

Sainsbury's Bank plc

Pillar 3 Disclosures 2012

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Sainsbury's Bank 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 (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 FSA prudential sourcebook (from April 2013 Prudential Regulation Authority). 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 2012.

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 2012. 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). On 8 May 2013, J Sainsbury plc announced their intention to purchase Lloyds Banking Group's 50% share of the Bank, with effect from 31 January 2014.

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 (RemCo).

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 members of 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.

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, operational risk, regulatory risk, liquidity risk and market risk (interest rate 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 Board retains ultimate responsibility for risk management in the Bank.

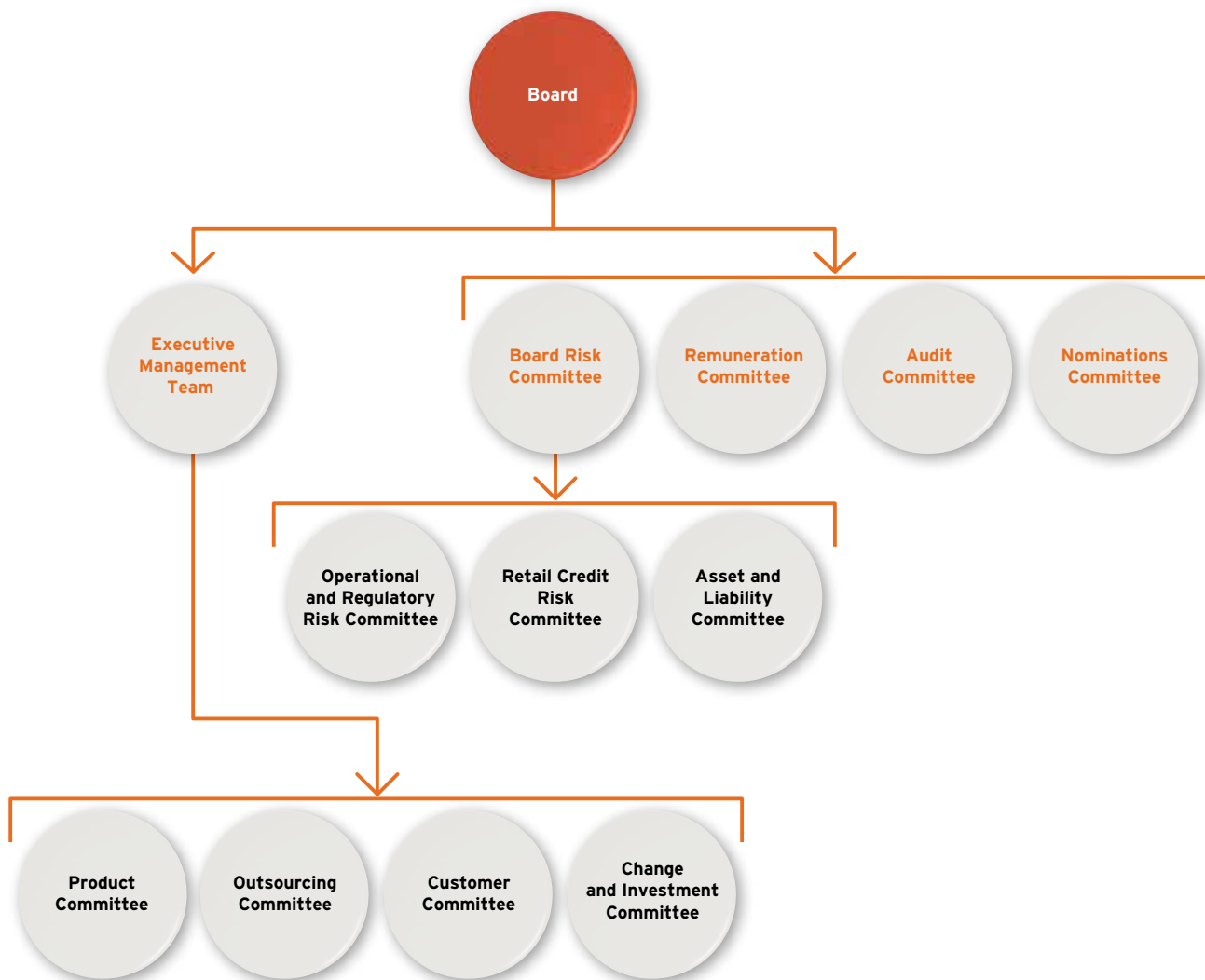
- 1 The first line of defence is responsible for execution of the Bank's strategy, business performance, setting and implementation of policy and management of risks and internal controls. This primarily lies with the Chief Executive and the entire Executive Management Team. On a day-to-day basis, management 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 internal audit team supplemented by 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.

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 assessed in 2012 utilising a methodology 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.

Sainsbury's Bank Pillar 3 Disclosure continued

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. A number of Board functions are delegated to four key sub-committees - the Board Risk Committee (BRC), the Audit Committee, the Remuneration Committee (RemCo) and the Nominations Committee.

Executive Management Team

The Chief Executive and Executive Management Team 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 Investment Committee, Outsourcing Committee, Customer Committee and Product 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 Executive Management Team 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 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 (including payments of guaranteed remuneration for appointees and retention terms).

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.

Sainsbury's Bank Pillar 3 Disclosure continued

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.

Change and Investment Committee

The Change and Investment Committee (CIC) 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 ultimately to ensure best practice.

Product Committee

The Product Committee (PC) reports to the Executive Management Team. 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.

Operational and Regulatory Risk Committee

The Operational and Regulatory Risk Committee (ORRC) is a sub-committee of the BRC. 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. 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 BRC. 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 performance.

Asset and Liability Committee

The Asset and Liability Committee (ALCO) is a sub-committee of the BRC. 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.

2.4 Risk exposures

The main risks to which the Bank is exposed are credit risk (retail and wholesale), operational risk, regulatory risk, liquidity risk and market risk (interest rate 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
- tolerance levels for the quality of loans and credit card stock and new business.

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.

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. In addition, behavioural scoring is used to assess the conduct of customers' accounts on an ongoing basis, for example granting extensions to limits. Where subjective assessments are undertaken, these are subject to strict controls and monitoring with manual underwriting being undertaken by specialist teams in operational areas.

Comprehensive management information on the economy, portfolio limits, quality of new business, stock performance, bad debt 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 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 (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 ALCO and subject to BRC 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 BRC. Derivatives are subject to the same credit risk control procedures as are applied to other wholesale market instruments and credit risk mitigated by posting of collateral to cover positions.

Sainsbury's Bank Pillar 3 Disclosure continued

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 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 Regulatory risk

Regulatory risk is the risk of the consequences from the Bank failing to meet the requirements of legislation and regulatory requirements as defined by any relevant regulatory bodies. This can encompass legal and compliance risk, prudential risk and conduct with customers.

The Bank's aim is to meet all legal and regulatory requirements and minimise any reputational impact by maintaining an effective control framework. The Bank has adopted a 'Three lines of defence' model which is intended to provide regulatory advice and guidance to the business and deliver effective monitoring and assurance of regulatory risk.

Conduct risk is the risk that, by mistake, our actions or decisions could result in an unfair outcome causing loss or inconvenience for our customers. Keeping the trust of our customers is very important to us. We therefore have a low risk appetite for conduct risk and are committed to managing our business in a way that ensures we:

- reduce the chance of mistakes happening by looking to prevent them in the first place and
- listen to customers, learning from mistakes and putting things right if something does go wrong.

As the Bank is a predominantly outsourced business, this also applies to our third party suppliers.

The regulatory risk team regularly reports to the ORRC, the BRC and the Board.

2.4.5 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. The Bank seeks to maintain a liquidity and funding profile to ensure that it can meet its financial obligations under stressed market conditions.

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 idiosyncratic stresses, market stresses and a combination of both.

In meeting internal limits as well as regulatory 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 Prudential Regulation Authority.

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.

2.4.6 Market risk

The main source of market risk is interest rate risk in the banking book which 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. Where possible, the Bank takes advantage of natural hedging opportunities between fixed rate assets and liabilities with similar re-pricing dates. Net re-pricing gaps are managed within limits set by the Board Risk Committee using fixed rate funding. These exposures are monitored by the Asset and Liability Committee and the Board Risk Committee.

During the year, the Bank entered into several derivative contracts with the objective of managing interest rate risk on the personal loan portfolio. These 'pay fixed, receive floating' rate interest swap contracts are designed to hedge the re-pricing risk on segments of the personal loan portfolio which earn fixed rate income and hence reduce net interest earnings volatility.

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 approved by ALCO.

Sainsbury's Bank Pillar 3 Disclosure continued

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 2012	85.0	85.0	170.0
At 31 December 2011	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 Subordinated loan capital

	31 December 2012 £m	31 December 2011 £m
Dated loan capital		
£60 million Floating Rate subordinated loan 2014	60.0	60.0
Undated loan capital		
£50 million Floating Rate subordinated loan	50.0	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 regulator. 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 regulator 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 regulator'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 currently 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 and ALCO and is reported to the FSA on a monthly basis (PRA from April 2013). 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 was due to commence on 1 January 2013 but is subject to delays in the finalisation of the regulations and endorsement through the EU legislation process. Finalised legislation is due to be published in 2013 and implementation expected on 1 January 2014. 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. The Bank continues to assess the impact of these regulations on the Bank's regulatory capital position.

Sainsbury's Bank Pillar 3 Disclosure continued

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 2012 Minimum Capital Requirement £m	31 December 2012 Risk weighted Assets £m
Exposure Class		
Retail	147.4	1,842.0
Secured on real estate property	2.5	31.3
Past due items	2.7	33.1
Institutions	3.1	39.1
Collective investment undertakings	6.0	75.0
Others	4.2	52.8
Total Credit Risk Minimum Capital Requirement	165.9	2,073.3

	31 December 2011 Minimum Capital Requirement £m	31 December 2011 Risk weighted Assets £m
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

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.

	31 December 2012 £m	31 December 2011 £m
Operational Risk Minimum Capital Requirement	26.2	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.

Sainsbury's Bank Pillar 3 Disclosure continued

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	2012 Average £m	Total 31 December 2012 £m
Retail	2,431.4	2,536.5
Collective investment undertakings	375.5	375.0
Secured on real estate property	72.4	69.7
Sovereign	457.2	477.3
Financial Institutions	1,357.7	1,535.0
Total	4,694.2	4,993.5

Credit Exposure	2011 Average £m	Total 31 December 2011 £m
Retail	2,438.7	2,375.1
Collective investment undertakings	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

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

2012 - Credit Exposure	United Kingdom £m	Rest of Europe £m	Total £m
Retail	2,536.5	-	2,536.5
Collective investment undertakings	-	375.0	375.0
Secured on real estate property	69.7	-	69.7
Sovereign	477.3	-	477.3
Financial Institutions	1,505.8	29.2	1,535.0
	4,589.3	404.2	4,993.5

2011 - Credit Exposure	United Kingdom £m	Rest of Europe £m	Total £m
Retail	2,375.1	-	2,375.1
Collective investment undertakings	-	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	168.3	4,510.9

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.

Sainsbury's Bank Pillar 3 Disclosure continued

5.5 Residual maturity

2012 - Exposure Class	Up to 12 months £m	1-5 years £m	More than 5 years £m	Total £m
Retail	1,292.7	1,213.6	30.3	2,536.6
Collective investment undertakings	375.0	-	-	375.0
Secured on real estate property	12.7	34.4	22.5	69.6
Sovereign	477.3	-	-	477.3
Financial Institutions	1,505.8	29.2	-	1,535.0
Total	3,663.5	1,277.2	52.8	4,993.5

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
Collective investment undertakings	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

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	Caal and below	CCC+ and below

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

2012	Credit Quality Step 1 £m	Credit Quality Step 2 £m	Credit Quality Step 3 £m	Unrated exposure £m	Total £m
Retail	-	-	-	2,536.6	2,536.6
Secured on real estate property	-	-	-	69.6	69.6
Sovereign	477.3	-	-	-	477.3
Financial Institutions	96.0	1,409.8	29.2	-	1,535.0
Collective investment undertakings	375.0	-	-	-	375.0
Total exposure pre mitigation	948.3	1,409.8	29.2	2,606.2	4,993.5
Total exposure post mitigation	948.3	142.8	29.2	2,606.2	3,726.5

2011	Credit Quality Step 1 £m	Credit Quality Step 2 £m	Credit Quality Step 3 £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
Collective investment undertakings	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

5.7 Credit risk mitigation

Financial institutions

The maximum credit exposure to any client or counterparty as of 31 December 2012 was £1,267.0m (31 December 2011 - £1,132.6m) before taking into account collateral or other credit enhancements of £362m (31 December 2011 - £340m). 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.

Sainsbury's Bank Pillar 3 Disclosure continued

5.7 Credit risk mitigation continued

Financial institutions continued

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 Bank of Scotland 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 2012 was £8.6m (31 December 2011 - £10.4m). The fair value of collateral held against possession cases was £nil (31 December 2011 - £0.1m).

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 2012 £m Retail	31 December 2012 £m Secured on real estate property	31 December 2012 £m Total Lending
Impaired			
Less than 3 months, but impaired	2.7	-	2.7
Past due 3 to 6 months	7.1	0.6	7.7
Past due 6 to 12 months	-	0.4	0.4
Past due over 12 months	-	1.2	1.2
Recoveries	102.7	-	102.7
Possession	-	-	-
Total Gross Impaired loans	112.5	2.2	114.7
Past due but not impaired			
Past due up to 3 months but not impaired	14.6	3.0	17.6
Total Gross past due but not impaired	14.6	3.0	17.6
Neither past due nor impaired*			
Not impaired	2,442.9	64.5	2,507.4
Total Gross neither past due nor impaired	2,442.9	64.5	2,507.4
Total Gross amount due	2,570.0	69.7	2,639.7
*Includes loans and advances that would have been past due or impaired had their terms not been renegotiated	2.5	-	2.5

	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

Sainsbury's Bank Pillar 3 Disclosure continued

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

5.8.1 Retail continued

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.

The Bank provides relief to assist certain customers in financial difficulty through a renegotiated payment profile. The aim of forbearance is to return customers to a position where they can meet their financial obligations. Forborne balances are separately monitored.

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 2012	104.5	8.8	113.3
New impairment provisions less releases charged to the profit and loss account	44.2	(1.9)	42.3
Recoveries of amounts previously written off released to the profit and loss account	(9.7)	-	(9.7)
Amounts written off	(51.0)	-	(51.0)
Discount unwind on impaired loans and advances to customers	(2.0)	-	(2.0)
Provisions at 31 December 2012	86.0	6.9	92.9

	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

5.8.2 Loans and advances to banks

The total gross amount of individually impaired loans and advances to banks as at 31 December 2012 was £nil (31 December 2011 - £nil). The fair value of collateral held for loans and advances to banks was £362m (31 December 2011 - £340m). 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 2012 £m	31 December 2011 £m
Aaa to A3	1,377.0	1,226.0
Total	1,377.0	1,226.0

Sainsbury's Bank Pillar 3 Disclosure continued

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 2012 was £nil (31 December 2011 - £nil).

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

	Treasury bills £m	Investment securities £m	Total £m
As at 31 December 2012			
Aaa to A3	474.4	-	474.4
Baa1 to Baa3	-	29.2	29.2
Total	474.4	29.2	503.6

	Treasury bills £m	Investment securities £m	Total £m
As at 31 December 2011			
Aaa to A3	451.3	73.3	524.6
Baa1 to Baa3	-	15.0	15.0
Total	451.3	88.3	539.6

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.

5.8.4 Counterparty credit risk

The Bank uses derivative contracts to manage interest rate risk in the banking book and foreign exchange risk on foreign denominated investments.

The capital effects of this are monitored in the Bank's budgetary process and assessed in the ICAAP process.

Policies and contracts are in place to transfer/receive cash collateral when derivative mark to market exposures exceed agreed minimum transfer values, documented under standard ISDA agreements with supporting credit support annex agreements (CSA).

At 2012 year end, notional value of interest rate swaps were £9m and foreign exchange swaps were £27m. The positive mark to market position for all derivatives held was £nil.

Exposures are calculated under the CRR mark to market method.

	Notional £m	MTM £m	Exposure £m	Collateral posted £m
2012				
Foreign exchange	27.0	(5.5)	1.4	-
Interest rate	9.0	(0.2)	0.1	-

	Notional £m	MTM £m	Exposure £m	Collateral posted £m
2011				
Foreign exchange	94.0	(21.6)	5.4	-
Interest rate	10.0	(0.1)	0.1	-

6 Securitisation

The Bank has not securitised assets that it has originated.

Sainsbury's Bank Pillar 3 Disclosure continued

7 Remuneration

7.1 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.

RemCo 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 or J Sainsbury's plc). The committee is constituted in a way that enables it to exercise independent judgment, and members do not perform any executive function within SB. The quorum is two committee members, one of whom is the Chairman. All members of RemCo 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.

RemCo 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 RemCo.

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 RemCo, 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 RemCo.

RemCo 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 RemCo 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 incentives

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 RemCo.

RemCo 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 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 Proportionality level 3 category for 2012 as the relevant total assets did not exceed £15bn.

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 years ended 31 December was as follows:

	2012 £000	2011 £000
Senior management	3,005.1	3,053.5
Other code staff	347.1	409.6
Total	3,352.2	3,463.1

- Remuneration includes fixed remuneration (base salary and other cash payments in the year) and variable remuneration which includes bonus awards made in the 2012 financial year
- Included within 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 code staff' 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.