Sainsbury's Bank plc
Pillar 3 Disclosures 2013

COMPANY NUMBER: 3279730

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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 Disclosures by Sainsbury's Bank plc (the Bank).

The information has been prepared purely for the purposes of: explaining the basis on which the Bank has prepared and disclosed certain capital requirements; providing information about the management of risks relating to those requirements; and presenting remuneration information as required by the Capital Requirements Directive and Prudential Regulation Authority (PRA) 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. These Disclosures are presented in respect of the year to 31 December 2013.

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.

These disclosures are based on the Bank's ownership as at 31 December 2013. Up until 31 January 2014, the Bank was a joint venture between J Sainsbury plc and Bank of Scotland plc with a contractual arrangement in place to govern the sharing of joint control. Bank of Scotland plc is a subsidiary of Lloyds Banking Group plc. J Sainsbury plc and Bank of Scotland plc are incorporated and domiciled in England and Scotland respectively. Sainsbury's Bank plc is incorporated and domiciled in England. From 1 February 2014, the Bank is a wholly-owned subsidiary of J Sainsbury plc.

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 Disclosures will be published on an annual basis in a reporting cycle aligned with the publication of the Bank's Annual Report and Financial Statements.

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 Disclosures will be published on the J Sainsbury plc corporate website www.j-sainsbury.co.uk/investor-centre.

1.5 Verification

These Disclosures have been reviewed and recommended by the Bank's Audit Committee. The Disclosures are not subject to audit. However certain information has been extracted from the Annual Report and Financial Statements of the Bank, the Financial Statements having been subject to independent external audit.

2. Risk management objectives and policies

2.1 Risk management approach

The Bank aims to appropriately manage all risks that arise from its activities. Through its normal operations the principal risks to the Bank are credit risk, liquidity and funding risk, market risk, operational risk, conduct risk and regulatory risk.

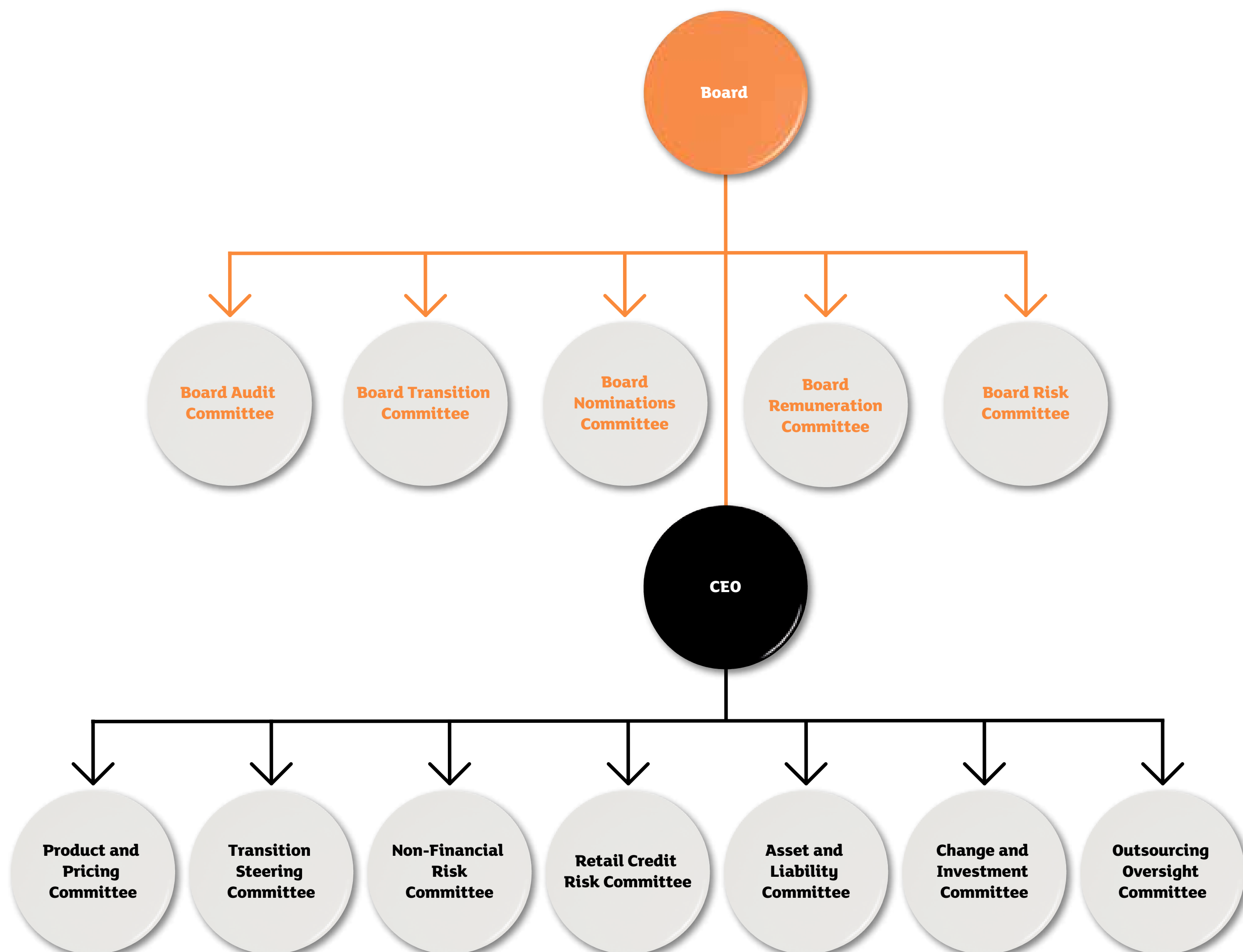
The Bank has established a risk framework and formal structure to monitor and manage risks across its operations. The Board has agreed statements of risk appetite and these are adhered to via detailed risk management policies and through reporting to the various governance committees.

The governance framework in place at the Bank vertically segregates into 3 levels:

- Board level governance
- Collective management level governance
- Executive level governance

2. Risk management objectives and policies continued

2.1 Risk management approach continued



2.1.1 Board level governance

The Board level governance holds overall accountability for the outcomes achieved, decisions made and steering the Bank subject to certain shareholder reserved matters where the consent of J Sainsbury plc is required such as approval of a material reorganisation or redirection of the business, changes in capital composition or the Bank's business plan. The Board then subsequently delegates the appropriate responsibility, authority and accountability to the CEO to deliver the Bank's strategy through the appropriate governance committees and Executive Management Team.

- 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 is comprised of key Executive members from the Bank, and Non-Executive Directors from J Sainsbury plc as well as Independent Non-Executive Directors. The chairman is an Independent Non-Executive Director. A number of Board functions are delegated to five key sub-committees – the Board Risk Committee (BRC), Audit Committee, Remuneration Committee (RemCo), Nominations Committee and Transition Committee.

- Audit Committee

The Audit Committee's key responsibility is to advise the Board on the Bank's financial statements, both interim and final, including systems and controls and related policy issues together with the work of and the relationships with internal and external auditors. The Committee is also responsible for oversight of the Bank's Internal Audit function.

- Transition Committee

The Transition Committee oversees the programme of projects to migrate from Lloyds Banking Group plc systems and processes to the New Bank processes and systems.

- 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 of 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.

- **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).

- **Board Risk Committee**

The Board Risk Committee (BRC) is forward looking with respect to anticipating future risks whilst it simultaneously monitors and provides oversight of existing risks. It is responsible for reviewing and reporting its conclusions to the Board on the Bank's risk appetite and the Bank's risk management framework.

2.1.2 Collective management level governance

The collective management level governance is established to ensure appropriate checks, balances and transparency on executive decision making. Responsibilities include general operational management 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 CEO's oversight and governance of the Bank is supported and affected through a number of Management Committees.

- **Product and Pricing Committee**

The Product and Pricing Committee (PPC) oversees and manages the Bank's product portfolio; including management of tactical decisions regarding pricing and product terms and conditions, and product/channel alignment. It also makes those decisions in relation to products and pricing that are necessary to ensure that the Bank operates within relevant and defined risk appetite.

- **Transition Steering Committee**

The Transition Steering Committee is responsible for ensuring that there is effective governance and oversight of the New Bank Programme, focusing on delivering on time, within budget, and to prescribed quality standards.

- **Non-Financial Risk Committee**

The Non-Financial Risk Committee (NFRC) is in place to ensure effective risk management across operational risk, fraud risk, information risk, regulatory risk and conduct risk and makes those decisions necessary to ensure that the Bank operates within its defined risk appetite.

- **Retail Credit Risk Committee**

The Retail Credit Risk Committee (RCRC) is responsible for monitoring the performance of the retail lending book and the credit card portfolio. 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 responsible for ensuring the balance sheet of the Bank is managed effectively with its main areas of responsibility being market risk, wholesale credit risk, liquidity risk, and capital adequacy.

- **Change and Investment Committee**

The Change and Investment Committee (CIC) is responsible for the management and oversight of the Bank's business as usual (BAU) change portfolio ensuring appropriate prioritisation of projects and tracking of progress versus plan.

- **Outsourcing Oversight Committee**

The Outsourcing Oversight Committee (OOC) 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.

2.1.3 Executive level governance

This relates to individual Bank Executives and the operation of their functional mandates (from the Chief Executive Officer) through established working groups.

2.2 Risk appetite

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, liquidity risk, operational risk, regulatory risk and conduct 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.

The Bank has developed and operates an Enterprise Wide Risk Management Framework (EWRMF) which details the process through which risk is managed this is detailed within the risk model section below.

The Bank operates within appetite tolerances and regularly reports against performance to the Board through its management committees.

2.3 Risk model

As part of the EWRMF that the Bank operates, the risk model requires that the roles and responsibilities of risk management, risk oversight and risk assurance are clearly delineated from those of the commercial and operational activities of the Bank, and there is in place effective segregation. This is known as the Three Lines of Defence model and operates as follows:

- 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, the Executive Committee (ExCo) and through delegated authority to management committees. 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.
- 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 risk and related risk appetite.
- 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 internal audit team and is supplemented by J Sainsbury plc Internal Audit or external firms. Up to 31 January 2014, Internal Audit was also assisted by Lloyds Banking Group Internal Audit. The Board retains ultimate responsibility for risk management in the Bank.

2.4 Risk exposures

The principal risks to the Bank are retail and wholesale credit risk, liquidity risk, market risk, operational risk, regulatory and conduct risk. The principal risks and uncertainties are described in more detail below together with examples of relevant controls and mitigating factors. It should be noted that the risk assessment and mapping employed by the Bank goes beyond this assessment and captures less material risks that may still impact the business and require monitoring for future changes in materiality. In addition, the Bank continues to monitor uncertainties, such as Scottish independence as well as potential new regulations impacting the Bank's credit card interchange fees, to assess whether they give rise to material new risks to the business.

The Bank has identified transitional risk as a new and emerging risk to the Bank.

Transitional risk

The change to full ownership of the Bank to J Sainsbury plc introduces change driven operational risk in particular through the transitional period. This transitional risk could have an impact on the Bank including on people, process, regulatory compliance and technical infrastructure.

2. Risk management objectives and policies continued

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 limits its activities to the 'prime' segment of the market (customers with clean credit histories who are not over-indebted).

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

- the target market for its lending; and
- 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 debts trends and collections and recoveries performance is presented in detail to the Retail Credit Risk Committee.

Within the EWRMF, the Retail Credit Risk policy is classified as a key risk policy and is approved by the Board. The Retail Credit Risk Committee ensures that standards are in place to ensure that we are responsible lenders and manage customers in financial difficulties appropriately. There are appropriate frameworks, toolkits, processes and procedures in place to ensure adherence to policies and standards. Internal Audit and Risk Assurance teams carry out regular reviews of all elements of the framework.

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 Board Risk Committee/Board 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 risk are controlled and managed according to 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/Board. 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.

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 NFRC and the BRC to ensure alignment with the Bank's requirements for operational risk management, its alignment to the Bank's Risk Appetite Statement and its continued relevance to the Bank's current and planned operations.

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 control self assessment. Regular reports are provided to the NFRC and other governance bodies, such as the OOC to ensure regular, effective review of operational risks both within the Bank and our extensive supplier base.

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
- Data security and integrity
- Cyber attacks

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 and conduct 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 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 the Bank. The Bank therefore has a low risk appetite for conduct risk and is committed to managing the business in a way that ensures it:

- reduces the chance of unfair outcomes by looking to prevent them in the first place;
- listens to customers, learns from mistakes and put things right if something does go wrong; and
- ensures that when making decisions, the interests of customers come first.

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

The regulatory risk and conduct risk teams regularly report to the NFRC, 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 PRA.

In addition to this, the Bank prepares both long-term and short-term forecasts to assess liquidity requirements. Short-term forecasting covers a rolling 12 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 3 month 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 (IRRBB) 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 rate resets for assets and liabilities arising from their potentially different maturities as well as the impact of using different indices when resetting contracted financial obligations (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 and does not operate a trading book.

The policy sets the framework and standards under which the Bank will measure, monitor and manage interest rate risk. Interest rate risk limits aligned with 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 cash collateralised interest rate swaps. Residual exposures are monitored by ALCO and the Board Risk Committee according to risk appetite.

During the year, the Bank continued to transact hedging swaps with the objective of managing interest rate risk arising predominantly from the personal loan portfolio. These pay fixed, receive LIBOR 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 Bank also transacted a series of receive fixed, pay LIBOR swaps for the purpose of stabilising earnings arising from the Bank's net non interest sensitive liabilities which include the Bank's reserves.

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.

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

2013 – Parallel instantaneous rate shift	Impact on 12 months income	
NII sensitivity	**-50 bps**	**+50bps**
Consolidated	**–**	**-£1m**

2012 – Parallel instantaneous rate shift	Impact on 12 months income	
NII sensitivity	-50 bps	+50bps
Consolidated	+£2m	-£3m

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

3. Capital resources

The PRA sets and monitors capital requirements for the Bank. In implementing current capital requirements the PRA 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 2013 and throughout the year, the Bank complied with the capital requirements that were in force as set out by the PRA.

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; and
- 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:

	2013 £m	2012 £m
Tier 1 capital:		
Ordinary share capital	**170**	170
Reserves	**139**	99
Deduction for intangible assets	**(4)**	(5)
Total Tier 1	**305**	264
Upper Tier 2 capital:		
Undated loan stock	**50**	50
Allowable element of provisions	**6**	7
Lower Tier 2 capital:		
Dated loan stock	**12**	24
Total Tier 2	**68**	81
Total capital	**373**	345

3. Capital resources continued

3.1 Total capital resources continued

	2013	2012
Risk weighted assets (£m)	**2,475**	2,401
Core Tier 1 capital ratio (%)	**12.3**	11.0
Total capital ratio (%)	**15.1**	14.3

3.2 Share capital

	2013 £m	2012 £m
Authorised ordinary shares		
At 31 December	**200**	200

	'A' ordinary shares of £1 £m	'B' ordinary shares of £1 £m	Total ordinary shares of £1 £m
Allotted, called up and fully paid:			
At 1 January 2013	**85**	**85**	**170**
Issued ordinary shares	**–**	**–**	**–**
At 31 December 2013	**85**	**85**	**170**
At 1 January 2012	85	85	170
Issued ordinary shares	–	–	–
At 31 December 2012	85	85	170

During 2013 and 2012, the share capital was divided into class 'A' and class 'B' Ordinary shares which rank pari passu in all respects.

On 31 January 2014, J Sainsbury plc purchased the 50% holding in the Bank from Lloyds Banking Group plc. From this date, the Bank is a wholly owned subsidiary of J Sainsbury plc.

From 1 February 2014, the Bank altered its Articles of Association to change the status of its share capital to one class of ordinary shares. At the same time, the authorised share capital limit of the Bank was removed in line with the provisions of the Companies Act 2006.

On 7 February 2014, the Bank issued £20m of share capital for cash to J Sainsbury plc.

On 28 February 2014, the Bank repaid £50m of undated loan notes with J Sainsbury plc through the issue of £50m of share capital.

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

	2013 £m	2012 £m
Dated loan capital:		
£60 million floating rate subordinated loan 2014		
Repayable in less than 1 year	**60**	–
Repayable between 1 and 5 years	**–**	60
	60	60
Undated loan capital:		
£50 million floating rate subordinated loan – undated	**50**	50

Dated loan capital

No repayment, for whatever reason, of dated subordinated debt prior to its stated maturity may be made without the consent of the PRA. 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. Interest on the £60 million floating rate subordinated loan dated 2014, is payable three months in arrears at LIBOR plus a margin of 0.6% per annum for the duration of the loan.

Undated loan capital

The undated subordinated loan capital shall be repaid on such date as the PRA 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. Interest on the £50 million floating rate undated loan capital is payable three months in arrears at LIBOR plus a margin of 1.0% per annum for the duration of the loan.

Loan capital was owned 50% by J Sainsbury plc and 50% by Lloyds Banking Group at 31 December 2013. On 31 January 2014 J Sainsbury plc purchased the Lloyds Banking Group's holding. On 28 February 2014, the Bank repaid £50m of undated loan notes with J Sainsbury plc through the issue of £50m of share capital.

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 Approach 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 the risks to the adequacy of its capital, 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 PRA on a monthly basis. The Bank holds capital well in excess of the capital requirement calculated in the ICAAP.

In June 2013, the European Commission published the final version of the Capital Requirements Directive (CRD) and the Capital Requirements Regulations (CRR), 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. The regulations were implemented on 1 January 2014, with the first reporting under the framework for the reference date ending 31 March 2014.

The Regulation element became law in member states directly, replacing existing sections of the existing rulebooks (GENPRU and BIPRU in the UK) with significant changes to regulations. The regulations 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 monitors the regulatory capital position under CRD IV. UK Liquidity regulations remain in force and the Bank monitors its liquidity position under BIPRU 12 and additionally calculates liquidity coverage from March 2014 onwards.

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.

As at 31 December 2013	**Minimum capital requirement £m**	**Risk weighted assets £m**
Retail	**151**	**1,887**
Collective investment undertakings	**5**	**61**
Secured on real estate property	**2**	**25**
Financial institutions	**4**	**44**
Past due items	**2**	**29**
Others	**7**	**85**
Total credit risk	**171**	**2,131**

As at 31 December 2012	Minimum capital requirement £m	Risk weighted assets £m
Retail	147	1,842
Collective investment undertakings	6	75
Secured on real estate property	3	31
Financial institutions	3	39
Past due items	3	33
Others	4	53
Total credit risk	166	2,073

The others category above is non credit risk weighted assets e.g. tangible 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.

As at 31 December 2013	**Minimum capital requirement £m**	**Risk weighted assets £m**
Total operational risk	**28**	**344**

As at 31 December 2012	Minimum capital requirement £m	Risk weighted assets £m
Total operational risk	26	328

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

	Average 2013 £m	**Total 31 December 2013 £m**
Retail	**2,538**	**2,595**
Collective investment undertakings	**336**	**307**
Secured on real estate property	**64**	**60**
Sovereign	**484**	**515**
Financial institutions	**1,361**	**1,326**
Total credit risk exposure	**4,783**	**4,803**

	Average 2012 £m	Total 31 December 2012 £m
Retail	2,431	2,564
Collective investment undertakings	376	375
Secured on real estate property	72	70
Sovereign	457	477
Financial institutions	1,358	1,535
Total credit risk exposure	4,694	5,021

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. Credit risk and dilution risk continued

5.4 Geographical and counterparty sectors

Credit exposure

31 December 2013	**United Kingdom £m**	**Rest of Europe £m**	**Total £m**
Retail	**2,595**	**–**	**2,595**
Collective investment undertakings	**–**	**307**	**307**
Secured on real estate property	**60**	**–**	**60**
Sovereign	**515**	**–**	**515**
Financial institutions	**1,294**	**32**	**1,326**
	4,464	**339**	**4,803**

31 December 2012	United Kingdom £m	Rest of Europe £m	Total £m
Retail	2,564	–	2,564
Collective investment undertakings	–	375	375
Secured on real estate property	70	–	70
Sovereign	477	–	477
Financial institutions	1,506	29	1,535
	4,617	404	5,021

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

Exposure class

31 December 2013	**Up to 12 months £m**	**1–5 years £m**	**More than 5 years £m**	**Total £m**
Retail	**1,358**	**1,218**	**19**	**2,595**
Collective investment undertakings	**307**	**–**	**–**	**307**
Secured on real estate property	**5**	**20**	**35**	**60**
Sovereign	**515**	**–**	**–**	**515**
Financial institutions	**1,292**	**34**	**–**	**1,326**
	3,477	**1,272**	**54**	**4,803**

31 December 2012	Up to 12 months £m	1–5 years £m	More than 5 years £m	Total £m
Retail	1,320	1,214	30	2,564
Collective investment undertakings	375	–	–	375
Secured on real estate property	13	35	22	70
Sovereign	477	–	–	477
Financial institutions	1,506	29	–	1,535
	3,691	1,278	52	5,021

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 exposure	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

2013	**Credit quality Step 1 £m**	**Credit quality Step 2 £m**	**Credit quality Step 3 £m**	**Unrated exposure £m**	**Total £m**
Retail	**–**	**–**	**–**	**2,595**	**2,595**
Secured on real estate property	**–**	**–**	**–**	**60**	**60**
Sovereign	**515**	**–**	**–**	**–**	**515**
Financial institutions	**133**	**1,159**	**32**	**2**	**1,326**
Collective investment undertakings	**307**	**–**	**–**	**–**	**307**
Total exposure pre-mitigation	**955**	**1,159**	**32**	**2,657**	**4,803**
Total exposure post-mitigation	**955**	**233**	**32**	**2,655**	**3,875**

2012	Credit quality Step 1 £m	Credit quality Step 2 £m	Credit quality Step 3 £m	Unrated exposure £m	Total £m
Retail	–	–	–	2,564	2,564
Secured on real estate property	–	–	–	70	70
Sovereign	477	–	–	–	477
Financial institutions	96	1,410	29	–	1,535
Collective investment undertakings	375	–	–	–	375
Total exposure pre-mitigation	948	1,410	29	2,634	5,021
Total exposure post-mitigation	948	143	29	2,634	3,754

5.7 Credit risk mitigation

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 2013 was £7m (31 December 2012 – £9m). The fair value of collateral held against possession cases was £nil (31 December 2012 – £nil).

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

Financial institutions

The maximum credit exposure to any client or counterparty as of 31 December 2013 was £963m (31 December 2012 – £1,273m) before taking into account collateral or other credit enhancements of £211m (31 December 2012 – £362m). This exposure was to Lloyds Banking Group plc and represents short-term interbank deposits, lending under a reverse repo arrangement which is supported by 100% UK gilt collateral, and derivative exposures.

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 Bank of Scotland plc covering cash borrowing and lending which would be invoked by the Bank if necessary.

Collateral is also posted in respect of derivative exposures, with daily margining to mitigate counterparty risk.

5. Credit risk and dilution risk continued

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 2013	Retail £m	Secured on real estate property £m	Total lending £m
Impaired			
Less than 3 months, but impaired	**2**	–	**2**
Past due 3 to 6 months	**7**	**1**	**8**
Past due 6 to 12 months	–	–	–
Past due over 12 months	–	–	–
Recoveries	**91**	–	**91**
Possession	–	–	–
Total gross impaired loans	**100**	**1**	**101**
Past due but not impaired			
Past due up to 3 months but not impaired	**14**	**3**	**17**
Total gross past due but not impaired	**14**	**3**	**17**
Neither past due nor impaired*			
Not impaired	**2,502**	**56**	**2,558**
Total gross neither past due nor impaired	**2,502**	**56**	**2,558**
Total gross amount due	**2,616**	**60**	**2,676**

*Includes retail loans and advances that would have been past due or impaired had their terms not been renegotiated of less than £2m.

31 December 2012	Retail £m	Secured on real estate property £m	Total lending £m
Impaired			
Less than 3 months, but impaired	3	–	3
Past due 3 to 6 months	7	1	8
Past due 6 to 12 months	–	–	–
Past due over 12 months	–	1	1
Recoveries	103	–	103
Possession	–	–	–
Total gross impaired loans	113	2	115
Past due but not impaired			
Past due up to 3 months but not impaired	15	3	18
Total gross past due but not impaired	15	3	18
Neither past due nor impaired*			
Not impaired	2,442	65	2,507
Total gross neither past due nor impaired	2,442	65	2,507
Total gross amount due	2,570	70	2,640

*Includes retail loans and advances that would have been past due or impaired had their terms not been renegotiated of less than £3m.

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
Provision as at 1 January 2013	**86**	**7**	**93**
New impairment provisions less releases charged to the profit and loss account	**36**	**(1)**	**35**
Recoveries of amounts previously written off released to the profit and loss account	**(7)**	**–**	**(7)**
Amounts written off	**(37)**	**–**	**(37)**
Discount unwind on impaired loans and advances to customers	**(2)**	**–**	**(2)**
Provisions at 31 December 2013	**76**	**6**	**82**
Provisions at 1 January 2012	105	9	113
New impairment provisions less releases charged to the profit and loss account	44	(2)	42
Recoveries of amounts previously written off released to the profit and loss account	(10)	–	(10)
Amounts written off	(51)	–	(51)
Discount unwind on impaired loans and advances to customers	(2)	–	(2)
Provisions at 31 December 2012	86	7	93

5.8.2 Loans and advances to banks

The total gross amount of individually impaired loans and advances to banks as at 31 December 2013 was £nil (31 December 2012 – £nil). The fair value of collateral held for loans and advances to banks was £209m (31 December 2012 – £362m). 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:

	2013 £m	2012 £m
Aaa to A3	**1,059**	1,377
Total	**1,059**	1,377

5.8.3 Debt securities, Treasury bills and other eligible bills

The total gross amount of individually impaired debt securities, cash and balances with central banks, Treasury bills and other eligible bills as at 31 December 2013 was £nil (2012: £nil). No collateral is held regarding these assets. The tables below present an analysis of the credit quality of money market funds included within cash and cash equivalents. The credit quality of Treasury bills and investment securities by market value is also included. Analysis is by rating agency designation, based on Moody's ratings:

31 December 2013	Cash and balances with central banks £m	Treasury bills £m	Investment securities £m	Total £m
Aaa to A3	**307**	**510**	**–**	**817**
Baa1 to Baa3	**–**	**–**	**32**	**32**
ATM cash and balances with central banks	**137**	**–**	**–**	**137**
	444	**510**	**32**	**986**

31 December 2012	Cash and balances with central banks £m	Treasury bills £m	Investment securities £m	Total £m
Aaa to A3	375	474	–	849
Baa1 to Baa3	–	–	29	29
ATM cash and balances with central banks	99	–	–	99
	474	474	29	977

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. Credit risk and dilution risk continued

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 31 December 2013, the notional values of interest rate swaps were £637m and foreign exchange swaps were £27m.

Exposures are calculated under the CRR mark to market method.

31 December 2013	**Notional £m**	**MTM £m**	**Exposure £m**	**Collateral posted £m**
Foreign exchange	**27**	**(6)**	**1**	**–**
Interest rate	**637**	**2**	**2**	**2**

31 December 2012	Notional £m	MTM £m	Exposure £m	Collateral posted £m
Foreign exchange	27	(6)	1	–
Interest rate	9	(0)	–	–

6 Securitisation

The Bank has not securitised assets that it has originated.

7 Leverage

The Bank calculates and monitors a non-risk based leverage ratio as required by CRD IV. This measures the ratio of the capital resources to total assets and supplements risk-weighted capital adequacy requirements.

The ratio is calculated as Tier 1 capital/total assets (on and off balance sheet) adjusted for capital deductions. The Bank has calculated the Leverage ratio under the rules applicable at 31 December 2013, under the transitional CRD IV basis and under final CRD IV rules.

	2013	2012
Current rules	**6.1%**	5.0%
CRD IV	**6.0%**	4.9%

The leverage ratio shown is a 3 month average of capital as a proportion of total exposures. Note that the leverage ratio calculated under CRD IV transitional rules is identical to the ratio under final rules.

8 Remuneration

8.1 Remuneration Committee (RemCo)

The role of RemCo is to determine and agree the broad policy for remuneration and for compliance with the PRA 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.

Until 31 January 2014, RemCo comprised 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 judgement, 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; and
- the competent and experienced nature of all individuals who are a member of or who attend RemCo, which enables them to exercise independent judgements 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 (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.

8.2 Link between pay and performance

8.2.1 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).

8.2.2 Long-term incentives

Sainsbury's Bank rewards certain staff with long-term incentive plans. These plans have been and continue to be operated on the Bank's behalf by either J Sainsbury plc or Lloyds Banking Group. There are a number of performance hurdles, which need to be met both at an organisational level (employer and parent) 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 J Sainsbury plc and Lloyds Banking Group 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.

8.3 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 2013 as the relevant total assets did not exceed £15bn.

During 2013, Bank colleagues were employed by J Sainsbury plc or Lloyds Banking Group plc with payments met by the Bank. From 1 February 2014, Bank colleagues were employed by Sainsbury's Bank plc. Remuneration paid or allocated to Code Staff for the years ended 31 December was as follows:

	2013 £'000	2012 £'000
Senior management	**3,581**	3,005
Other Code staff	**782**	347
Total	**4,363**	3,352

- Remuneration includes fixed remuneration (base salary and other cash payments in the year) and variable remuneration which includes bonus awards made in the 2013 financial year.
- Included within remuneration for senior management are emoluments for members of the Bank's Executive Management Team and Non-Executive Directors. During 2013, 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.