### 6.1.9. Credit Risk Mitigation

The retail products offered by TPF plc are unsecured consumer lending products and no credit risk mitigation is obtained in relation to these products. Policies are in place which allow the use of credit risk mitigation to reduce Counterparty Credit Risk. As at end February 2011 no use has been made of collateral other than industry standard ISDA agreements used in relation to financial derivative transactions.

There is currently no use of credit risk mitigation in regulatory capital calculations.

## *6.2. Dilution Risk*

TPF plc has no exposure to dilution risk.

# 7. Market Risk

TPF plc has no Trading Book and no exposure to traded Market Risk.

## 8. Operational Risk

Operational Risk is the risk of loss caused by human error, ineffective or inadequately designed processes, system failure or improper conduct (including criminal activity). TPF plc risk appetite is to maintain a low level of operational risk, while accepting in the short term a higher level of risk inherent in the transformation programme to build stand-alone systems and capability independent of the Royal Bank of Scotland Group. TPF plc has undertaken a significant transformation programme to develop and embed its own infrastructure to allow it to migrate systems and support from the Royal Bank of Scotland Group infrastructure. The migration of the insurance infrastructure platforms has been completed and the migration of financial systems is underway. Systems migration is set to continue well into 2011 as TPF plc continues to migrate its banking products onto its own IT platforms. Operational Customer Service Centres have been created in Glasgow and Newcastle managing banking and insurance customers as part of the transformation programme.

The Chief Risk Officer, and his direct report, the Head of Operational Risk, are responsible for developing and overseeing the implementation of the framework, policies and standards for the identification, management and mitigation of operational risk across the business.

In addition, the Head of Operational Risk also has responsibility for fraud risk management (internal and external to the Business) and anti - money laundering (AML).

TPF plc maintains appropriate and effective internal control systems to monitor and manage operational and related risks, as well as to ensure that it meets its statutory, regulatory and supervisory responsibilities, including the following:

- A risk and control assessment process is used by the business to identify, assess, manage, monitor and report its operational risks. This information enables the business to assess its residual risk exposure and determine its approach to managing risk;
- A formal escalation process to manage events which have or could have an adverse impact on TPF plc's customers, staff, operational effectiveness, finances or reputation. This process enables the event to be managed effectively with the root cause established and addressed to reduce the likelihood of a recurrence;
- Loss data management process to capture, classify, record and analyse the business's operational risk losses;
- A change management process to ensure that all new products and all material variations to existing products are subject to a thorough risk assessment prior to launch;
- Policies and processes to minimise exposure to financial crime, including fraud and money laundering;
- Control assurance testing to monitor the effectiveness of internal controls, and
- Information security policy and procedures.

TPF plc assesses its operational risk capital requirement using the Standardised Approach.

## 9. Treasury Risk

Treasury is responsible for leading the approaches to the management of the capital and liquidity resources of TPF plc. This includes responsibility for co-ordinating the ICAAP, the Individual Liquidity Assessment Process ("ILAA") and stress testing processes. The specific risks managed by the team include liquidity, interest rate risk in the banking book, foreign exchange risk, large exposures and intra group limits. Capital management activities are discussed in Sections 4 and 5.

TPF plc has a low risk appetite for all treasury risks and activities.

### 9.1. Interest Rate Risk in the Non-Trading Book

Interest Rate Risk in the Banking Book (IRRBB) or Non-Trading Book arises where there is potential for changes in benchmark interest rates (that embed little or no credit risk) to result in a movement in the Banking Book net interest income.

IRRBB may arise from a number of sources, for example:

- risks related to the mismatch of repricing of assets and liabilities and off Balance Sheet short and long-term positions;
- risks arising from hedging exposure to one interest rate with exposure to a rate which reprices under slightly different conditions;
- risk related to the uncertainties of occurrence of transactions e.g. when expected future transactions do not equal the actual transactions; and
- risks arising from consumers redeeming fixed rate products when market rates change.

TPF plc has established limits that describe its risk appetite in this area and stress tests are performed using sensitivity to fluctuations in underlying interest rates in order to monitor this risk. The Treasurer is responsible for ensuring that IRRBB is managed within limits approved by ALCO. The IRRBB policy is owned and monitored by Treasury and approved by ALCO.

The main policy objectives are to:

1. Manage the overall IRRBB of TPF plc by:
   - Identifying, assessing, controlling and reporting TPF plc's interest rate risk exposure within risk appetite parameters;
   - Minimising the sensitivity at product, balance or business level of net interest income to changes in benchmark interest rates; and
   - Ensuring that IRRBB arising in TPF plc is transferred to the market or managed efficiently by Treasury within approved limits.
2. Ensure that compliance with evolving regulatory IRRBB requirements is maintained within each jurisdiction in which TPF plc operates, including requirements set out as part of the ICAAP process.

TPF plc has no traded interest rate risk.

Non traded interest rate risk primarily arises from the consumer lending portfolios and retail deposits. Prepayment risk in the personal loan book creates Interest Rate Risk for TPF plc, where customers repay fixed rate loans outwith the contractual payment terms. Prepayment assumptions are used to create a repayment profile which reflects expected customer repayment behaviour. Actual prepayment rates are monitored on a monthly basis and reported to ALCO to validate the accuracy of the prepayment assumptions. Hedging strategies are amended as required to ensure that TPF plc remains within stated risk appetite. Assumptions are utilised for non maturity deposits. Treasury assets and liabilities are managed using contractual repricing dates. All assumptions are formally validated on an annual basis and monitored monthly.

The main hedging instrument used is interest rate swaps and the residual exposure is reported to ALCO monthly using two key risk measures:

- 1 day Value at Risk ("VaR") to a 95% confidence level; and
- net interest income sensitivity to an instantaneous 1% parallel movement in interest rates.

The different methodologies can be summarised as:

**VaR** – is a technique that produces estimates of the potential negative change in the value of a portfolio over a specified time horizon at given confidence levels. For internal risk management purposes, TPF plc use a time horizon of one trading day and a confidence level of 95%.

TPF plc use historical interest rate models in computing VaR. The model uses the previous 500 trading days of market data. This approach assumes that risk factor changes observed in the past are a good estimate of those likely to occur in the future and is, therefore, limited by the relevance of the historical data used.

**NII Sensitivity** – This measures the effect of a 1.0% interest rate shock on the next 12 months net interest income, based on the re-pricing gaps in the existing portfolio.

In addition to the two key measures outlined above TPF plc also monitors the contractual interest rate sensitivity gap.

| Measure | February 2011 (£k) | February 2010 (£k) |
|---|---|---|
| Interest Rate VaR | 35 | 74 |
| NII Sensitivity | (0.62%) | (0.93%) |

## 9.2. Funding Liquidity Risk

TPFG Board approves the Liquidity Risk Management policy framework and delegates the day to day responsibility for complying with the framework to the Treasurer.

TPF plc monitors a number of liquidity and Balance Sheet ratios on a daily basis. The key liquidity measures are the Individual Liquidity Guidance ("ILG") ratio, the Net Stable Funding Ratio ("NSFR") and the Net Wholesale Funding Outflow. The ILG ratio requires TPF plc to maintain sufficient high quality liquid assets to meet liquidity requirements during periods of market dislocation and stress. The NSFR measure is designed to enable TPF plc to fully fund long term and illiquid assets by an appropriate combination (size and maturity) of stable liabilities. The ratio does not give any credit for short-term wholesale funding thereby mitigating refinancing risk. Management of the Net Wholesale Funding Outflow is designed to restrict high concentrations of cash outflows and to spread funding maturities.

The Treasurer is responsible for ensuring that all liquidity and funding measures are respected. Liquidity management information is provided on a regular basis to the ALCO and TPFG Board with any exceptions highlighted. Stress testing and reverse stress testing of current and forecast Balance Sheets is conducted to inform TPF plc of required liquidity resources and the circumstances that would result in liquidity resources being exhausted.

To ensure ongoing completeness and accuracy there is a periodic Balance Sheet reconciliation of the liquidity Balance Sheet to the General Ledger.

As part of the FSA's new liquidity framework TPF plc is required to complete an ILAA submission to the FSA. This is approved by ALCO and TPFG Board before submission.

## 9.3. Foreign Exchange Risk

Whilst the large majority of TPF plc's Balance Sheet is denominated in the accounting reference currency of sterling, non sterling exposures exist in the form of Euro denominated credit cards, Euro and US Dollar denominated treasury investment assets, travel money foreign exchange exposures and some limited accounts payable. The Treasurer is responsible for ensuring these are managed in accordance with the Non-trading Foreign Exchange Risk policy approved by ALCO.

TPF plc is exposed to limited foreign exchange risk as the majority of this risk has been eliminated through the use of a series of foreign exchange swaps and cross currency swaps.

## 9.4. Large Exposures and Intra Group Limits

The Treasurer is responsible for ensuring that TPF plc respects the FSA's Large Exposures limits on a daily basis and reports against those limits to the FSA as required.

TPF plc is also responsible for ensuring that it maintains control over intra group limits.

Both of these policies are approved by ALCO.

## 10. Non trading book exposures in Equities

TPF plc non trading exposure in equities relates to the investment in TU who underwrite Motor and Home insurance contracts under the Tesco Bank brand. TU is an associate of TPF plc which has a 49.9% equity share. This equity position in the non-trading book is held for strategic objectives. TPF plc values the investment in TU at cost less any provision for impairment. At 28th February 2011 this investment was valued at £71,708k and accounted for all non-trading book equities.

## 11. Insurance Risk

TPF plc is exposed to insurance risks through its historic distribution arrangement with RBSI and indirectly through it's ownership of 49.9% of TU, an authorised insurance company.

The legacy arrangement with RBSI is now in run off and the primary risk that TPF plc remains exposed to is Reserving Risk – the risk that claims reserves will be insufficient to cover the ultimate cost of insurance claims arising from this activity. This is particularly relevant to Motor Insurance claims where the ultimate cost of large bodily injury claims is uncertain and the time taken to settle such claims can vary significantly depending on the severity of the injury. This risk is, in part, mitigated by the use of reinsurance to limit the Group's exposure to the cost of individual claims above certain pre determined limits. However, the nature of this exposure results in the process of estimating the ultimate cost of these claims carrying a degree of uncertainty.

Since October 2010 the majority of new business policies for Home and Motor Insurance product sold by TPF plc have been underwritten by TU. Customers renewing their Motor or Home insurance policies have been underwritten by TU since November 2010. The key insurance risks within TU relate to Underwriting Risk and specifically the potential for a major weather event to generate significant claims on Home insurance or on Motor insurance the cost of settling bodily injury claims. Exposure to this risk is actively managed within TU with close monitoring of performance metrics and the use of reinsurance to limit TU's exposure above pre-determined limits.

Since October 2010 Pet, Travel and Breakdown insurance have all been distributed by TPF plc on a 'white label' basis. TPF plc does not carry the insurance risk associated with these products.

The TPF plc insurance risk framework seeks to:

- Provide an effective and consistent approach to insurance risk management in areas including Actuarial & Pricing, Commercial & Marketing, Insurance Operations and with counterparties, including TU, RBSI and white label providers;
- Use the understanding of aggregate risk exposures (including those under the oversight of Regulatory, Operational, Credit and Treasury Risk functions) to:
    - Better understand and manage the potential volatility of the insurance results;
    - Take action, where required, to manage or mitigate risk;
    - Inform strategic development decisions;
    - Learn from experience, and develop and improve the quality of the risk assessment.
- Measure the extent to which the insurance business within TPF plc is being conducted in accordance with the TPF plc risk appetite and policies.
- Provide subject matter expert support to the business in identifying, assessing and managing risk in accordance with the TPF plc Risk Management Policy.

The TPF plc Risk function has a dedicated Insurance Risk team that operates as the primary risk contact across all risk disciplines for the insurance business. However, the insurance business is also subject to second line of defence oversight by the other Risk functions.

In addition, TU operates a separate risk framework with dedicated risk and compliance teams and a suite of TU risk policies. TU is working to implement Solvency II which aims to establish an enhanced set of capital and risk management standards across the European insurance industry. The TPF plc Risk engagement policy has been developed to provide assurance that risk is being managed effectively within TU.

# 12. Regulatory Risk

Regulatory Risk is the failure to meet TPF plc's obligations under the Financial Services and Market's Act ('FSMA'), the Consumer Credit Act and the Data Protection Act and to meet the expectations of TPF plc's regulators.

TPF plc has a minimal appetite for Regulatory Risk and maintains a control framework to comply with regulatory requirements.

The Chief Risk Officer, and his direct report, the Head of Regulatory Risk, together with a dedicated Regulatory Risk team are responsible for regulatory risk management policies and processes and the oversight of regulatory risk and compliance across the TPF business.

Regulatory Risk provides oversight and support to the business to ensure regulatory rules and requirements are adhered to and that regulatory risks are identified and managed appropriately. Regulatory Risk's scope includes FSA, Consumer Credit and Data Protection Act requirements as well as internal regulatory risk management policies.

The activities undertaken by the Regulatory Risk team include:

- regular and ad-hoc compliance monitoring, with regular monitoring captured and agreed through the Risk Assurance process and plan;
- regulatory risk reporting internally and externally, including to the FSA;
- supporting the business in identifying and responding to the impact of regulatory change or managing the compliance requirements brought about by internal change or new products;
- review and sign off of financial promotions and customer marketing material;
- maintaining a robust framework for TPF plc's Significant Influence Approved Persons;
- providing day to day compliance consultancy support to the business and change programmes; and
- supporting the management of the relationship with the FSA.

As part of the TPF plc Policy Framework, Regulatory Risk is responsible for a number of policies including Data Protection, Marketing Approval, Regulatory Contact and Share Dealing and Market Abuse. In addition, the Compliance Manual sets out the scope of TPF plc's regulatory responsibilities and its approach to managing regulatory risk across the business. The Compliance Manual is approved through RMC.

# 13. Securitisation

## *13.1. Securitisation Roles and Objectives*

TPF plc operates within the securitisation market as originator and investor with objectives including:

- Accessing the wholesale markets as originator to actively manage the Balance Sheet as part of the overall diversified funding plan;
- Purchasing certain securitisation issuances as an investor for the purposes of diversifying its treasury assets and managing its liquidity position.

As an originator, TPF plc's main objective is funding and, at present, there are no regulatory capital benefits derived from these origination activities. All of TPF plc's originated asset backed securities have been retained and all AAA rated asset backed securities were provided by way of collateral to the Bank of England for participation in the Special Liquidity scheme, thus providing TPF plc with access to Treasury Bills in support of its liquidity position. As an investor, TPF plc invests directly in asset backed securities.

TPF plc's involvement in securitisation activity is summarised in Table 15 below with originated securitisation exposure value being the current amount of outstanding notes in issue. The underlying securitised credit card receivables remain on TPF plc's Balance Sheet. All of the securitised revolving exposures originated by TPF plc are traditional securitisations.

**Table 15: TPF plc Securitisation Involvement**

| Total Outstanding Securitisation Exposure as at 28 February 2011 | | | | |
|---|---|---|---|---|
| Securitisation Role / Exposure Type | Exposure Value (£k) | Impaired Exposures (£k) | Past Due Exposures (£k) | Securitation Losses recognised in period (£k) |
| Originated Securitisations | | | | |
| Credit Card Receivables (ABS) | 1,165,600 | - | - | - |
| Invested Securitisations | | | | |
| Residential Mortgage Backed Securities (RMBS) | 73,444 | - | - | - |

| Total Outstanding Securitisation Exposure as at 28 February 2010 | | | | |
|---|---|---|---|---|
| Securitisation Role / Exposure Type | Exposure Value (£k) | Impaired Exposures (£k) | Past Due Exposures (£k) | Securitation Losses recognised in period (£k) |
| Originated Securitisations | | | | |
| Credit Card Receivables (ABS) | 1,165,600 | - | - | - |
| Invested Securitisations | | | | |
| Residential Mortgage Backed Securities (RMBS) | 96,901 | - | - | - |

### 13.2. Approach to Calculating Risk Weighted Exposure Amounts

TPF plc adopts the Standardised Approach to securitisations. For risk weighting purposes, originated exposures are treated as if they had not been securitised in accordance with the provisions of BIPRU 9. In relation to invested securitisations, TPF plc calculates risk weighted exposure amounts using the credit quality steps prescribed in BIPRU 9. Fitch Ratings are used for assessment of regulatory capital.

The aggregate amount of securitisation positions purchased, analysed by risk weight band, is provided in Table 16 below.

**Table 16: Securitisation Positions analysed by risk rating**

| Invested Residential Mortgage Backed Securitisation Positions held by TPF plc at 28 February 2011 | | | |
|---|---|---|---|
| Rating | Risk Weight Band | Purchased Exposure Value £k | Deduction from Capital £k |
| AAA | 20% | 73,444 | 0 |
| **Invested Residential Mortgage Backed Securitisation Positions held by TPF plc at 28 February 2010** | | | |
| Rating | Risk Weight Band | Purchased Exposure Value £k | Deduction from Capital £k |
| AAA | 20% | 96,901 | 0 |

### 13.3. Accounting Treatment

TPF plc consolidates all of the originated securitisation Special Purpose Entities (SPE's) related to the securitisation of any of its assets on a line by line basis within the financial statements. These SPE's are not derecognised in accordance with International Accounting Standard (IAS) 27 and SIC 12 IAS 39 which require SPE's to be consolidated where the substance of the relationship between the Group and the SPE indicates that the SPE is controlled by the Group.

Invested securities are held on the Balance Sheet as Available-for-Sale financial assets. Available-for-sale investments are those intended to be held for an indefinite period of time, which may be sold in response to the need for liquidity or changes in interest rates, exchange rates or other market prices.

Available-for-sale financial assets are initially recognised at fair value plus transaction costs and measured subsequently at fair value with gains and losses being recognised in the statement of comprehensive income, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised.

If an available-for-sale financial asset is determined to be impaired, the cumulative gain or loss previously recognised in the statement of comprehensive income is recognised in the income statement. Interest on available for sale assets is calculated using the effective interest method, and foreign currency gains and losses on monetary assets classified as available for sale are recognised in the income statement.

The Group records contracts that take place on the date at which the contract has been entered into.

### 13.4. ECAIs Used in Securitisations

TPF plc has utilised Standard & Poor's and Moody's as External Credit Assessment Institutions in the originated securitisation process, both of whom continue to rate the originated credit card receivables securitisation. Moody's, Standard & Poors and Fitch Ratings are used as part of the credit assessment process for invested securitisations.

### 13.5. Securitised Revolving Exposures

Due to the retained nature of the credit card securitisation no liquidity risk or capital exposure exists for TPF plc.

### 13.6. Summary of Securitisation Activity

TPF plc did not securitise any exposures during its financial year ended 28th February 2011.

There were no realised gains or losses on originated securitisation activity during the financial year.

Subsequent to the year end TPF plc formally exited the Bank of England Special Liquidity Scheme. The outstanding originated credit card securitisation notes were cancelled on 19th May 2011.

## 14. Remuneration

TPF plc has been brought into scope of the revised FSA Remuneration Code with effect from 1st January 2011 and is working to ensure full compliance in advance of 1st July 2011, in accordance with the transitional guidance set out by the FSA.

The Remuneration disclosures required under Pillar 3 will be published on the Tesco plc corporate website (http://www.tescoplc.com) during the second half of 2011.