



CAPITAL REQUIREMENTS DIRECTIVE
Pillar 3 Disclosure Document 2011
(As at 31st December 2010)

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1. Introduction

Purpose

This document is intended to provide background information on the Bank's approach to risk management and the maintenance of its capital resources. As such, it includes details of:

- The approach to risk management, its policies and objectives;
- The governance structure of the Bank, including Board and Committees;
- Asset information and capital resources; and
- Compliance with the FSA Handbook on capital adequacy matters.

Legislative framework

The Capital Requirements Directive (CRD), more commonly referred to as Basel 2, was introduced by the European Union in 2007. This governs the amount of capital all financial institutions must hold to protect their depositors and shareholders. In the UK this is implemented by our regulator, the Financial Services Authority (FSA).

The Bank aims to ensure that we protect our depositors' funds by having sufficient capital even during a significant economic downturn.

As well as setting out capital requirements, the CRD framework also includes various disclosures covering key aspects of the Bank's risk management policies and procedures, including the main risks faced by the Bank and the governance thereof.

The CRD is split into 3 parts, known as Pillars:

Pillar 1 - Minimum capital requirements, on a risk based approach

Pillar 2 - Assessment of capital requirements by the Bank and the FSA

Pillar 3 - Disclosure

This disclosure document deals with the requirements laid down in Pillar 3 and the information provided is in accordance with the rules laid out in the FSA Handbook BIPRU Chapter 11.

Pensions Bank approach

Under Pillar 1, the Bank has followed the Standardised Approach when calculating the minimum capital requirements. This is based on using prescribed formulae that mainly focus on credit and operational risks.

As required by Pillar 2, the Board has then performed a detailed assessment of the risks facing the Bank and has calculated the amount of capital that it considers necessary to cover these risks. This includes detailed stress tests of risks and financial forecasts to determine whether additional capital is required to mitigate these risks, including in a severe economic downturn.

The process of determining the total capital requirements is called the Internal Capital Adequacy Assessment Process (ICAAP) and this is reviewed by the FSA through a Supervisory Review and Evaluation Process (SREP).

The document will be updated on at least an annual basis.

Coverage

Pensions Bank Limited is not part of a Group of companies and consequently, this disclosure document applies to Pensions Bank Limited only.

Figures

All the figures within this document are as at 31st December 2010 unless stated otherwise.

2. Risk management objectives and policies

The Board is responsible for determining a framework for risk management and control. It approves all policies and Committee terms of reference. The Executive Directors are responsible for designing, operating and monitoring risk management and internal control processes. The Bank uses a risk register to assess the likelihood and impact of its key risks. This is reviewed regularly by Management and at least annually by the Board and it forms one of the bases for identification of risks that will be incorporated in the ICAAP under Pillar 2.

The Board's Risk Committee, comprising the Non-executive Directors and Chief Executive Officer, is responsible for monitoring risks of the Bank. This is explained more fully in section 3. The Board's Audit and Compliance Committee, consisting solely of non executives, considers the adequacy of internal controls, the Compliance function and the evaluation of risks. The system of internal control is designed to enable the Bank to achieve its corporate objectives within a managed risk profile, not to eliminate all risk. The internal audit function provides independent and objective assurance that these processes are appropriate and effectively applied.

The principal risks to which the Bank is exposed and which are continually assessed and managed by the management team comprise:

Foreign exchange risk

Despite being a UK bank with all activities denominated in Sterling, the Bank has an exchange rate risk imposed by having a capital requirement in Euros, comprising €5m plus an adjustment for additional risks outlined by the FSA. As at 31 December 2010, the Board hedged this risk by means of forward contracts to buy Euros. Gains and losses on the forward contracts (which impact profitability) moved in line with fluctuations in the sterling value of the capital requirement. The hedge excluded the impact of corporation tax and so was not perfect, but without the hedge the Bank could have found itself unable to meet its capital requirement. It was agreed that during 2011 the Bank would consider a further contract to ensure that the net profit after tax moved in an equal and opposite way to the capital requirement.

The Board had considered a number of options and concluded that hedging by means of forward contracts was the best option available at the time. For instance, the Board considered converting to a Euro-based bank, but felt that this would present other problems to a bank whose customer base, income and expenses are all sterling based. The Board also continued to consider bringing Euro based items onto the balance sheet. It may be possible in the long-term to 'outgrow' the problem by increasing the size of the balance sheet so that this Euro capital requirement is no longer applicable.

Interest rate risk

When interest rates are low and interest rate margins are squeezed it is more difficult for the Bank to generate revenue to meet expenses. When interest rates rise and margins are less tightly squeezed the position is alleviated. During 2009 and 2010, the Board improved the asset side of the Bank's balance sheet through short-term lending to pension schemes. The Board was attracted to this type of lending for two reasons in particular: it was a complementary product to the Bank's pensions banking services; and it had an inherent level of security by being contained within pension funds covered by pension regulations.

Credit risk

Credit risk is the risk that unexpected losses may arise as a result of the Bank's borrowers or treasury counterparties failing to meet their obligations as they fall due. The Board's Risk Committee is responsible for approving and monitoring the Bank's credit exposures, which they do through a formal review and approval of the Bank's lending and treasury policies respectively. These are then approved by the main Board, with the minutes of the committee being reviewed by the Board.

All loan applications are assessed with reference to the Bank's lending policy. The Credit Committee and risk Committee receive reports on performance of the Bank's lending. Treasury counterparties are considered separately below.

Counterparty risk

Since the 'credit crunch' of September 2008, the Bank has kept its approved counterparty list very short but of high quality, consisting mainly of the UK clearing banks. Some market confidence has improved since 2008 but the Bank has maintained its stance of limiting its authorised counterparties to only a few names. The Board continues to review this policy, but feels that the Bank's risk of a counterparty default is limited to a systemic risk of the market as a whole.

Concentration risk – loss of a major customer

The substantial majority of the Bank's client deposits are placed by pension funds that are currently managed by two pension fund administrators. The commercial arrangements with the more significant of these have recently been renegotiated and, based on available information and discussions to date, the Board feels confident that the relationship will continue. The Bank has been taking action to reduce this risk by diversifying the source of its deposits.

Liquidity risk

Liquidity risk is the risk that the Bank may be unable to meet its financial obligations as they fall due.

The Bank has policies in place to ensure that it has sufficient liquid funds available at all times so that it can meet its liabilities as they fall due, and thus maintain full public confidence in the solvency of the organisation. This is achieved through maintaining a high level of liquid assets and by control of the growth of the business.

A series of liquidity stress tests are performed on a regular basis to confirm that limits remain appropriate. The Board does not believe that liquidity and depositor protection are key risks: the Bank remains highly liquid with the maturity profile of investments being short-term.

Market risk

The Bank is exposed to movements in interest rates. This is because there is always an element of mismatch between the dates on which interest receivable on assets and interest payable on liabilities are next reset, or between the dates on which assets and liabilities mature. The Bank manages this risk on a continuing basis, within limits set by the Risk Committee.

The ALCO receives monthly reports analysing interest rate risk, including the use of a parallel shift in interest rates of 2% to assess interest rate shock against a strict policy limit determined by the Board. This is also considered alongside scenario projections of profitability under different interest rate environments.

Operational risk

This relates to the risk of loss arising from inadequate or failed internal processes or systems, human error or external events.

Such risks are identified, assessed, and carefully monitored by the Bank. Risks and controls are reviewed on a regular basis via a formal risk management structure, which includes an Executive Committee reporting through the Audit & Compliance Committee to the Board. To mitigate some of these operational risks, the Bank also maintains a range of insurance policies to cover eventualities such as business interruption, loss of computer systems, financial crime, loss of fixed assets, professional indemnity, etc.

To monitor the operational and other risks, the Bank has developed a risk register model that allows a value and likelihood of impact to be assigned to each risk. These values are recorded both before controls and with controls in place, which allows the Bank to manage both the effectiveness of controls and any residual risk. The risk register is reviewed at each meeting of the Risk Committee and at least annually is formally reviewed by the Board.

3. Board and Board Committee structure

Authority for managing the Bank's risks ultimately rests with the Bank's Board of Directors. The Board currently comprises two Executive Directors and three non-Executive Directors.

The Board's risk and governance structure is outlined below.

Audit and Compliance Committee

Composition: The Committee is made up of at least three non-executive directors, and is attended by the Chief Executive and the Finance Director. The Committee also meets with the external auditors at least once per year.

Main functions:

- To review and discuss the draft annual accounts and audit report, and to make recommendations, as considered appropriate, to the Board;
- To establish an overall work programme for the Internal Audit function;
- To review and discuss all reports produced by Internal Audit;
- To establish the overall work programme of the Compliance function;
- To review and discuss reports produced by the Compliance function;
- To consider and recommend to the Board the appointment (and on an annual basis the reappointment) of the External Auditor.

Other duties of the Committee include:

- Consider and recommend for approval by the Board the following policies:
 - Complaints;
 - Data Protection;
 - IT Security;
 - Whistleblowing;
- Annual meetings with the External Auditors;
- To recommend the audit fee to the Board;
- Review and discussion of any management points identified by the external auditors, and recommendations on same to the Board;

Frequency: normally meets quarterly, or more frequently if required.

Risk Committee

Composition: The Committee is made up of all the non-executive directors, together with the Chief Executive Officer, and may be attended by the Finance Director, Director of Risk and other Management.

Main functions:

The prime purpose of the Risk Committee is to determine a structure for risk management to ensure that the Bank operates effectively within its overall risk appetite to achieve its business objectives. This includes the identification, control and management of the risks inherent in Pensions Bank

Limited and ensuring that these risks are fully documented in the Risk Register, with a review of the overall level of risk and key risks at every meeting.

Other duties of the Committee include:

- Consider and recommend for approval by the Board the following policies:
 - Anti fraud and corruption;
 - Anti money laundering;
 - Foreign exchange;
 - Interbank placements;
 - Interest rates;
 - Lending;
 - Large exposures;
 - Liquidity;
 - Risk management;
 - Trading;
- To approve the authorised list of counterparties;
- To assess and sanction lending recommendations given by the Credit Committee that fall outside any limits contained within the lending policy;
- The Committee will be responsible for ensuring that the Risk Management systems, including people and processes, are appropriately resourced.

Frequency: normally meets monthly.

Nominations and Remuneration Committee

Composition: The Committee is made up of three Non-executive Directors.

Main functions:

- To review the structure, size and composition required of the Board and ensure that the Board fulfils these requirements;
- To consider the appointments of new Executive and Non-Executive Directors, and the making of recommendations to the Board as appropriate;
- To review of all new Director contracts and/or remuneration arrangements, and the making of recommendations to the Board as appropriate;
- To provide an annual review of all Directors' remuneration arrangements and the making of recommendations to the Board as appropriate;
- To oversee the operation of the Annual Bonus Scheme and recommendations to the Board concerning discretionary bonus payments in accordance with the provisions of that scheme;
- To review annually all staff remuneration levels, together with the Chief Executive.

Frequency: meets at least annually or more frequently if required.

Remuneration

In compliance with the requirements set out in the FSA's Policy Statement PS10/21 'Implementing CRD3 requirements on the disclosure of remuneration' issued in December 2010, the following tables display the 2010 remuneration for the Group's managers and members of staff whose actions have a material impact on the risk profile of the Society (Code Staff). This includes executive and non-executive directors.

Tier 2 disclosure requirements, under the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU), can be sourced as follows:

- BIPRU 11.5.18R(1, 2 & 3): The Nomination and Remunerations Committee meets annually to distribute the variable remuneration from an aggregated pool of reserves;
- BIPRU 11.5.18R(6 & 7): The required aggregate quantitative information on Code Staff remuneration is shown in the tables below.

Details of remuneration paid to Code Staff:

| Fixed remuneration £k | Variable remuneration £k | Total remuneration £k | Proportion of variable remuneration to total remuneration % | Number of beneficiaries |
|--------------------------|-----------------------------|--------------------------|--|-------------------------|
| 494 | 19 | 512 | 4 | 8 |

4. Capital resources

The Capital Resources of the Bank are calculated in accordance with the FSA Handbook, Prudential Standards, General Prudential Sourcebook (GENPRU 2 Annex 2).

The total assets of the Bank at 31 December 2010 were £71,523k.

The capital resources at 31 December 2010 totalled £6,918k, made up of £6,818k tier 1 and £100k tier2. This is analysed as follows:

| | |
|----------------------------|--------------|
| | £k |
| Share capital | 5,548 |
| Share premium | 693 |
| Capital redemption reserve | 150 |
| Profit and loss account | 428 |
| Total tier 1 | 6,818 |
| Subordinated liabilities | 100 |
| Total tier 2 | 100 |
| Total capital resources | 6,918 |

5. Compliance with FSA Handbook Prudential Sourcebook & Pillar 2

Adequacy of capital

Underpinning the Bank's Business Plan is the need to maintain its capital resources above the Board agreed requirement, which is in turn higher than the minimum required by Pillar 1 of the Capital Requirements Directive. In order to do this, the Bank needs to generate sufficient levels of profits that will add to reserves.

The Business Planning process, in addition to establishing objectives and strategies, also determines a risk appetite framework and policies to manage risk.

Capital Adequacy Assessment Process

Complementing the Business Plan, the Bank undertakes an Internal Capital Adequacy Assessment Process (ICAAP), which ensures that the Bank's capital resources are sufficient to deliver the Plan's objectives, both in normal and stressed conditions.

This process involves reviewing all risks relating to assets and operations and making an assessment of capital required to mitigate any material financial impact of those risks. Included in this process is a detailed assessment of the results of the Bank's stress models based on a number of stressed economic scenarios. The key risk areas are detailed in section 2. The Bank holds capital against additional risk under Pillar 2 of the CRD.

The Bank translates its overall risk appetite into a range of lending and liquidity limits controlling the exposures taken. These exposures, and other risks, are carefully monitored by the Board (or Board Committees) on a regular basis.

The Board assesses relevant financial information for each of these areas against a clearly defined risk appetite and approves the capital requirements arising from this detailed review. It also takes into account any areas where it feels the models and internal assessments do not adequately capture the full risk exposure, by holding extra capital where appropriate.

Risk weighted exposure amounts & operational risk capital

The assets of the Bank are analysed by risk category and given weightings according to the level of risk entailed. Credit risk weightings are determined by the "Standardised Approach" within the FSA Handbook BIPRU 3. Operational risk is calculated under the "Basic Indicator Approach" as 15% of the Bank's average net income over the previous three years, as set out in the FSA Handbook BIPRU 6.

Under the Capital Requirements Directive, banks are required to hold a minimum resource of €5m. If the Bank's calculated capital requirements are less than this, then the Bank will hold the equivalent of €5m plus other capital as required in addition to this.

| Pillar 1 Capital Requirements At 31 December 2010 | Assets £k | Risk weighted assets £k | Minimum capital required £k |
|---|--------------|----------------------------------|--------------------------------------|
| Loans and advances to credit institutions | 52,313 | 10,427 | 837 |
| Past due items ¹ | 220 | 220 | 18 |
| Debt securities | 15,299 | 3,014 | 241 |
| Loans and advances to customers | 3,226 | 3,142 | 251 |
| Fixed and other assets | 464 | 464 | 37 |
| Credit risk capital requirement | | 17,267 | 1,384 |
| Operational risk capital requirement | | 1,388 | 111 |
| Total Pillar I capital requirement | | | 1,495 |
| Sterling equivalent of €5m at €1.1604 : £1 | | | 4,309 |
| Pillar 1 Capital Requirement is the higher of the last two items | | | 4,309 |

¹ Past due item relates to a deposit with Kaupthing Singer & Friedlander, which was placed into administration on 8 October 2008. The balance outstanding is £471k, for which a provision of £220k (representing the expected level of loss) has been made at 31 December 2010.

Counterparty Credit Risk

The selection of counterparties and the approval of limits involves consideration of background rating information as well as up to date credit reports and other market intelligence. The Assets & Liabilities Committee reviews counterparty limits on a monthly basis and recommends changes to the Risk Committee for approval. The assessment of counterparties includes ensuring that exposures have limits on their original terms, operating as a subset of the overall limit. Limits may be temporarily suspended in the event of adverse market intelligence. No dealing can be undertaken with counterparties which do not have a pre-approved limit. Where appropriate, exposure to counterparties is also monitored on a consolidated basis.

Residual maturity breakdown by Exposure Class

As at 31st December 2010

| All figures in £k | Up to 3 months | 3 months to 1 year | Total |
|---|----------------|-----------------------|--------|
| Loans and advances to credit institutions | 56,814 | - | 56,814 |
| Loans and advances to customers | 3,226 | | 3,226 |
| Debt securities | - | - | |

The maturities in the table above are shown on a contractual basis.

Provisions

The Bank will make specific and general provisions for losses based on an appraisal of the expected recoveries on loans and other advances.

Specific provisions are assessed on individual loans, and are made to reduce outstanding balances where expected realisable values are lower than the balances on those accounts.

Any general provision is based on an appraisal of losses that may exist on assets not covered by specific provisions. This is calculated by applying factors that reflect the probability of default and likely loss given default.

Amounts charged in the profit and loss account represent losses written off in the accounting year, together with the net change in provisions. Interest in respect of all loans is credited to the income and expenditure account as it becomes receivable. Irrecoverable interest is written off against interest receivable.

At the end of 2010, only one transaction was in default, the deposit with Kaupthing Singer & Friedlander, for which full provision against the expected level of default has been made in the Accounts.

Further details relating to the above can be found in the 2010 Directors' Report and Financial Statements.