Sainsbury's Bank plc

Pillar 3 Disclosures 2009

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Pillar 3 Disclosures

1 Overview

1.1 Background

The Basel II Capital Requirements Directive (Basel II) consists of three 'pillars'. Pillar 1 of the standards sets out the minimum capital requirements firms are required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1.

The aim of Pillar 3 is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on a firm's capital, risk exposures and risk assessment processes. The disclosures are to be made to the market for the benefit of the market.

This document represents the Pillar 3 Disclosure by Sainsbury's Bank (the Bank).

The information has been prepared purely for the purpose of explaining the basis on which the Bank has prepared and disclosed certain capital requirements and information about the management of risks relating to those requirements, and for no other purpose. It therefore does not constitute any form of financial statement of the Bank nor does it constitute any form of contemporary or forward looking record or opinion of the Bank.

1.2 Scope of Application

The Bank has complied with Basel II throughout the year. This Disclosure is presented in respect of the year to 31 December 2009.

As the Bank has adopted the standardised approach to the calculation of the credit and operational risk capital requirements, no Internal Ratings Board or Advanced Measurement Approach disclosures are included.

This disclosure is based on the Bank's ownership as at 31 December 2009. J Sainsbury plc and Bank of Scotland plc each hold 50 per cent of the issued share capital of the Bank, with a contractual arrangement in place to share joint control. Consequently there is no ultimate parent company.

Following the acquisition of HBOS plc by Lloyds TSB Group plc on 16 January 2009, Bank of Scotland plc became part of the Lloyds Banking Group plc (LBG).

1.3 Frequency

The Bank's Pillar 3 Disclosure will be published on an annual basis in a reporting cycle aligned with the publication of the bank's Annual Report and Accounts.

This frequency will be reviewed if there is a material change in the approaches used for the calculation of capital, characteristics of the business or regulatory requirements.

1.4 Medium and Location for Publication

The Pillar 3 Disclosure will be published on the J Sainsbury Plc corporate website, www.j-sainsburys.co.uk/investors.

1.5 Verification

These disclosures have been reviewed by the Bank's Audit Committee. The disclosures are not subject to audit except where they are equivalent to those prepared under accounting requirements and disclosed in the Bank's annual report and accounts.

2 Risk Management Objectives and Policies

2.1 Risk Management Controls

Identification, measurement and management of risk are strategic priorities for the Bank.

Overall responsibility for identifying and managing risks lies with the Board. Responsibility for managing the Bank's exposure to its principal risks has been delegated to the Risk Management Committee. The framework outlined below was in place for 2009 and early 2010. Further enhancements were made to governance structures in May 2010 and these are highlighted at the end of section 2.2.

A comprehensive framework of internal controls and governance structures has been established for risk management. Control systems are designed to manage risk.

The Bank's risk appetite is set by the Board, defined in Policies such as Lending and Operational Risk, and articulated through Limits and Objectives (e.g. Net Interest Income Sensitivity, Credit Risk Exposures, Bad Debt Charge), Operational Risk Key Risk Indicators, and Financial Balanced Scorecard metrics.

Approval processes for all Policies and Limits are clearly defined in the Bank's governance structures. For example, Lending and Operational Risk Policies are approved a minimum of once a year by the Risk Management Committee and any material change to Policies requires approval from the Board.

Updates on lending strategy and bad debt progress are frequently presented to the Board. This allows the Board to assess the Bank's risk appetite on a regular basis and to ensure the taking of risk is directly linked to the achievement of business objectives.

The Bank has adopted the 'Three Lines of Defence' model in its approach to risk management, and enhanced it through the access to risk experience in its parents:

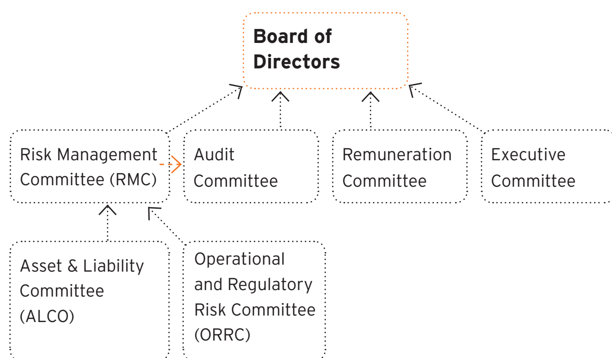
1. The primary responsibility for management of risk lies with the Chief Executive and the Executive Management Team [EMT]. The Bank's Head of Risk is an integral part of the EMT. On a day to day basis, control of the risks in the business is owned by the individual business units. Escalation procedures are in place such that any control failures are reported to the independent risk team within the Bank, and to the Executive and relevant governance bodies.

2. The Bank's governance structure provides the next line of defence with the key committees (as described below), supported by the Bank's risk team, ensuring risk management is optimal and providing independent challenge to the business units. The parameters, policies and standards are approved by the Risk Management Committee or Operational and Regulatory Risk Committee.

   As well as Bank specific risk teams, all committees have attendance from Lloyds Banking LBG and most from J Sainsbury plc, the Bank's parent Companies, to ensure the Bank gains maximum risk learning from its parents.

3. Independent assurance of risk management is provided primarily by the LBG Internal Audit function, assisted where appropriate by the equivalent function in J Sainsbury plc. This is the Bank's final line of defence. The audit functions agree their focus in audit plans set out annually and approved by the Bank's Audit Committee. All audit teams are given unrestricted access to personnel at all levels in the Bank.

2.2 Risk Management Governance



The Board
The Bank's Board has overall responsibility for setting the Bank's strategic aims, ensuring necessary financial and human resources are in place to meet objectives, defining the Bank's risk appetite and credit policy, approving changes to financial and non-financial risks, and ensuring that risk is monitored and controlled effectively through a comprehensive risk management framework.

The Board has delegated responsibility for identifying risks and managing them effectively to the Risk Management Committee, the Audit Committee and the Executive Management Team.

The Risk Management Committee (RMC)
The RMC sets the policy and standards for Credit Risk, Operational and Regulatory Risk. It reviews and approves actions designed to increase the effectiveness of the control environment.

Its responsibilities include the application of the Bank's Lending Policy, monitoring performance of the credit portfolios against exposure limits and other KPIs, bad and doubtful debt provisioning, and management of the Bank's policies on balance sheet and interest rate risk.

The RMC itself overviews the work of two committees: the Operational and Regulatory Risk Committee and the Asset and Liability Committee.

The Operational and Regulatory Risk Committee (ORRC)
The ORRC sets the policy and standards for Operational and Regulatory Risk. It assesses and considers the Bank's current performance in respect of Operational and Regulatory Risk, reviews the effectiveness of the risk management and control of the organisation, and considers initiatives and actions designed to increase the effectiveness of the control environment.

The Asset and Liability Committee (ALCO)
The ALCO measures, monitors and controls Interest Rate Risk, Wholesale Credit Risk, Liquidity Risk and Foreign Exchange within an agreed risk appetite. The ALCO is also responsible for monitoring Treasury performance and ensuring compliance with prudential requirements of the Financial Services Authority (FSA).

The Audit Committee
A number of Board functions are delegated to the Audit Committee. The Committee's key responsibility is to advise the Board on the Bank's financial results, both interim and final, examine any provisions or estimates which are subject of judgement, monitor the accounting policies adopted within the Bank and approve the Bank's Financial Statements and Pillar 3 disclosures.

It reviews and considers enhancement to the internal control framework, including information systems, and monitors the adequacy of systems and management processes to ensure compliance with regulatory and legislative requirements. The Committee is also responsible for the appointment, reappointment and removal of the external auditor as well as assessing their effectiveness, independence and objectivity.

The Remuneration Committee
During the year the Bank considered the conclusions reached in the Walker review which examined corporate governance arrangements in UK banks and other financial industry entities. Although the majority of the recommendations are not applicable to the Bank, a decision was taken to establish the Remuneration Committee to help improve governance in line with the key themes identified. The Remuneration Committee is responsible for providing oversight and challenge over the approach to remuneration in respect of all individuals working at the Bank.

The Executive Committee (ExCo)
The ExCo, chaired by the Chief Executive, is responsible for the day to day management of the Bank's business. The Board's direction on risk appetite is translated into action, monitoring and controls by the Bank's Executive, who determine exposure limits, pricing strategies, expectations for the bad debt charge, and Key Risk Indicators.

Changes to governance
From 1 May 2010 changes have been made to the governance structure outlined above. The changes are intended to further enhance the risk management framework in place at the Bank and are as follows:

- A Board Risk Committee (BRC) has been established which is a new sub-committee of the Board. It is responsible for reviewing and reporting its conclusions to the Board on the Bank's risk appetite (the extent and categories of risk which the Board regards as acceptable for the company to bear); and the Bank's risk management framework (embracing principles, policies, methodologies, systems, processes, procedures and people). In that regard, the committee shall take a forward-looking perspective, anticipating changes in business conditions.
- An Executive Risk Committee (ERC) has been established which replaces the previous risk management committee. This reports into the BRC. Similar to the previous committee, the ERC is responsible for exercising and monitoring compliance with Bank's activities in accordance with approved risk appetite and limits of authority approved by the Board and BRC. The ORRC and ALCO report into the ERC along with the Executive Credit Risk Committee (ECRC). The ECRC is a new committee established to focus on retail credit risk.
- A Banking Product Committee has been established which is a sub-committee of the ALCO. It approves new products, pricing changes to products and all significant feature changes to banking products.
- A Nominations Committee has been established which is a new sub-committee of the Board. It is responsible for reviewing the structure, size and composition of the Board as well as leading the process for making Board appointments. The committee is also responsible for considering the balance of skills, knowledge and experience required by the Board as well as succession planning into the Executive Committee.

2.3 Risk Exposures
The main risks to which the Bank is exposed are credit risk (retail and wholesale), operational risk, liquidity risk, interest rate risk (on the banking book), and foreign exchange risk.

2.3.1 Retail Credit Risk
The Bank manages three credit portfolios. The unsecured personal loans and credit card portfolios are active books. The mortgage book, which represents a very small percentage of the Bank's assets, is closed to new business and therefore running down. The entire Bank's retail lending is in the prime market.

The Bank's risk appetite for customer lending is defined in the Lending Policy, which defines:

- The range of assets available
- The target market for its lending
- The Bank's policies in respect of affordability and indebtedness
- Exposure limits for loans and credit card stock and new business
- Required responses to the exposure limits being breached.

The Bank monitors external economic indicators to identify changes to the external economic environment. Classifications for periods of stagflation and recession have been defined and in an economic downturn the risk appetite defines changed exposure limits and management actions.

The risk of customer defaults on loans and credit cards is managed through automated decision systems using scorecards and policy rules. Where subjective assessments are undertaken, these are subject to strict controls and monitoring.

The Bank benefits from its association with LBG through having access to improvements in LBG risk management policies and practices, with the opportunity to develop and implement scorecards and policies of specific benefit to the Bank.

Application scorecards for loans and credit cards, and account management scorecards for credit cards, are developed using data from the Bank's own credit portfolios supplemented by data from the credit bureaux. The effectiveness of the scorecards and policy rules is regularly monitored, and re-calibration undertaken where necessary.

Comprehensive Management Information on the economy, portfolio limits, quality of new business, stock performance, and collections and recoveries performance is presented in detail to the RMC each month.

All changes to lending policy and operational strategies are presented to RMC for approval. Change management processes are detailed and require sign-off from all relevant parties.

2.3.2 Wholesale Credit Risk
The Bank places surplus deposits raised through retail markets in a variety of investments as set out in the Treasury Strategy and Control Statement in the Bank's Lending Policy. Allowable investments include unsecured cash deposits, Floating Rate Notes, Repurchase arrangements, and Treasury Bills.

These investments give rise to the risk of loss arising from a counterparty being unable to meet their financial obligations to the Bank when they fall due. To mitigate this risk, all investment activity is controlled through dealing mandates with pre-approved high quality counterparties as agreed by the Bank and LBG Treasury Services, and is subject to ALCO and RMC overview.

The LBG credit risk team maintains an accessible record of exposures and credit lines, notifies the Bank of any known or planned rating downgrades or any other events that may impact on the credit status of a counterparty, and provides daily information on credit default swap spreads and equity market prices to facilitate the monitoring of credit risk. Formal weekly meetings are held between SB and LBG credit risk and the minutes of these meetings are subject to review by ALCO.

For the effective management of risks, any changes to potential counterparties, their limits or their ratings are approved by or advised to ALCO and RMC.

2.3.3 Operational Risk
Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people and systems.

The Bank has a defined Operational Risk Policy which is reviewed at least annually by the ORRC to ensure alignment with the Bank's requirements for operational risk management and its continued relevance to the Bank's current and planned operations.

The Bank identifies, evaluates and monitors operational risks through a number of core processes such as operational risk profiling, loss event reporting, the use of key risk indicators and regular control self assessments. Regular reports are provided to the ORRC and other governance bodies.

The major sources of Operational Risks faced by the Bank include:

- Outsourcing
- Internal and external fraud
- Failure of systems and processes
- Inadequate change management.

These risks are mitigated, for example, by defined processes for relationship management of outsourced activities, and contracts and service level agreements with service providers.

The ORRC receives a Monthly Operational Risk pack, and specific papers on emerging risks and key points of note. (As a sub-committee of the RMC, minutes from the ORRC and issues escalated for actions are presented to the RMC. An Operational Risk Update is submitted to the Audit Committee, and summaries of minutes and key decisions are noted by the Board.)

2.3.4 Liquidity Risk
Liquidity risk is the risk that the Bank cannot maintain or generate sufficient cash resources to meet its payment obligations as they fall due, or can only do so at materially disadvantageous terms.

The FSA requires the Bank to have a policy in place for the management of liquidity in both normal and abnormal circumstances. SB manages liquidity to ensure that sufficient liquid assets are at all times available to meet the Bank's obligations, after taking into account withdrawals of customer deposits, draw-down of customer facilities and growth in the balance sheet under various scenarios.

The Liquidity Policy Statement addresses these requirements and defines how the Bank maintains adequate liquidity, taking into account the nature and scale of its business, so that it is able to meet its obligations as they fall due. The Policy Statement is approved by the Board.

In line with this policy, the Bank maintains an FSA prescribed level of Sterling Stock Liquid Assets which comprises of high-quality assets that can be sold quickly for cash. The Policy is subject to annual review by ALCO, which also has responsibility for monitoring and controlling liquidity.

The Bank prepares both long-term and short-term forecasts to assess liquidity requirements. Daily operational management of liquidity is delegated to the Head of Finance, under the control of ALCO.

Liquidity risk under stressed conditions is assessed in the Bank's internal capital adequacy assessment process (ICAAP). This considers in detail the scenario of significantly higher than expected attrition of retail deposits. The Bank also undertakes an Individual Liquidity Adequacy Assessment (ILAA) in line with FSA requirements. This examines the liquidity risk deemed to exist under various scenarios, the composition and amount of liquidity held as well an assessment of internal controls.

2.3.5 Interest Rate Risk (on the Banking Book)

Interest rate risk arises from the provision of financial products to the Bank's retail customer base as well as from wholesale exposures and the consequent possibility of differences in the timing of maturities, rate resets for asset and liabilities and different positions resetting based on different indices (basis risk).

Management of interest rate risk is the responsibility of ALCO. The Bank's Market Risk Policy is reviewed annually approved by RMC and the Board. The Bank does not take any Market Risk for speculative purposes.

The Policy sets the framework and standards under which the Bank will measure, monitor and manage interest rate risk. Interest rate risk limits set by the Policy are defined on an aggregate portfolio basis across differing maturity periods.

Interest rate risk exposure is managed through hedging of the fixed rate elements of the Bank's retail lending.

The impact of adverse movements in interest rates is modelled across a range of instantaneous parallel interest rate shocks and reported to ALCO on a monthly basis. Input parameters for the modelling, such as product behavioural assumptions, and product pricing in the event of rate movements, are confirmed by ALCO. The impact of non-parallel shifts in the yield curve are also considered.

The Bank's sensitivity of interest income to a 50 bps instantaneous parallel rate shock was:

2009 – Parallel instantaneous rate shift	Impact on 12 months' income	
NII Sensitivity	-50 bps	+50 bps
Consolidated	+£0.6m	-£4.0m

2008 – Parallel instantaneous rate shift	Impact on 12 months' income	
NII Sensitivity	-50 bps	+50 bps
Consolidated	+£0.1m	-£2.3m

The figures are the sum of the retail and investment portfolio earnings movements.

2.3.6 Foreign Exchange Risks

Foreign exchange risk is that risk that the Bank could suffer a loss if Sterling falls against other currencies.

The Bank is exposed to foreign exchange risks from cash flows arising on some of its available for sale investment securities. These forecast transactions in foreign currencies are hedged with currency swaps. The cash flows on the currency swaps substantially match the cash flow profile of the hedged investment securities.

3 Capital Resources

The FSA sets and monitors capital requirements for the Bank. In implementing current capital requirements the FSA requires the Bank to maintain a prescribed level of capital with reference to risk weighted assets and the perceived risk management framework.

At 31 December 2009 and throughout the year, the Bank complied with the capital requirements that were in force as set out by the FSA.

The Bank manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of its activities.

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

Tier 1 capital includes ordinary share capital and retained earnings after the deduction of intangible assets.

Tier 2 capital includes dated and undated loan capital plus a collective impairment allowance.

Various limits are applied to elements of the capital base. Tier 2 capital cannot exceed Tier 1, and lower Tier 2 capital cannot exceed 50 per cent of Tier 1 capital.

The table below shows the breakdown of total available capital for the Bank.

3.1 Total Capital Resources

Tier 1 and Tier 2 capital resources, as calculated under Basel II, are as follows:

		31 December 2009 £m
Tier 1 capital		
Ordinary share capital	170.0	
Audited reserves	34.9	
Deduction for intangible assets	(1.3)	203.6
Tier 2 capital		
Upper tier 2		
Undated loan stock	50.0	
Allowable element of provisions	35.6	
Lower tier 2		
Dated loan stock	60.0	145.6
Total capital		349.2

	31 December 2009 £m
Risk weighted assets	2,848.0
Core Tier 1 capital ratio	7.2%
Total capital ratio	12.3%

3.1 Total Capital Resources continued

		31 December 2008 £m
Tier 1 capital		
Ordinary share capital	170.0	
Audited reserves	30.9	
Deduction for intangible assets	(1.6)	199.3
Tier 2 capital		
Upper tier 2		
Undated loan stock	50.0	
Allowable element of provisions	31.8	
Lower tier 2		
Dated loan stock	60.0	141.8
Total capital		341.1

	31 December 2008 £m
Risk weighted assets	2,540.5
Core Tier 1 capital ratio	7.8%
Total capital ratio	13.4%

3.2 Share Capital

	Ordinary shares £m
Authorised	
At 31 December 2009	200.0

	Ordinary shares £m
Authorised	
At 31 December 2008	200.0

	'A' Ordinary shares of £1	'B' Ordinary shares of £1	Total Ordinary shares of £1
Allotted, called up and fully paid			
At 31 December 2009	85.0	85.0	170.0

	'A' Ordinary shares of £1	'B' Ordinary shares of £1	Total Ordinary shares of £1
Allotted, called up and fully paid			
At 31 December 2008	85.0	85.0	170.0

The share capital is divided into class 'A' and class 'B' ordinary shares which rank pari passu in all respects.

The shareholders' agreement prescribes that a distribution of profits may not be made if the distribution would result in the Bank being in regulatory test deficit, the distribution would or would be likely to result in a breach of any covenant to any lender, or if a distribution would not be prudent having regard to the future outlook and performance of the Bank.

3.3 Loan Capital

	31 December 2009 £m
Dated loan capital - Repayable after five years	
£60 million Floating Rate subordinated loan 2014	60.0
Undated loan capital	
£50 million Floating Rate subordinated loan - undated	50.0

	31 December 2008 £m
Dated loan capital - Repayable after five years	
£60 million Floating Rate subordinated loan 2014	60.0
Undated loan capital	
£50 million Floating Rate subordinated loan - undated	50.0

Dated Loan Capital

The dated subordinated loan is split in proportion to shareholder funding. No repayment, for whatever reason, of dated subordinated debt prior to its stated maturity may be made without the consent of the Financial Services Authority (FSA). On a winding up of the Bank, the claims of the holders of dated subordinated debt shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the dated subordinated debt.

Undated Loan Capital

The undated subordinated loans are split in proportion to shareholder funding. The undated subordinated loan capital shall be repaid on such date as the FSA shall agree in writing for such repayment (following a request by either the Lender or Borrower) and in any event not less than five years and one day from the dates of drawdown. On a winding up of the Bank, the claims of the holders of undated subordinated debt shall be subordinated in right of payment to the claims of all depositors and creditors of that company other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the undated subordinated debt.

4 Compliance with BIPRU and the overall Pillar 2 Rule

4.1 Assessment of the Adequacy of Internal Capital

In order to protect the solvency of the Bank, internal capital is held to provide a cushion for unexpected losses. The extent of the capital held is determined by the FSA's guidance on capital adequacy, supplemented by the Bank's prudent approach which requires that a buffer in excess of the regulatory requirement is maintained at all times.

The Bank has adopted the Standardised approaches to the calculation of the Basel II Minimum Capital Requirement.

The Bank determined that the benefits of implementing the Internal Ratings Based Approach for Credit Risk and the Advanced Measurement Approach for Operational Risk to calculate risk weightings are outweighed by the costs of complying with their requirements. This is subject to regular review.

The Bank undertakes an annual Internal Capital Adequacy Assessment Process (ICAAP) to assess its risks, how it mitigates these risks and how much capital it requires to hold currently and in the future.

Capital adequacy is reviewed by the Board, ALCO and RMC, and reported to the FSA, on a monthly basis. The Bank holds capital well in excess of the capital requirement calculated in the ICAAP.

The Bank is currently considering the FSA's proposals for implementing changes that are required following amendments to the Capital Requirements Directive in the UK.

4.2 Minimum Capital Requirement: Standardised Credit Risk

The following table shows the Bank's minimum capital requirement for each of the standardised credit risk exposure classes. The minimum capital requirement is calculated as 8 per cent of the risk weighted exposures.

Minimum	31 December 2009 £m Capital Requirement	31 December 2009 £m Risk Weighted Assets
Exposure Class		
Retail	122.5	1,531.0
Secured on real estate property	3.3	41.4
Past due items	22.2	277.1
Institutions	50.0	624.4
Others	6.0	75.6
Total Credit Risk Minimum Capital Requirement	**204.0**	**2,549.5**

Minimum	31 December 2008 £m Capital Requirement	31 December 2008 £m Risk Weighted Assets
Exposure Class		
Retail	105.1	1,313.5
Secured on real estate property	3.5	44.4
Past due items	22.5	281.1
Institutions	45.8	572.9
Others	6.6	82.4
Total Credit Risk Minimum Capital Requirement	**183.5**	**2,294.3**

The others category above is non credit risk weighted assets e.g. fixed assets, accrued income, items in course of collection.

4.3 Minimum Capital Requirement: Standardised Operational Risk

The Bank calculates the capital requirement for Operational Risk using the Standardised Approach (TSA).

	31 December 2009 £m
Operational Risk Minimum Capital Requirement	**23.9**

	31 December 2008 £m
Operational Risk Minimum Capital Requirement	**19.7**

5 Credit Risk and Dilution Risk

5.1 Impairment Losses on Loans and Advances

Impairment loss calculations involve the estimation of future cash flows of financial assets, based on observable data at the balance sheet date and historical loss experience for assets with similar credit risk characteristics. These calculations are undertaken on a portfolio basis using various statistical modelling techniques. Impairment models are continually reviewed to ensure data and assumptions are appropriate. However, the accuracy of any such impairment calculation will be affected by unexpected changes to the economic situation, and assumptions which differ from actual outcomes. As such, judgement is also applied in selecting and updating impairment models.

5.2 Maximum Exposure to Credit Risk

The table below shows the maximum exposure to credit risk for the components of the balance sheet, including derivatives. The maximum exposure is shown gross, before the effect of mitigation through the use of collateral agreements.

Credit Exposure	2009 Average	Total at 31 December 2009 £m
Retail	2,094.8	2,111.2
Secured on real estate property	98.6	94.9
Sovereign	261.3	454.2
Financial Institutions	2,564.4	2,821.0
Total	5,019.1	5,481.3

Credit Exposure	2008 Average	Total at 31 December 2008 £m
Retail	1,825.8	1,818.9
Secured on real estate property	111.4	102.6
Sovereign	257.1	311.4
Financial Institutions	3,811.8	2,878.2
Total	6,006.3	5,111.1

5.3 Risk Concentrations of the Maximum Exposure to Credit Risk

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Bank's performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risk, the Bank's policies and procedures include specific guidelines to focus on maintaining a diversified portfolio. Identified concentrations of credit risks are controlled and managed according to client or counterparty (and their respective credit qualities), as opposed to geographical region or industry sector.

5.4 Geographical and Counterparty Sectors

2009 Credit Exposure	United Kingdom £m	Rest of Europe £m	North America £m	Australia £m	Total £m
Retail	2,111.2	–	–	–	2,111.2
Secured on real estate property	94.9	–	–	–	94.9
Sovereign	454.2	–	–	–	454.2
Financial Institutions	1,945.5	802.4	58.2	14.9	2,821.0
	4,605.8	802.4	58.2	14.9	5,481.3

2008 Credit Exposure	United Kingdom £m	Rest of Europe £m	North America £m	Australia £m	Total £m
Retail	1,818.9	–	–	–	1,818.9
Secured on real estate property	102.6	–	–	–	102.6
Sovereign	311.4	–	–	–	311.4
Financial Institutions	1,875.9	929.6	58.7	14.0	2,878.2
	4,108.8	929.6	58.7	14.0	5,111.1

Concentration by location for loans and advances is measured based on the location of the Bank's operations, which has a high correlation with the location of the borrower. Concentration by location for investment securities is measured based on the location of the issuer of the security.

5.5 Residual Maturity

2009 Exposure Class	Up to 12 months £m	1-5 years £m	More than 5 years £m	Total £m
Retail	1,108.8	932.1	70.3	2,111.2
Secured on real estate property	13.0	31.0	50.9	94.9
Sovereign	454.2	–	–	454.2
Financial Institutions	2,106.1	605.4	109.5	2,821.0
Total	3,695.7	1,568.5	230.7	5,481.3

2008 Exposure Class	Up to 12 months £m	1-5 years £m	More than 5 years £m	Total £m
Retail	1,037.3	721.3	60.3	1,818.9
Secured on real estate property	23.2	57.7	21.7	102.6
Sovereign	311.4	–	–	311.4
Financial Institutions	1,824.2	823.4	230.6	2,878.2
Total	3,096.1	1,602.4	312.6	5,111.1

5.6 Exposure by credit quality steps

Exposures are shown below by credit quality steps. The mappings between the main external credit assessment institutions used by the Bank and the credit quality steps used to determine the risk-weight is detailed in the following table. Where no external rating is used in the risk weighted asset calculation, the unrated credit quality step applies. This captures all retail exposures, where the risk-weight is prescribed by arrears status.

Credit quality step	Moody's assessments
Step 1	Aaa to Aa3
Step 2	A1 to A3
Step 3	Baa1 to Baa3
Step 4	Ba1 to Ba3
Step 5	B1 to B3
Step 6	Caa1 and below

Total exposure by the credit quality steps is detailed in the table below.

2009	Credit Quality Step 1 £m	Credit Quality Step 2 £m	Credit Quality Step 3 £m	Credit Quality Step 4 £m	Credit Quality Step 5 £m	Credit Quality Step 6 £m	Unrated exposure £m	Total £m
Retail	–	–	–	–	–	–	2,111.2	2,111.2
Secured on real estate property	–	–	–	–	–	–	94.9	94.9
Sovereign	454.2	–	–	–	–	–	–	454.2
Financial Institutions	2,587.1	233.9	–	–	–	–	–	2,821.0
Total exposure pre mitigation	3,041.3	233.9	–	–	–	–	2,206.1	5,481.3
Total exposure post mitigation	3,041.3	233.9	–	–	–	–	2,206.1	5,481.3

2008	Credit Quality Step 1 £m	Credit Quality Step 2 £m	Credit Quality Step 3 £m	Credit Quality Step 4 £m	Credit Quality Step 5 £m	Credit Quality Step 6 £m	Unrated exposure £m	Total £m
Retail	–	–	–	–	–	–	1,818.9	1,818.9
Secured on real estate property	–	–	–	–	–	–	102.6	102.6
Sovereign	311.4	–	–	–	–	–	–	311.4
Financial Institutions	2,755.2	123.0	–	–	–	–	–	2,878.2
Total exposure pre mitigation	3,066.6	123.0	–	–	–	–	1,921.5	5,111.1
Total exposure post mitigation	3,066.6	123.0	–	–	–	–	1,921.5	5,111.1

5.7 Credit Risk Mitigation

Financial Institutions

The maximum credit exposure to any client or counterparty as of 31 December 2009 was £1,405.6 million (31 December 2008 – £1,272.4 million) before taking into account collateral or other credit enhancements of £763.8 million (31 December 2008 – £1,092.2 million). This exposure was to Lloyds Banking Group plc and represents short-term interbank deposits and lending under a reverse repo arrangement which is supported by 150 per cent AAA rated collateral, the level prescribed by the FSA.

The existence of collateral helps the Bank manage concentration risk and credit risk. Amounts are invested in the repo facility up to a maximum of a year with varying maturities depending on forecast liquidity requirements.

Processes are in place to ensure the adequacy of the level of collateral in place in light of daily valuation movements.

All cash settlements are made gross. However, there is a netting agreement in place between the Bank and BOS plc covering cash borrowing and lending which would be invoked by the Bank if necessary.

Retail

Mortgages held over residential properties represent the only collateral held by the Bank for retail exposures. The fair value of collateral held for impaired loans and loans past due but not impaired at 31 December 2009 was £12.2 million (31 December 2008 – £15.1 million). The fair value of collateral held against possession cases was £0.3 million (31 December 2008 – £nil).

Where the arrears status of a customer deteriorates and there is a failure to respond to correspondence or an acceptable repayment proposal, including notice of default, the customer balance will fall into 'recoveries'. Recoveries will take steps to recover the debt, using their expertise to determine the optimum recovery strategy. Instigation of legal action will depend upon the anticipated recoveries and costs.

5.8 Credit quality impairment and past due analysed by class of financial asset

5.8.1 Retail

Loans and advances to customers are all within the United Kingdom and are summarised as follows:

	31 December 2009 £m Retail	31 December 2009 £m Secured on real estate property	31 December 2009 £m Total lending
Impaired			
Less than 3 months, but impaired	4.1	–	4.1
Past due 3 to 6 months	24.9	1.0	25.9
Past due 6 to 12 months	0.4	0.4	0.8
Past due over 12 months	–	2.7	2.7
Recoveries	162.6	–	162.6
Possession	–	0.2	0.2
Total gross impaired loans	192.0	4.3	196.3
Past due but not impaired			
Past due up to three months but not impaired	26.5	2.6	29.1
Total gross past due but not impaired	26.5	2.6	29.1
Neither past due nor impaired*			
Not impaired	1,999.3	88.0	2,087.3
Total gross neither past due nor impaired	1,999.3	88.0	2,087.3
Total gross amount due	2,217.8	94.9	2,312.7
*Includes loans and advances that would have been past due or impaired had their terms not been renegotiated	2.3	–	2.3

	31 December 2008 £m Retail	31 December 2008 £m Secured on real estate property	31 December 2008 £m Total lending
Impaired			
Less than 3 months, but impaired	2.5	–	2.5
Past due 3 to 6 months	23.6	1.9	25.5
Past due 6 to 12 months	0.3	1.4	1.7
Past due over 12 months	–	2.2	2.2
Recoveries	160.4	–	160.4
Possession	–	–	–
Total gross Impaired loans	186.8	5.5	192.3
Past due but not impaired			
Past due up to three months but not impaired	37.0	5.2	42.2
Total gross past due but not impaired	37.0	5.2	42.2
Neither past due nor impaired*			
Not impaired	1,710.8	91.9	1,802.7
Total gross neither past due nor impaired	1,710.8	91.9	1,802.7
Total gross amount due	1,934.6	102.6	2,037.2
*Includes loans and advances that would have been past due or impaired had their terms not been renegotiated	1.6	–	1.6

Past due is defined as one day or over and impaired is defined as three missed payments.

For the Bank's portfolios of loans and advances to customers, provisions are calculated for groups of assets, otherwise impairment is identified at a counterparty specific level following objective evidence that a financial asset is impaired. Such evidence may include a missed interest or principal payment or the breach of a banking covenant. The present value of estimated cash flows recoverable is determined after taking into account any security held. The amount of impairment is calculated by comparing the present value of the cash flows discounted at the loans' original effective interest rate with the balance sheet carrying value.

A write-off is made when all or part of a claim is deemed uncollectible or forgiven.

An allowance for impairment losses is also maintained in respect of assets which are impaired at the balance sheet date but which have not been identified as such, based on historical loss experience and other relevant factors. The methodology and assumptions used are regularly reviewed to reduce any differences between estimates and actual results.

A reconciliation of movements on impairment provisions on loans and advances is shown below:

	Individual impairment £m	Collective impairment £m	Total impairment £m
Provisions at 1 January 2009	**153.9**	**4.8**	**158.7**
New impairment provisions less releases charged to the profit and loss account	88.6	0.9	89.5
Recoveries of amounts previously written off released to the profit and loss account	(1.4)	–	(1.4)
Amounts written off	(88.4)	–	(88.4)
Discount unwind on impaired loans and advances to customers	(1.5)	–	(1.5)
Provisions at 31 December 2009	**151.2**	**5.7**	**156.9**

	Individual impairment £m	Collective impairment £m	Total impairment £m
Provisions at 1 January 2008	**165.3**	**7.4**	**172.7**
New impairment provisions less releases charged to the profit and loss account	79.6	(2.6)	77.0
Recoveries of amounts previously written off released to the profit and loss account	(3.7)	–	(3.7)
Amounts written off	(86.7)	–	(86.7)
Discount unwind on impaired loans and advances to customers	(0.6)	–	(0.6)
Provisions at 31 December 2008	**153.9**	**4.8**	**158.7**

5.8.2 Loans and Advances to Banks

The total gross amount of individually impaired loans and advances to banks as at 31 December 2009 was £nil (31 December 2008 – £nil). The fair value of collateral held for loans and advances to banks was £763.8 million (31 December 2008 – £1,092.2 million). Collateral takes the form of security over AAA rated debt securities.

The table below presents an analysis of lending to banks by rating agency designation, based on Moody's ratings:

	31 December 2009 £m
Aaa to A3	1,642.3
Total	1,642.3

	31 December 2008 £m
Aaa to A3	1,457.0
Total	1,457.0

5.8.3 Debt Securities, Treasury Bills and Other Eligible Bills

The total gross amount of individually impaired debt securities, treasury bills and other eligible bills as at 31 December 2009 was £nil (31 December 2008 – £39.3 million).

The tables below present an analysis of treasury bills and investment securities by rating agency designation, based on Moody's ratings:

As at 31 December 2009	Treasury bills £m	Investment securities £m	Total £m
Aaa to A3	451.6	948.4	1,400.0

As at 31 December 2008	Treasury bills £m	Investment securities £m	Total £m
Aaa to A3	308.7	1,126.3	1,435.0

Investment securities classified as available for sale are continually reviewed at the specific investment level for impairment. Impairment is recognised when there is objective evidence that a specific financial asset is impaired. Objective evidence of impairment might include a significant or prolonged decline in market value below the original cost of a financial asset and, in the case of debt securities, non-receipt of due interest or principal repayment, a breach of covenant within the security's terms and conditions or a measurable decrease in the estimated future cash flows since their initial recognition.

The disappearance of active markets, declines in market value and ratings downgrades do not in themselves constitute objective evidence of impairment and, unless a default has occurred on a debt security, the determination of whether or not objective evidence of impairment is present at the balance sheet date requires the exercise of management judgement.

6.0 Securitisation

The Bank has not securitised assets that it has originated.