Sainsbury's Bank plc

Pillar 3 Disclosures 2011

Company number: 3279730

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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, risk assessment processes and remuneration approach.

This document represents the Pillar 3 Disclosure by Sainsbury's Bank plc (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; information about the management of risks relating to those requirements; and remuneration information as required by the Capital Requirements Directive and Financial Services Authority (FSA) prudential sourcebook. This report has not been prepared for any 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 2011.

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 2011. J Sainsbury plc and Bank of Scotland plc each hold 50% 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. Bank of Scotland plc is part of Lloyds Banking Group plc (LBG).

The Bank is committed to ensuring that its remuneration practices are appropriate and compliance with the Remuneration Code (the Code) will fall within the responsibilities of the Remuneration Committee.

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 appetite

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 Board Risk Committee which oversees the Executive Risk Committee.

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 Board approves the Bank's strategic risk appetite, which defines the level of risk that the Bank is prepared to accept to achieve its strategic objectives. The Board Risk Committee approves the articulation of these risk appetite statements in relation to retail credit risk, wholesale credit risk, market risk (interest rate risk, currency risk and basis risk), prudential risk, liquidity risk, operational and regulatory risk, and reputational risk.

The Bank has a framework of policies in place, which are a manifestation of its risk appetite statements, to manage key risks. Each policy has an Executive owner who is responsible for maintenance of the policy and ensures it is reviewed at least annually and approved by the relevant governance committees.

2.2 Risk model

The Sainsbury's Bank risk model consists of three layers or 'three lines of defence'. The model is enhanced through access to, and leverage of, its joint venture partners' risk experiences and methodologies. The Board retains ultimate responsibility for risk management in the Bank.

1. The first line of defence is responsible for execution of the Bank's strategy, business performance, setting and implementation of policy and management of risks and internal controls. This primarily lies with the Chief Executive and the entire Executive Management Team (EMT). The Bank's Chief Risk Officer is an integral part of the EMT. On a day-to-day basis, management and control of risk in the business is owned by the individual business units. Escalation procedures exist such that any control failures are reported to the Bank's independent risk team, and to the Executive and relevant governance bodies.

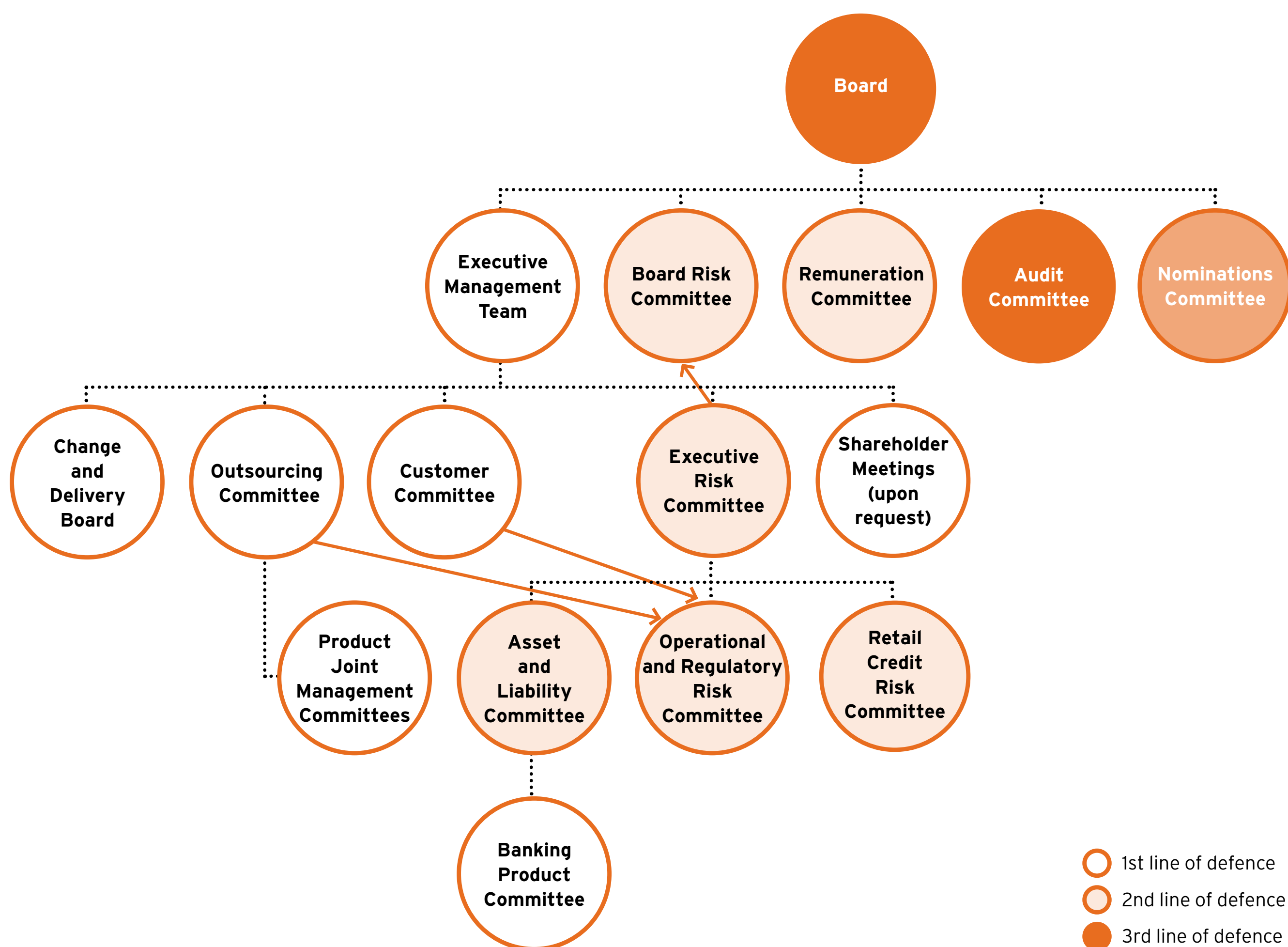
2. The second line of defence provides risk oversight, an independent and objective challenge to the first line of defence. The various committees in the risk governance structure challenge the main risk types, ensuring the risks are managed effectively in line with the risk appetite parameters. Representatives from both joint venture partners attend relevant risk committees.

3. The third line of defence provides independent and objective assurance on the effectiveness of the Bank's risk management, internal control and governance. This is provided by an in-house Head of Internal Audit and audit resource from Lloyds Banking Group (LBG) Internal Audit, J Sainsbury plc Internal Audit or external firms. This is supplemented by the role of the Audit Committee and Board.

As part of the second line of defence, risks are identified and managed by the Bank on an ongoing basis. The Bank's risks were reassessed in 2011 utilising a revised methodology, which is aligned to the three lines of defence model and the Bank's risk management framework.

Controls are implemented in the business to ensure that risks are effectively mitigated in line with the Bank's risk appetite and that a sound control environment is in place. A full Control Self Assessment (CSA) in the Bank is carried out at least annually and challenged by the Operational and Regulatory Risk Committee (ORRC). CSA is a technique whereby managers and staff systematically assess the controls within the areas for which they are responsible; to assess the extent to which they succeed in contributing to the achievement of business objectives and guarding against operational risks. The aim of the CSA is to provide positive assurance that management has an adequate level of control of the Bank's material risks, on the basis of both design and operation of controls.

2.3 Risk Governance Structure



- **The Board**

The Board is the key governance body and is responsible for the overall strategy, performance of the business and management of risk. It has delegated responsibility for the day-to-day running of the business to the Chief Executive and the Executive Management Team through apportionment of responsibility and delegated authorities.

The Board meets at least nine times a year. It comprises key Executive members from the Bank and three Non-Executive Directors from each of the shareholders and two independent Non-Executive Directors. The independent Non-Executive Directors were appointed during the year. A number of Board functions are delegated to four key sub-committees – the Board Risk Committee (BRC), the Audit Committee, Remuneration Committee (RemCo) and the Nominations Committee.

- **Executive Management Team**

The Chief Executive and Executive Management Team (EMT) have been delegated authority from the Board for the day-to-day running of the business. Responsibilities include general operational management (including oversight of the Change and Delivery Board, Outsourcing Committee, Customer Committee and Executive Risk Committee), delivery of the agreed business plan in line with agreed risk appetite, approval of new business plans or strategic changes prior to submission to the Board and senior management resourcing. The EMT is also responsible for monitoring financial and non-financial performance versus agreed targets on a regular basis.

- **Audit Committee**

The Audit Committee's key responsibility is to advise the Board on the Bank's financial results, both interim and final, including systems and policy issues and relationships with internal and external auditors.

- **Remuneration Committee**

The role of the Remuneration Committee (RemCo) is to determine and agree with the Board the broad policy for remuneration and for compliance with the FSA Remuneration Code ('the Code') to the extent that the provisions apply to the Bank. RemCo is responsible for recommending, monitoring and noting the level and structure of remuneration for senior management (categorised as 'Code Staff' for the purposes of the Code) and senior risk management and compliance colleagues.

RemCo continually reviews and assesses the impact of remuneration policies on the risk profile of the Bank and employee behaviour. RemCo has oversight over appointment and severance terms for relevant employees.

- **Nominations Committee**

The Nominations Committee is responsible for reviewing the structure, size and composition of the Board. The committee is also responsible for succession planning into the Board and the Executive Management Team and for ensuring a formal, rigorous and transparent process for recommending appointments to the Board to the Bank's shareholders.

- **Board Risk Committee**

The Board Risk Committee (BRC) is forward looking to anticipate future risks and is responsible for reviewing and reporting its conclusions to the Board on the Bank's risk appetite and the Bank's risk management framework.

- **Executive Risk Committee**

The Executive Risk Committee (ERC) is a sub-committee of the Board Risk Committee. It is responsible for monitoring and exercising compliance of the Bank's activities to approved risk appetite statements and guidelines and limits of authority approved by the Board and Board Risk Committee. The committee also establishes and maintains polices and methodologies for credit risk, market risk, liquidity risk, operational and regulatory risk and oversight of capital adequacy.

- **Change and Delivery Board**

The Change and Delivery Board (CADB) reports to the Executive Management Team. It is responsible for the management and oversight of the Bank change portfolio ensuring appropriate prioritisation of projects and tracking of progress versus plan.

- **Outsourcing Committee**

The Outsourcing Committee (OC) reports to the Executive Management Team. It is responsible for ensuring that outsourcing risk is managed in line with the approved risk appetite and a consistent approach is taken to managing supplier relationships across the Bank.

- **Customer Committee**

The Customer Committee (CC) reports to the Executive Management Team. It is responsible for the management and oversight of all customer matters including complaints and conduct risk considerations. The committee aims to understand and respond to systemic trends and root cause analysis and to ultimately ensure best practice.

- **Operational and Regulatory Risk Committee**

The Operational and Regulatory Risk Committee (ORRC) is a sub-committee of the ERC. It assesses and considers the Bank's current performance in respect of operational and regulatory risk and considers initiatives and actions designed to increase the effectiveness of the control environment in these areas from a second line risk oversight perspective. It is also responsible for overseeing the development and implementation of the Bank's Operational and Regulatory Risk Management Frameworks.

- **Retail Credit Risk Committee**

The Retail Credit Risk Committee (RCRC) is a sub-committee of the ERC. It is responsible for monitoring the performance of the retail lending book. This committee receives regular reports about the performance of all retail credit portfolios. This includes the credit cards and loans application process as well as collections and recoveries and fraud performance.

- **Asset and Liability Committee**

The Asset and Liability Committee (ALCO) is a sub-committee of the ERC. It is responsible for ensuring the balance sheet of the Bank is managed effectively with its main areas of responsibility being interest rate risk, wholesale credit risk, liquidity, and capital adequacy.

- **Banking Product Committee**

The Banking Product Committee (BPC) is a sub-committee of the ALCO. It approves new products, pricing changes to products and all significant feature changes to banking products. The committee also considers transfer pricing impact, capital considerations as well as changes to features that are relevant for interest rate risk.

2.4 Risk exposures

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

2.4.1 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 Bank only lends to prime UK customers.

The Bank's risk appetite for customer lending is defined in the Retail Credit Appetite Statement, which defines:

- The target market for its lending
- 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 environment. Classifications for levels of economic stress have been defined, as have the appropriate management actions to be considered in response to the change in the level of economic stress.

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

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, bad debts trends and collections and recoveries performance is presented in detail to the Retail Credit Risk Committee.

The Retail Credit Risk Committee ensures that appropriate policies are established and adhered to and this is subject to further oversight from the Board Risk Committee. Internal Audit teams carry out regular reviews of credit risk processes and policies on an annual basis.

2.4.2 Wholesale and derivative credit risk

The Bank places surplus deposits raised through retail markets in a variety of investments as set out in the Risk Appetite Statement and Tolerance section in the Bank's Lending Policy. Allowable investments include unsecured cash deposits, repurchase arrangements, gilts, Treasury bills, multilateral development banks (FSA eligible assets only), certificates of deposit and money market funds.

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's Treasury Services, and is subject to ALCO and Executive Risk Committee (ERC) overview.

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). Consideration is also given to geographical sector and in the case of wholesale credit risk the strength of the relevant sovereign.

Daily monitoring is undertaken by the Bank's Treasury department with updates provided to senior management and ALCO on a daily basis. These daily updates also make reference to early warning indicators which have been established to ensure wholesale and liquidity risk are identified in a timely basis.

For the effective management of risks, any changes to potential counterparties, their limits or their ratings are approved by or advised to ALCO and ERC. Derivatives are subject to the same credit risk control procedures as are applied to other wholesale market instruments.

2.4.3 Operational risk

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

The Bank has a defined Operational Risk Policy which is reviewed at least annually by the Operational and Regulatory Risk Committee (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, also considering potential linkages with other key risks to identify 'combined risks'.

The Bank identifies, evaluates and monitors operational risks against its defined risk appetite 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. A strategic risk map is maintained, which sets out details of the current impact and likelihood assessments of the key strategic risks of the Bank, along with a forward looking assessment of risks. Regular reports are provided to the ORRC and other governance bodies, such as the Outsourcing Committee to ensure regular, effective review of operational and outsourcing risks.

The major potential 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.

Internal audit undertakes reviews across the business throughout the year under a risk-based programme agreed with the Bank Audit Committee.

2.4.4 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 extreme cost.

As required by the regulations the Bank has completed an Individual Liquidity Adequacy Assessment (ILAA). This allows the Bank to demonstrate that it understands the liquidity risks it is running and has appropriate controls in place to mitigate them. The Bank has established a risk appetite as well as a suite of limits stemming from the ILAA process that determines the minimum level of liquidity held. Limits are informed by a number of stress scenarios that assess the survival period of the Bank. These include firm-specific stresses, market stresses and a combination of both.

In meeting internal limits as well as FSA requirements the Bank maintains a stock of high quality liquid assets that can be readily sold to meet the Bank's obligations to depositors and other creditors. The portfolio of assets is managed on a daily basis and within the framework as outlined in the ILAA and by the FSA.

In addition to this, the Bank prepares both long term and short term forecasts to assess liquidity requirements. Short term forecasting covers a rolling twelve month period and takes into account factors such as ATM cash management, investment maturities and customer deposit patterns and balances. These reports support daily liquidity management and are reviewed daily by senior management along with other early warning indicators. Early warning indicators include market stress indicators such as the 3m LIBOR and the yield spread on UK bonds and also firm specific indicators such as early signs of withdrawals on the Bank's retail deposits.

2.4.5 Interest rate risk (in 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, consequently, the 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 and approved by ALCO and the Board Risk Committee. 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 Bank's sensitivity of interest income to a 50 basis points (bps) instantaneous parallel rate shock was:

2011 – Parallel Instantaneous Rate Shift	Impact on 12 Months' Income	
NII Sensitivity*	-50 bps	+50 bps
Consolidated	+£1.3m	-£2.8m

2010 – Parallel Instantaneous Rate Shift	Impact on 12 Months' Income	
NII Sensitivity*	-50 bps	+50 bps
Consolidated	+£0.2m	-£3.6m

*Net Interest Income

2.4.6 Foreign exchange risks

Foreign exchange risk is the 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 2011 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% 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 2011 £m
Tier 1 capital		
Ordinary share capital	170.0	
Audited reserves	68.6	
Deduction for intangible assets	(4.7)	
		233.9
Tier 2 capital		
Upper tier 2		
Undated loan stock	50.0	
Allowable element of provisions	30.5	
Lower tier 2		
Dated loan stock	36.0	
		116.5
Total		350.4

	31 December 2011 £m
Risk weighted assets	2,128.3
Core Tier 1 capital ratio	9.6%
Total capital ratio	14.4%

		31 December 2010 £m
Tier 1 capital		
Ordinary share capital	170.0	
Audited reserves	48.1	
Deduction for intangible assets	(2.4)	
		215.7
Tier 2 capital		
Upper tier 2		
Undated loan stock	50.0	
Allowable element of provisions	32.4	
Lower tier 2		
Dated loan stock	48.0	
		130.4
Total capital		346.1

	31 December 2010 £m
Risk weighted assets	2,277.8
Core Tier 1 capital ratio	8.4%
Total capital ratio	13.4%

3.2 Share capital

	'A' Ordinary shares of £1	'B' Ordinary shares of £1	Total Ordinary shares of £1
Allotted, called up and fully paid			
At 31 December 2011	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 2010	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 2011 £m
Dated loan capital	
£60 million Floating Rate subordinated loan 2014	60.0
Undated loan capital	
£50 million Floating Rate subordinated loan	50.0

	31 December 2010 £m
Dated loan capital	
£60 million Floating Rate subordinated loan 2014	60.0
Undated loan capital	
£50 million Floating Rate subordinated loan	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.

In July 2011 the Basel Committee on Banking Supervision published its proposed legislation for the Capital Requirements Directive (CRD) and the Capital Requirements Regulation, which together make up CRD IV. CRD IV reflects the Basel III proposals for capital and liquidity reform, plus additional rules for non-compliance with prudential rules, corporate governance and remuneration. Implementation is due to commence on 1 January 2013 and is expected to run until 2021 (there are transitional arrangements for some elements). When effective, the Regulation element will become law in member states directly, replacing sections of the existing rulebooks (GENPRU and BIPRU) with significant changes to UK regulations. Proposals include changes to the definition of capital, new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Finalised legislation is due to be published in June 2012. The Bank continues to assess the impact of these draft regulations on the Bank's regulatory capital position.

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% of the risk weighted exposures.

	31 December 2011 £m Minimum Capital Requirement	31 December 2011 £m Risk weighted Assets
Exposure Class		
Retail	138.0	1,724.3
Secured on real estate property	2.7	34.3
Past due items	15.7	196.3
Institutions	7.4	92.7
Collective investment undertakings	1.3	16.0
Others	5.2	64.7
Total Credit Risk Minimum Capital Requirement	**170.3**	**2,128.3**

	31 December 2010 £m Minimum Capital Requirement	31 December 2010 £m Risk weighted Assets
Exposure Class		
Retail	133.2	1,665.6
Secured on real estate property	3.0	37.9
Past due items	17.7	221.3
Institutions	23.2	289.6
Others	5.1	63.4
Total Credit Risk Minimum Capital Requirement	182.2	2,277.8

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 2011 £m
Operational Risk Minimum Capital Requirement	**24.9**

	31 December 2010 £m
Operational Risk Minimum Capital Requirement	24.9

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	2011 Average	Total at 31 December 2011 £m
Retail	2,438.7	2,375.1
Corporate	6.7	80.0
Secured on real estate property	80.0	76.0
Sovereign	488.7	453.8
Financial Institutions	1,898.2	1,526.0
Total	4,912.3	4,510.9

Credit Exposure	2010 Average	Total at 31 December 2010 £m
Retail	2,340.9	2,294.6
Secured on real estate property	90.1	85.3
Sovereign	481.1	503.6
Financial Institutions	2,634.9	2,429.5
Total	5,547.0	5,313.0

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

2011 – Credit Exposure	United Kingdom £m	Rest of Europe £m	North America £m	Total £m
Retail	2,375.1	-	-	2,375.1
Corporate	80.0	-	-	80.0
Secured on real estate property	76.0	-	-	76.0
Sovereign	453.8	-	-	453.8
Financial Institutions	1,437.7	88.3	-	1,526.0
	4,422.6	88.3	-	4,510.9

2010 – Credit Exposure	United Kingdom £m	Rest of Europe £m	North America £m	Total £m
Retail	2,294.6	-	-	2,294.6
Secured on real estate property	85.3	-	-	85.3
Sovereign	503.6	-	-	503.6
Financial Institutions	1,884.7	483.8	61.0	2,429.5
	4,768.2	483.8	61.0	5,313.0

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

2011 – Exposure Class	Up to 12 months £m	1-5 years £m	More than 5 years £m	Total £m
Retail	1,212.9	1,131.5	30.7	2,375.1
Corporate	80.0	-	-	80.0
Secured on real estate property	8.5	23.5	44.0	76.0
Sovereign	453.8	-	-	453.8
Financial Institutions	1,437.7	63.2	25.1	1,526.0
Total	3,192.9	1,218.2	99.8	4,510.9

2010 – Exposure Class	Up to 12 months £m	1-5 years £m	More than 5 years £m	Total £m
Retail	1,122.4	1,109.1	63.1	2,294.6
Secured on real estate property	0.3	14.9	70.1	85.3
Sovereign	503.6	-	-	503.6
Financial Institutions	1,945.8	444.2	39.5	2,429.5
Total	3,572.1	1,568.2	172.7	5,313.0

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	Fitch assessments
Step 1	Aaa to Aa3	AAA to AA-
Step 2	A1 to A3	A+ to A-
Step 3	Baa1 to Baa3	BBB+ to BBB-
Step 4	Ba1 to Ba3	BB+ to BB-
Step 5	B1 to B3	B+ to B-
Step 6	Caa1 and below	CCC+ and below

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

2011	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	-	-	-	-	-	-	2,375.1	2,375.1
Secured on real estate property	-	-	-	-	-	-	76.0	76.0
Sovereign	453.8	-	-	-	-	-	-	453.8
Financial Institutions	221.1	1,289.9	-	15.0	-	-	-	1,526.0
Corporate	80.0	-	-	-	-	-	-	80.0
Total exposure pre mitigation	754.9	1,289.9	-	15.0	-	-	2,451.1	4,510.9
Total exposure post mitigation	754.9	169.8	-	15.0	-	-	2,451.1	3,390.8

2010	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	-	-	-	-	-	-	2,294.6	2,294.6
Secured on real estate property	-	-	-	-	-	-	85.3	85.3
Sovereign	503.6	-	-	-	-	-	-	503.6
Financial Institutions	2,221.4	164.1	44.0	-	-	-	-	2,429.5
Total exposure pre mitigation	2,725.0	164.1	44.0	-	-	-	2,379.9	5,313.0
Total exposure post mitigation	1,370.7	164.1	44.0	-	-	-	2,379.9	3,958.7

5.7 Credit risk mitigation

Financial institutions

The maximum credit exposure to any client or counterparty as of 31 December 2011 was £1,132.6m (31 December 2010 – £1,357.8m) before taking into account collateral or other credit enhancements of £340.0m (31 December 2010 – £642.6). 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 100% UK gilt collateral.

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 2011 was £10.4m (31 December 2010 – £11.1). The fair value of collateral held against possession cases was £0.1m (31 December 2010 – £0.2m).

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 2011 £m Retail	31 December 2011 £m Secured on real estate property	31 December 2011 £m Total Lending
Impaired			
Less than 3 months, but impaired	4.4	-	4.4
Past due 3 to 6 months	15.9	0.7	16.6
Past due 6 to 12 months	0.3	0.4	0.7
Past due over 12 months	-	1.4	1.4
Recoveries	117.5	-	117.5
Possession	-	0.1	0.1
Total Gross Impaired loans	138.1	2.6	140.7
Past due but not impaired			
Past due up to 3 months but not impaired	18.8	2.5	21.3
Total Gross past due but not impaired	18.8	2.5	21.3
Neither past due nor impaired*			
Not impaired	2,266.4	70.9	2,337.3
Total Gross neither past due nor impaired	2,266.4	70.9	2,337.3
Total Gross amount due	2,423.3	76.0	2,499.3
*Includes loans and advances that would have been past due or impaired had their terms not been renegotiated	2.6	-	2.6

	31 December 2010 £m Retail	31 December 2010 £m Secured on real estate property	31 December 2010 £m Total Lending
Impaired			
Less than 3 months, but impaired	5.9	-	5.9
Past due 3 to 6 months	19.5	0.6	20.1
Past due 6 to 12 months	0.3	0.3	0.6
Past due over 12 months	-	1.7	1.7
Recoveries	132.3	-	132.3
Possession	-	0.2	0.2
Total Gross Impaired loans	158.0	2.8	160.8
Past due but not impaired			
Past due up to 3 months but not impaired	23.7	2.7	26.4
Total Gross past due but not impaired	23.7	2.7	26.4
Neither past due nor impaired*			
Not impaired	2,179.4	79.8	2,259.2
Total Gross neither past due nor impaired	2,179.4	79.8	2,259.2
Total Gross amount due	2,361.1	85.3	2,446.4
*Includes loans and advances that would have been past due or impaired had their terms not been renegotiated	2.5	-	2.5

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 2011	**117.7**	**4.2**	**121.9**
New impairment provisions less releases charged to the profit and loss account	55.7	4.6	60.3
Recoveries of amounts previously written off released to the profit and loss account	(9.5)	–	(9.5)
Amounts written off	(57.3)	–	(57.3)
Discount unwind on impaired loans and advances to customers	(2.1)	–	(2.1)
Provisions at 31 December 2011	**104.5**	**8.8**	**113.3**

	Individual impairment £m	Collective impairment £m	Total Impairment £m
Provisions at 1 January 2010	151.2	5.7	156.9
New impairment provisions less releases charged to the profit and loss account	67.5	(1.5)	66.0
Recoveries of amounts previously written off released to the profit and loss account	(5.5)	–	(5.5)
Amounts written off	(93.3)	–	(93.3)
Discount unwind on impaired loans and advances to customers	(2.2)	–	(2.2)
Provisions at 31 December 2010	117.7	4.2	121.9

5.8.2 Loans and advances to banks

The total gross amount of individually impaired loans and advances to banks as at 31 December 2011 was £nil (31 December 2010: £nil). The fair value of collateral held for loans and advances to banks was £340.0m (31 December 2010: £642.6). Collateral takes the form of security over UK gilt securities.

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

	31 December 2011 £m
Aaa to A3	1,226.6
Total	1,226.6

	31 December 2010 £m
Aaa to A3	1,599.0
Total	1,599.0

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 2011 was £nil (31 December 2010 – £nil).

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 2011	Treasury bills £m	Investment securities £m	Total £m
Aaa to A3	451.3	73.3	524.6
Baa1 to Baa3	–	15.0	15.0
Total	451.3	88.3	539.6

As at 31 December 2010	Treasury bills £m	Investment securities £m	Total £m
Aaa to A3	500.5	500.8	1,001.3
Baa1 to Baa3	–	44.0	44.0
Total	500.5	544.8	1,045.3

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 Securitisation

The Bank has not securitised assets that it has originated.

7 Remuneration

7.1 Remuneration Committee (RemCo)

The role of RemCo is to determine and agree the broad policy for remuneration and for compliance with the FSA Remuneration Code ('the Code') to the extent that the provisions apply to the Bank. RemCo is responsible for monitoring and noting the level and structure of remuneration for senior management (categorised as 'Code Staff' for the purposes of the Code) and senior risk management and compliance staff.

RemCo continually reviews and assesses the impact of remuneration policies on the risk profile of the Bank and colleague behaviour. RemCo has oversight over appointment and severance terms for relevant colleagues (including payments of guaranteed remuneration for appointees and retention terms). The Board is responsible for the appointment of members to RemCo and for the revocation of any such appointments.

The Committee comprises no less than three members at any time, two of which are Non-Executive Board Directors and the other an executive from either parent organisation (Lloyds Banking Group plc or J Sainsbury plc). The Committee is constituted in a way that enables it to exercise independent judgment, and members do not perform any executive function with the bank. The quorum is two Committee members, one of whom is the Chairman. All members of the Committee are advised of the business to be transacted at any meeting even if they are unable to be present.

The Chairman of RemCo is a Non-Executive Director. The Chief Executive Officer and Sainsbury's Bank HR Director are invited to attend, except when issues regarding their own remuneration are discussed. Remuneration advisors provide independent opinion as requested by the Chairman.

The Remuneration Committee reviews the general principles underpinning the Remuneration Policy on an annual basis. No independent review of the Policy is undertaken, but it can be carried out at the request of the Remuneration Committee.

Remuneration decisions take into account the implications for risk and risk management of the Bank through:

- the requirement for all bonus schemes to be reviewed by the Bank's Board Risk Committee;
- the competent and experienced nature of all individuals who are a member of or who attend the Bank's Remuneration Committee, which enables them to exercise independent judgments regarding the remuneration decisions presented by management.

The long-term interests of all stakeholders are taken into account through the process of debating, tabling and agreeing remuneration decisions through the Remuneration Committee.

The Remuneration Committee has the ability to apply discretion to adjust awards that may arise through the Bank's bonus plan or other incentive arrangements. The Remuneration Policy of the Bank supports the firm's business strategy, which is based on providing shoppers with a compelling reason to purchase financial services from Sainsbury's, but doing so in a way which considers and manages the financial impact of its business decisions.

The Bank has prepared a Remuneration Policy Statement as (RPS), as required by SYSC 19A, which sets out the principles for pay, incentives and recognition within Sainsbury's Bank, taking into account its business strategy, objectives, risk tolerance and long-term interests. The key objective is to ensure that the Bank strikes an appropriate balance between risk and reward, consistent with its risk appetite.

7.2 Link between pay and performance

7.2.1 Assessment of performance

Sainsbury's Bank aims to base colleague reward and remuneration on both the Bank's performance and individual performance, while at the same time being sufficiently competitive to ensure that it attracts and retains the people it depends upon for success.

The Bank operates a balanced bonus framework and has developed this into balanced scorecard objectives. The annual bonus is based on financial and non-financial targets including customer-related objectives and certain criteria which are unique to individual departments. Overall, through aligning reward to the Bank's balanced scorecard, its aim is to recognise performance against targets including how well colleagues manage risk and therefore the long term health of the business.

Pay increases and personal bonus awards are influenced by the individual's level of performance. Performance is a balance of achieving a balanced scorecard range of personal objectives, as well as demonstrating the organisational 'ways of working' which reflect the Bank's culture. Consideration is given to how objectives have been met, and bonus awards will be reduced if the Bank's leadership behaviours and values have not been observed. The targets included within each colleague's balanced scorecard measures are benchmarked against last year's performance. The Bank's bonus schemes do not include a guaranteed minimum figure and are also capped at a maximum level.

The Bank has geared its remuneration structures so that a higher proportion of the reward package is "at risk" commensurate with the seniority of the individual, but this is balanced to ensure that individuals are not incentivised inappropriately.

Sainsbury's Bank has not made any guaranteed bonus payments to date. If any were to be awarded in the future they must be overseen by the Remuneration Committee and be Code compliant (i.e. paid in exceptional circumstances; in the context of hiring new colleagues; and limited to the first year of service).

7.2.2 Long term incentive plans

Sainsbury's Bank, in conjunction with its parent employing organisations (J Sainsbury plc and Lloyds Banking Group), runs a small number of performance based incentive plans. There are a number of performance hurdles which need to be met both at an organisational (parent and/or bank) and individual level for these awards to be made. If any Code Staff at Sainsbury's Bank participate in such schemes, any long term incentive awards they receive will comply with the Code and any changes to the arrangements will be agreed with either or both parent organisations and through the Bank's Remuneration Committee.

The Remuneration Committee will review any future long term incentive requirements proposed for the Bank to ensure that targets are aligned with the long term performance of the organisation.

7.3 Design and structure of remuneration

7.3.1 Risk management and risk tolerance

The Bank ensures that its remuneration practices promote sound and effective risk management, and do not encourage risk-taking that exceeds the firm's tolerated level of risk. The way in which its reward framework considers risk management is detailed below.

The Bank's strategy is used to determine its high-level risk principles and risk appetite measures. The risk appetite is proposed by the Executive and is reviewed and approved by the Bank Board, which in turn feeds into the Bank's remuneration practices. Decisions affecting Code Staff are made by the Bank's Remuneration Committee.

RemCo considers a Quality of Earnings Review, prepared by the Board Risk Committee, which it uses to take into account the quality of capital and management of risk taken in achieving its financial targets. RemCo has the power to adjust bonus awards depending on the information contained in the Quality of Earnings Review– it can make adjustments for all types of current and potential risk and take into account the cost and quality of the capital employed and the liquidity required.

Salaries are reviewed to ensure that there is an appropriate balance of fixed and variable remuneration. The Bank's incentive plans target a range of financial and operational measures. All bonus plans include an element for the achievement of personal performance targets, and these include risk objectives which must be met in full to "unlock" a bonus payment. This places individual accountability on the management of risk.

Risk colleagues have more specific risk objectives which are reviewed 6-monthly by the Risk Director, and the final bonus of senior Risk and Compliance colleagues is determined by the Remuneration Committee.

7.3.2 Profit based measurement and risk adjustment

The Bank is able to demonstrate that its techniques for assessing variable remuneration take sufficient account of current and future risk.

Bonus awards are determined through the achievement of specific measures which are set annually by the Board and are agreed by the Remuneration Committee and the Board Risk Committee and are calculated according to a pre-set formula.

The Bank's bonus scheme for all colleagues, including those who perform a significant influence function, incorporates a profit based measure. The metrics which underpin the bonus plan are: underlying profit, customer related metrics and personal performance, including specific risk-based targets.

In relation to Code Staff who are subject to deferral, the Remuneration Committee may make retrospective adjustments to the awards to take into account any material information that comes to light which affects the basis upon which the calculation was made.

7.4 Quantitative disclosures

Under BIPRU 11.5, the Bank is required to make certain aggregate quantitative disclosures regarding the remuneration of Code Staff for the year. The complexity of disclosure is dependent on the size of the entity. Sainsbury's Bank falls into the 'Tier 2' category as it has capital resources between £50m and £1bn.

Bank colleagues are employed by J Sainsbury plc or Lloyds Banking Group plc with payments met by the Bank. Remuneration paid or allocated to Code Staff for the year ended 31 December 2011 was as follows:

2011	Senior Management £000	Other £000	Total
Fixed remuneration	2,065.5*	294.0	2,359.5
Variable remuneration	988.0	115.6	1,103.6
Total	3,053.5	409.6	3,463.1
Number of staff included above	17	4	21

2010	Senior Management £000	Other £000	Total £000
Fixed remuneration	1,865.4*	158.0	2,023.4
Variable remuneration	1,730.6	139.7	1,870.3
Total	3,596.0	297.7	3,893.7
Number of staff included above	15	3	18

- Fixed remuneration includes base salary and other cash payments in the year (excluding variable pay).
- Variable remuneration includes bonus awards made in the 2011 financial year.
- *Included within fixed remuneration for senior management are emoluments for members of the Bank's Executive Management Team and Non-executive Directors. Certain non-executive Directors are employees of the Bank's shareholders and are paid by J Sainsbury plc or Lloyds Banking Group plc. These Directors receive no remuneration for their role as a Director of the Bank. There has been no recharge to the Bank as their emoluments are deemed to be wholly attributable to services to the respective shareholder companies. These Directors are allocated a "notional" fixed fee that is not subject to any performance-related achievement.
- 'Other' describes those additional members of staff whose actions are deemed to have a material impact on the risk profile of the Bank.

Sainsbury's Bank is only deemed to operate in one business segment – Retail Banking.