PILLAR 3 DISCLOSURES

For the year ended 31 December 2013

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1. Overview

1.1 Background

The Capital Requirements Directive (CRD), initially introduced on 1 January 2007, aims to promote safety and soundness in the financial system. It is structured around three Pillars of regulation:

- Pillar 1 defines minimum capital requirements;
- Pillar 2 sets out the supervisory review process; and
- Pillar 3 on market discipline specifies disclosure requirements, which allow market participants to assess key pieces of information on the firm's capital, risk exposures and risk assessment process.

This document sets out the Pillar 3 disclosures of OneSavings Bank and its subsidiaries (‘the Group’, ‘the Bank’, or ‘OSB’), in accordance with the requirements of BIPRU 11. The disclosures are based on data as at 31 December 2013. All figures are consistent with the basis used for regulatory reporting and differ from what is disclosed in the annual accounts on the following basis.

- Lending commitments for which capital is held are included.
- Exposure amount is presented net of specific provisions.
- Some fee income that has not yet been recognised in accounting figures is included.

2 Pillar 3 Disclosure Policy

The Group is supportive of the overarching objective of Pillar 3 disclosures, which is to promote market discipline through disclosure, as a complement to supervisory efforts, to encourage banks to assess risk, maintain capital and develop and maintain sound risk management systems and practices.

The Group will publish Pillar 3 disclosures setting out its risk management objectives and policies covering:

- the strategies and processes to manage those risks;
- the structure and organisation of the relevant risk management function or other appropriate arrangements;
- the scope and nature of risk reporting and measurement systems; and
- the policies for hedging and mitigating risk, and the strategies and processes for monitoring the continuing effectiveness of hedges and mitigants.

2.1 Materiality

The Group regards information as material in disclosures if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions. If the Group deems a certain disclosure to be immaterial, it may be omitted from the Pillar 3 disclosure.

2.2 Confidentiality

The Group regards information as proprietary if sharing that information with the public would undermine its competitive position. Proprietary information may include information on products or systems which, if shared with competitors, would render the Group's investments therein less valuable. Further, the Group must regard information as confidential if there are obligations to customers or other counterparty relationships binding the Group to confidentiality. In the event that any such information is omitted, we shall disclose such and explain the grounds why it has not been disclosed.

2.3 Verification

The information contained in the Pillar 3 disclosure document has not been audited by the Group's external auditors, does not constitute any form of financial statement and must not be relied upon in making any judgement about the Group. The Pillar 3 disclosures have been prepared purely for explaining the basis on which the Group has prepared and disclosed certain capital requirements and information about the management of certain risks and for no other purpose.

2.4 Basis and frequency of disclosure

Pillar 3 disclosure will be made at least annually and more frequently if management determines that significant events justify such disclosure. The disclosure will generally be made following the publication of the Group Report and Accounts.

2.5 Media and location of publication

The Group's Pillar 3 will be published on the Group's website (www.osb.co.uk).

2.6 Management and Board sign-off

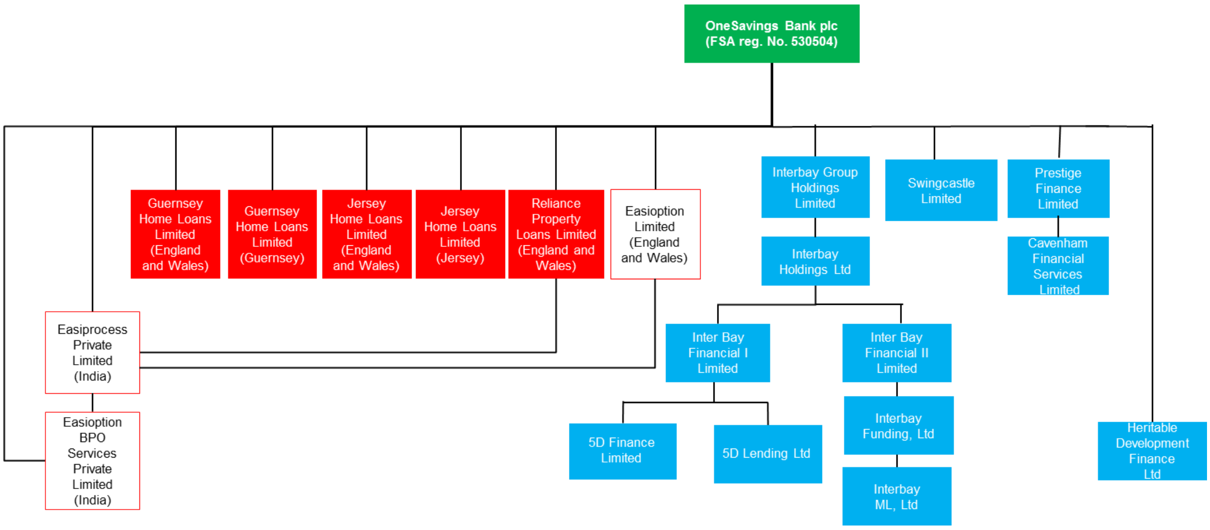
The Executive Committee and the Risk Committee are responsible for assessing and confirming the appropriateness of the Pillar 3 disclosures, including their verification and frequency. The disclosures must convey the Group's risk profile comprehensively to market participants. If that is deemed not to be the case then information in addition to that required by BIPRU 11 must be disclosed.

The Pillar 3 disclosures are reviewed by the Board-level Risk Committee, who recommends them to the Board for approval.

3 Scope

The Group operates a number of lending subsidiaries for functional or fiscal reasons rather than to effect risk transfer. Figure 1 sets out the Group's group structure.

Figure 1: Group structure



The Group accounts include the results of the Bank and its subsidiary undertakings. Subsidiaries are fully consolidated from the date on which control is transferred to the Group and are de-consolidated from the date that control ceases. Upon consolidation, inter-company transactions, balances, and unrealised gains on transactions are eliminated. Unrealised losses are also eliminated, unless the transaction provides evidence of impairment of the asset transferred. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

In the Bank's financial statements, investments in subsidiary undertakings are stated at cost less provision for any impairment.

All subsidiaries are 100 per cent funded by the Group and solo consolidated with the Group, with the exception of Prestige Finance and Swingcastle Limited and Rochester Financing ltd, to which the Group has a minimal exposure. Consequently, there is no material difference in the basis of consolidation for accounting and prudential purposes.

4 Risk management objectives and policies

4.1 Risk management framework

A core objective for the Group is the effective management of risk in order to protect depositors, borrowers, and shareholders, and to ensure that the Group at all times has adequate capital and liquidity resources. Given the nature of the activities undertaken, the key risks that the Group faces are credit risk, market risk (including interest rate risk), liquidity risk, and operational risk. The Group has a Chief Risk Officer who is responsible for ensuring each risk is adequately identified, monitored, managed, and/or mitigated.

The Board is responsible for ensuring that an effective risk management framework is in place. The risk management framework consists of five key components:

A. **Strategy and Risk Appetite**: The Board's articulation of strategic intent and risk appetite, complimented by targets and risk limits set by the executive management.

B. **Organisation:** Clear roles, responsibilities, reporting lines, committees, and mandates.

C. **Policies and Procedures:** A comprehensive set of risk policies, processes, and control procedures.

D. **Reporting and Analytics:** Comprehensive and timely management reporting of risk exposures.

E. **IT, Systems, and Data:** Robust IT systems and data quality.

The Group operates a "three lines of defence" model:

1. The **first line of defence** comes through the operational management in the business, which maintains appropriate systems and controls that are effectively implemented on a day-to-day basis.

2. The **second line of defence** comprises Risk and Compliance as well as the governance and oversight carried out by committees shown in Figure 2.

3. The **third line of defence** is independent assurance checking and challenge. This is provided by Internal Audit and the external audit assurance reviews. Assurance reporting is provided to the Audit Committee.

The Group's committee structure ensures proper governance and oversight and is illustrated in Figure 2.

Figure 2: Risk oversight and committee structure

	Board				
	Risk Committee, Audit Committee, Nominations Committee and Remunerations Committee				
	Executive Committee				
Risk theme	**Credit Risk**	**Market Risk (incl. Interest Rate Risk)**	**Liquidity and Funding Risk**	**Operational Risk**	**M&A**
Governance	Credit Committee	ALCO	ALCO	Operational Risk Committee*	Executive M&A Committee (EMAC)
Key control documents	Lending, Arrears Handling and Provisions Policies	Interest Rate Risk and Treasury Policies	Treasury Policy and ILAA document	Operational Risk Policy	M&A procedure
Management information	Credit MI Pack	ALCO MI Pack	ALCO MI Pack	Operational Risk Update	Deal Qualification Memos

* A sub-committee of the Operations Committee

4.1.1 The Board of Directors

4.1.1.1 Role

The ultimate control of the Group rests with the Board. Under the articles of association of the Group, the Directors direct its business and may exercise powers that are not reserved to its members in general meetings.

The Group's purpose is outlined in the articles of association. The Board will set the Group's aims and objectives, and it is the Board's responsibility to ensure that the necessary financial and human resources are in place to enable the Group to meet those objectives. The Board is also responsible for reviewing management performance.

The Board specifies the Group's risk appetite statement and its supporting quantitative limits, and delegates authority to subcommittees to act in specific areas, including the approval of certain policies and limits, as discussed in section 4.1.1.2.

It is the responsibility of the Board to ensure that there are appropriate governance arrangements, including:

- A clear organisational structure
- Well defined, transparent and consistent lines of responsibility
- Effective processes to identify, manage, monitor and report risks to which the Group may be exposed
- Internal control mechanisms

- Arrangements to ensure compliance with legal and regulatory requirements
- Effective control and safeguard arrangements for all information processing systems

4.1.1.2 Board subcommittees

The Board has delegated specific areas of oversight and control to the subcommittees set out below. Each committee has Board-approved terms of reference, which are reviewed at least annually. The Board subcommittees and their objectives are listed in Table 1.

Table 1: Board subcommittees

Subcommittee	Objectives
Audit Committee	• Assist the Board in overseeing the system of internal control and external financial reporting across the Group • Ensure the external and internal audit arrangements are appropriate and effective • Ensure the compliance arrangements are appropriate and effective • Ensure that fraud prevention and whistleblowing arrangements are established • Ensure that the annual report and accounts, related internal control disclosures, and any other publicly available financial information are reviewed and scrutinised
Nominations Committee	• Lead the process for Board appointments • Ensure the Board and its Committees, and the boards of the subsidiaries, have an appropriate balance of skills, experience, availability, independence, and knowledge of the Group to enable them to discharge their respective responsibilities effectively
Remuneration Committee	• Advise the Board on developing policy on executive remuneration • Fix the remuneration packages of individual directors and member of the Executive Team
Risk Committee	• Oversight of the Group's risk appetite, risk monitoring, and capital management • Provide oversight and advice to the Board on current risk exposures and future risk strategy • Assist the Board to foster a culture within the Group that emphasises and demonstrates the benefits of a risk-based approach to internal control and management of the Group • Approve lending up to 20% of Tier 1 capital at the connection level • Approve asset purchases up to £50m investment and £4m capital consumption • Approve secured funding lines up to £20m lending and £4m capital consumption

4.1.2 The Executive

4.1.2.1 Role

The Board sets out its directive controls in policy and through delegation of powers, authority and responsibility to the CEO. The CEO chairs the Executive Committee, made up of the following:

- CEO,
- Finance Director,
- CRO,
- Group Chief Operating Officer,
- Sales and Marketing Director,
- Group General Counsel and Company Secretary,
- Chief Credit Officer,
- Commercial Director, and
- Chief Technology Officer.

The CEO apportions and allocates powers and duties to management through the executive team. Policies set out mandates and limits for the discharge of responsibility, and job descriptions formalise the roles of individual staff. All staff are made aware of their duties, the limits of their authority, the reporting lines and the processes over which they have jurisdiction. All management and staff in the core business are considered the first line of defence. They are responsible for implementing the controls and mitigating actions that minimise or eliminate risks to the business.

Management has embedded the internal controls required within procedure manuals and carries out supervision, exception monitoring, and staff training to ensure the effectiveness of these controls.

The Group has a Whistleblowing Standard to encourage employees and others who have serious concerns about any aspect of its affairs or those of the wider group to come forward and voice those concerns without the fear of subsequent victimisation, discrimination, or disadvantage.

4.1.2.2 Executive subcommittees

The Executive Committee has delegated specific responsibilities to a number of sub-committees which report directly into it, as listed in Table 2.

Table 2: Executive sub-committees

Committee	Main objectives and responsibilities
Assets and Liabilities Committee (ALCO)	• Reports to Executive Committee and monitored by Risk Committee • Ensure the Treasury is operating effectively and in accordance with the Board's Interest Rate and Basis Risk Policy • Assess the exposure of the Group to movements in interest rates and establish a strategy for managing and containing such risks • Review the limit report and highlight any departure or threat of departure from agreed limits • Monitor the net interest margin
Pricing Committee	• Subcommittee of ALCO • Consider and approve pricing and criteria of savings and lending products within terms set by ALCO • Make recommendations to ALCO on pricing and criteria changes that fall outside terms set by ALCO • Ensure consideration of economic, competitive, operational, and regulatory factors in pricing and criteria decisions
Credit Committee	• Reports to Executive Committee and monitored by Risk Committee • Review, assess, and recommend to Risk Committee proposed changes to Lending Policy, Arrears and Possession Policy, and Forbearance Policy • Approval of certain lending decisions as required by Lending Policy • Monitoring adherence to Lending Policy, including approval of subsidiary lending policies, as long as they are within overall Group Lending Policy • Review of credit risk exposure in lending portfolio, including arrears • Review, assess, and approve recovery strategies • Review, assess, and recommend to Audit Committee any changes to Loan Loss Provisioning Policy • Oversight of calculation of specific and collective provisions • Identifying and recommending improvements to systems and controls for the management of credit risk • Monitor conduct risk considerations in lending activity • Review staff loans annually

Committee	Main objectives and responsibilities
Transactional Credit Committee	• Subcommittee of the Credit Committee • Consider and approve lending decisions that fall outside the mandates of underwriters but within the mandates for the Committee • Consider and approve bespoke pricing • Review and recommend certain adjustments to Lending Policy
Operations Committee	• Oversee operational management of business • Provide operational inputs into larger projects • Structure and manage smaller operational projects • Receive reports from Change Control Committee on project progress • Oversee Indian Operations
Change Control Committee	• Subcommittee of Operations Committee • Chaired by Chief Technology Officer • Oversee implementation of changes to business processing, including monitoring of IT change projects[1]
Operational Risk Committee	• Subcommittee of Operations Committee • Oversee measurement and management of operational risk
Executive M&A Committee (EMAC)	• Coordinate internal OSB stakeholders for inorganic agenda • Ensure that due diligence covers all relevant aspects • After completion, oversee delivery of the integration plan

4.1.3 Risk and Compliance

Risk and Compliance are independent of the business by virtue of their reporting lines. These include a direct line to the Board and a direct line to the Executive Committee. Their role is to review, approve and test the risks and control systems designed by management.

Risk and Compliance work with the executives to ensure general risks and regulatory risks respectively are identified, assessed, prioritised, owned, recorded, reported and mitigated by the business. They provide independent challenge to help identify gaps in the risk and control system. These are reported to the Executive Committee and the Board and recorded on the tracking systems with timescales for action, nominated owners, and regular reports on progress to the Board Risk and Audit Committees.

Risk and Compliance also provide regular MI on the risks being run by the business, including credit risk, asset liability risk, and operational risk. This MI is provided to the

[1] Larger projects have dedicated governance, including working groups, steering committees and project boards. This is supplemented by reporting into Change Control Committee and Operations Committee.

appropriate executive committees, the Risk Committee, and the Board. Risk and Compliance also use the insights gained in the collection and reporting of this information to advise the business on its management of risks.

The Chief Risk Officer (CRO) and the Group General Counsel also provide assurance to the Board through regular reports which assess strategic risks as well as business risks.

The CRO role includes ensuring that all key business risks are appropriately considered, with allocated business owners responsible for taking remedial action to mitigate shortcomings. The CRO is also responsible for ensuring the PRA's requirements are met. The CRO facilitates action and provides regular reporting to the Executive Committee and the Board. Assurance is provided that risks are controlled through the Risk Committee.

The Group General Counsel's role includes ensuring that FCA requirements are met and all relevant legislation is complied with. A compliance risk assessment is carried out annually and informs the prioritisation of compliance activities, resourcing and plans for the year, including compliance monitoring, review and assessment activity.

4.1.3.1 Internal Audit

Internal Audit has been outsourced to Grant Thornton, who hence act as the Group's "third line of defence" and report directly to the Chairman of the Audit Committee. Ideally, all significant failings are captured by the first and second lines of defence. However a further line of defence is needed to identify any failure of systems and controls, either because they are poorly designed or they are not operating as they are intended.

Internal Audit carries out its own risk analysis of the Group's business and will review the risk assessments carried out by Risk and Compliance but may not place reliance on them. Internal Audit will review the work carried out by Risk and Compliance and report any weaknesses or areas for concern to the Audit Committee.

An inspection plan is drawn up, based on priorities arising from the risk analysis. This is then considered and approved by the Audit Committee. The results of the audits carried out are reported to the Board, together with the Executive Committee's proposed responses to mitigate findings. Any systemic weaknesses or major control weaknesses are highlighted, and the reports are graded with an opinion on the controls implications and severity of the findings.

The Board and the Executive Committee ensure that agreed actions are allocated to responsible individuals who are accountable for achieving the action within the timescales set and agreed.

4.1.4 Recovery and Resolution Plan (RRP)

The RRP is a regulatory requirement, which has two distinct elements:

- the recovery plan is the Group's menu of options for addressing a range of financial stresses caused by idiosyncratic problems, market wide stresses, or both; and
- resolution planning is the provision of information and analysis to the authorities, in order to help them prepare a resolution plan for the Group.

The Group's RRP has been reviewed and approved by the Board.

4.2 Risk categorisation

The Group uses the following risk categories to define and group significant risks under common headings:

- Credit risk
- Market risk (including interest rate and basis risk)
- Liquidity and funding risk
- Operational risk
- Conduct risk
- Other risks (including but not limited to regulatory risk, taxation risk, securitisation risk)

The Group maintains a risk appetite for each of the key risks and performance against the risk appetite statements is monitored and reported on a monthly basis to the Risk Committee and the Board.

4.2.1 Credit risk

The Group's exposure to retail and commercial credit risk is managed by the Credit Committee which reports to the Executive Committee and the Risk Committee. The Group's exposure to wholesale and counterparty credit risk is managed by the Asset and Liability Committee (ALCO) which reports to the Risk Committee and to the Board.

4.2.1.1 Retail and commercial credit risk

The Group operates quantitative credit risk appetite limits for each of its major lending segments in order to ensure that the credit portfolio is sufficiently diversified. For clarity the Group's major lending segments are:

- Residential[2]
    - Bespoke residential (originated and acquired)
    - Second-charge (originated and acquired)
    - Shared ownership
    - Bridging
- BTL/SME
    - Buy-to-let

[2] Within the Group, 'residential' refers to owner-occupied properties. It is not used to refer to buy-to-let properties, despite the fact that they too are secured on residential property in the context of BIPRU. This segment does, however, include a small amount of BTL acquired in portfolio purchases.

    - Semi-/Commercial
    - Development finance
    - Bridging
- Personal loans

Retail and commercial credit risk is managed within the Group's underwriting process, which seeks to ensure that borrowers only take on a debt they can afford to repay, safeguarding both the borrower and the Group. On occasions, borrowers find themselves in financial difficulties which impact their ability to meet their mortgage or loan service obligations. The Group has established procedures to manage such situations to a satisfactory conclusion, which adhere to the principles of Treating Customers Fairly. Usually this involves working with the borrower to clear arrears or making other arrangements commensurate with the borrower's circumstances. In rare cases where the situation deteriorates significantly and irreparably, the Group takes possession of the underlying security.

In situations where the Group determines that it is appropriate in order to meet customer needs, it applies a policy of forbearance and may grant a concession. The Group considers forbearance on a case by case basis. This may arise where the Group considers that the financial stress of the customer is temporary and potentially recoverable. Such a concession, which will only be implemented after obtaining the customer's consent, may involve capitalisation of arrears, temporary or permanent conversion to an interest only repayment basis, a reduced monthly payment, a mortgage term extension, or a payment holiday. By dealing with arrears at an early stage and monitoring continuously, it is anticipated that a lower level of long term arrears will be achieved, resulting in a more favourable outcome for both the customer and the business.

4.2.1.2 Wholesale and counterparty credit risk

Wholesale and counterparty credit risk arise from the risk that counterparties will be unable to repay loans and other financial instruments that the Group holds as part of its liquidity portfolio or for hedging purposes. This risk is managed by restrictions on the type of assets held, assessment of the creditworthiness of counterparties, maintenance of exposure limits with each counterparty, sector limits and collateral posting for derivatives. The Group has no direct exposure to the countries most affected by the Eurozone crisis (i.e. Portugal, Ireland, Italy, Greece and Spain) and limited exposure to emerging markets and non-investment grade debt, including investments with other building societies.

The Group's exposure to wholesale and counterparty credit risk is managed by the ALCO, which reports to the Risk Committee and to the Board.

4.2.2 Market risk (including interest rate risk)

Market risk is the risk that the value of assets and liabilities, earnings and/or capital may change as a result of changes in market prices of financial instruments. The majority of the Group's market risk arises from changes in interest rates. The Group recognises that the effective management of market risk is essential to the maintenance of stable earnings and preservation of customer value.

Interest rate risk is most prevalent in mortgage lending where fixed rate mortgages are not funded by fixed rate deposits of the same duration, or where the fixed rate risk is not hedged by a fully matching interest rate derivative.

The Group is exposed to movements in interest rates reflecting the mismatch between the dates on which interest receivable on assets and interest payable on liabilities are next reset to market rates or, if earlier, the dates on which the instruments mature.

The interest rate characteristics of the Group's assets and liabilities including Treasury assets, wholesale liabilities, all mortgage loans, retail savings and capital instruments are modelled in the Bank's risk systems. Prepayment characteristics of all fixed rate mortgages are assessed and prepayment assumptions are included in the risk modelling for hedging.

Treasury monitors the Group's interest rate risk and hedges exposures accordingly through the use of derivative contracts to ensure the Bank remains within the Board approved interest rate risk appetite limits. This process is reviewed by ALCO on a monthly basis.

Interest rate sensitivity is measured by applying a 2% parallel movement to the yield curve in both directions un-floored. At December 2013 month end the interest rate gap sensitivity to this test was +/-£1,302,000 (0.98% of Tier 1 capital).

The Group does not seek to take a significant interest rate position. Un-hedged gap and basis risk positions are accepted within limits to allow management flexibility as assets and liabilities come off and on the balance sheet and to allow for management of differences between economic, accounting, and regulatory views of exposure, but the target is broadly neutral.

The secondary market risk faced by the Group is basis risk. Basis risk arises when the Group finances an asset with a liability which re-prices from a different interest rate index. The Group manages this exposure on an on-going basis within limits set by the Board and monitored by ALCO monthly. The Board approved risk appetite limits for interest rate and basis risk are reviewed annually through the ICAAP process.

The Group holds Treasury assets that are classified as 'available for sale' which are valued monthly and the fair value is recognised in the separate available for sale reserve account in accordance with the accounting standards.

4.2.3 Liquidity and funding risk

Liquidity and funding risk is the risk that the Group's resources will prove inadequate to meet its liabilities as they contractually fall due or as a result of any contingent or discretionary cash outflows that may occur in a stress. It arises from the mismatch of timings of cash flows generated from the Group's assets and liabilities (including derivatives). Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed in line with policies approved by ALCO. The Group's liquidity management policies are reviewed and approved annually by the Board Risk Committee (on behalf of the Board).

The Group's policy is to ensure that sufficient funds are available at all times to meet demands from depositors, to fund agreed advances, to meet other commitments as and when they fall due, and to ensure the Board risk appetite is met. This is achieved through maintaining a prudent level of liquid assets, through wholesale funding facilities, and through control of the growth of the business.

The Board's risk appetite for liquidity risk is defined in terms of:

- survival periods which measures the degree of sufficiency of liquid assets to support the Bank's activity over time under a number of stress scenarios;
- adherence to strategic liquidity risk measures; and
- compliance with all regulatory liquidity risk limits.

The Group monitors its liquidity position on a daily basis. The liquidity position is reported monthly to ALCO and the Board. It also monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed, and regularly assesses its funding position. This is supported with detailed contingency funding plans and recovery options, which are tested and reviewed on a regular basis. The Group's liquidity management framework is designed in line with PRA BIPRU regulations and industry guidelines.

Liquidity management is governed by the Treasury Policy, which is developed, implemented and monitored by the ALCO, which also sets limits over the level and maturity profile of wholesale funding and monitors the composition of the Group balance sheet. A series of liquidity stress tests are performed daily to confirm that the limits are not at risk of being breached. Day-to-day management is delegated to the Treasury function with oversight of the Risk function.

4.2.4 Operational risk

Operational risk, which is inherent in all business activities, is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, or systems or from external events. It can occur in any of the Group's businesses and includes errors, omissions, natural disasters, and deliberate acts such as fraud. The Group manages this risk within an overall governance and control strategy. Within this structure, potential risk exposures are assessed to determine the appropriate type of controls to be applied. It is recognised that such risks can never be entirely eliminated and that the cost of controls in minimising these risks may outweigh the potential benefits. However, where required, the Group continues to invest in risk management and mitigation such as business continuity management and incident management. Each business area or function has appointed an operational risk champion who is responsible for the day-to-day identification and reporting of operational risk incidents. The Operational Risk Committee is responsible for the development, implementation, and monitoring of the Operational Risk Policy.

The Group's business strategy is reflective of a moderate appetite for operational risk.

4.2.5 Conduct risk

Conduct risk, which is the risk that the Group's behaviours, offerings or interactions will result in unfair outcomes for customers, is considered throughout the established systems and controls including on-going oversight and monitoring from the existing executive subcommittees. Significant conduct risks are reported to the Board Risk Committee and the Board.

4.2.6 Other risks

4.2.6.1 Regulatory risk

Regulatory risk is the risk of regulatory changes and enforcement, with the potential for fines and/or restrictions in business activities. Over recent years, the financial services industry has seen increased regulatory scrutiny and supervision around governance, capital, liquidity and remuneration. There has also been focus on conduct and treating customers fairly.

4.2.6.2 Taxation risk

Taxation risk is the risk associated with changes in taxation law or in the interpretation of taxation law. It also includes the risk of changes in taxation rates and the risk of failure to comply with procedures required by taxation authorities. Failure to manage taxation risks could lead to an additional taxation charge.

4.2.6.3 Securitisation risk

Securitisation risk is the exposure to risks transferred through securitisation of assets should those transfers fail for any reason. The Group has undertaken a securitisation transaction, placing mortgage assets originated through portfolio purchases and flow agreements in the Rochester vehicle and selling AAA and AA+ rated notes with a nominal value of £273m, but keeping the assets consolidated on the balance sheet and continuing to hold capital for them.

5 Capital Resources

Table 3 shows the Group's total available capital resources.

Table 3: Capital resources

	2013	2012
	£'000	**£'000**
Tier 1 Capital		
Permanent share capital	198	197
Transfer reserve	(12,818)	(12,818)
Retained earnings / (losses)	24,031	(545)
Share premium account / Capital contribution	121,157	106,421
Deductions from tier 1 capital	(1,117)	(910)
Non-cumulative preference shares	1,067	804
Total tier 1 capital after deductions	**132,518**	**93,149**
Tier 2 Capital		
Perpetual subordinated bonds	36,852	37,189
Available for sale reserve	(156)	1,285
Collective provisions	3,072	1,284
Subordinated liabilities	26,650	26,873
Bonds	703	703
Deductions from tier 2 capital	(7,078)	(4,147)
Total tier 2 capital after deductions	**60,043**	**63,187**
Excess of Tier 2 over Tier 1	**-**	**-**
Total regulatory capital	**192,561**	**156,336**

Notes:

2013 figures include profits subsequently verified when the annual accounts were signed

Capital forecasts are made for a minimum 12-month rolling period and are updated monthly. The expectation is that capital will continue to be generated organically.

The Group's Recovery and Resolution Plan discusses options for raising capital in a stress, some of which (e.g. reduction in new business origination) are considered as management actions in the analysis of the capital planning buffer in the Group's ICAAP while others (e.g. sale of portions of the business) are reserved for more severe situations that are outside the scope of the ICAAP.

Intangible assets include capitalised software. All the Perpetual Subordinated Bonds (PSBs), Subordinated Liabilities and Bonds are issued by OSB. Table 4 shows the terms of PSBs, Subordinated Liabilities and Bonds are detailed below:

Table 4: PSBs, Subordinated Liabilities and Bonds

	2013 £'000	2012 £'000
Linked to LIBOR (London Interbank Offered Rate):		
Floating rate Subordinated Liabilities 2015	**3,002**	**3,002**
Floating rate Subordinated Liabilities 2016	**3,003**	**3,003**
Floating rate Subordinated Liabilities 2017	**5,656**	**5,656**
Floating rate Subordinated Loans 2022	**706**	**703**
Linked to the average standard mortgage rate of the five largest building societies:		
Floating rate Subordinated Liabilities 2017	**5,049**	**5,049**
Fixed rate:		
6.45% Subordinated Liabilities 2024	**10,163**	**10,163**
7.875% Perpetual Subordinated Bonds	**15,263**	**15,189**
6.591% Perpetual Subordinated Bonds	**22,457**	**22,000**
Total	**65,299**	**64,765**

Subordinated liabilities and bonds which are in their final five years to maturity are being amortised on a straight line basis.

6 Capital requirements

6.1 Pillar 1 requirements

The Pillar 1 capital requirement is calculated using the following approaches[3]:

- Credit – Standardised Approach (BIPRU 3)
- Operational risk – Basic Indicator Approach (BIPRU6)[4]
- Market risk – not applicable (BIPRU 7)

The following table shows the RWAs in accordance with the standardised approach to credit risk and separately 8% hereof reflecting the minimum Pillar 1 capital requirement for each of the standardised credit risk exposure classes. The table also shows the Group's operational risk capital requirement calculated in accordance with the basic indicator approach and its capital requirements due to counterparty credit risk.

[3] From 1 January 2014, the Group will also calculate a CVA (credit valuation adjustment) capital charge under the Standardised Method (Article 384 of the CRR).

[4] 31 December 2013 was the last day BIPRU 6 was in force. From 1 January 2014, this capital requirement is covered under Article 192 of the CRR.

Table 5: Pillar 1 capital requirements

	2013	
Standardised Exposure Classes[1]	**Risk Weighted Assets £'000**	**Capital Requirement £'000**
Central government and central banks	-	-
Regional governments or local authorities	-	-
Administrative bodies and non-commercial	-	-
Multilateral development banks	-	-
International organisations	-	-
Institutions[2]	14,933	1,195
Corporates[2]	-	-
Retail	149,378	11,950
Secured by mortgages on residential property	946,153	75,692
Secured by mortgages on commercial real estate	135,003	10,800
Past due	122,436	9,795
Regulatory high-risk categories	-	-
Covered bonds	-	-
Securitisation positions	6,095	488
Short-term claims on institutions and corporates	-	-
Collective Investment Undertakings (CIUs)	-	-
Other items	25,567	2,045
Total Credit Risk	1,399,565	**111,965**
Operational Risk - Basic Indicator Approach		**1,781**
Counterparty Credit Risk		**57**
Total Pillar 1 Capital Requirements		**113,803**

Notes:

1 Credit risk categories shown reflect FSA/PRA reporting.

2 Excluding those assessed as short-term claims on institutions and corporates

6.2 Large Exposures

The Group tracks its exposures by connection and regularly reports on its largest exposures, those exceeding £4m,[5] to the Credit Committee, Risk Committee, and Board. Risk

[5] This report covers connections that are not defined as large exposures under BIPRU 10.5.1R as of 31 December 2013 (since 1 January 2014, it is covered under Article 392 of CRR), which is 10 per cent of capital resources. Exposures below £4m are reported at the discretion of the Risk team.

Committee approval is required for any lending that would take exposure to a connection over 10 per cent of Tier 1 capital (c. £13m), with full Board approval required for any exposure over 20 per cent of Tier 1 capital (c. £26m).

As of December 2013, there were twenty-two connections of over £4m with a total net exposure of £147m. Of these, two carried specific provisions, with a total carrying value of £14m and provision of £2.4m.

Connections within the large exposure list are subject to detailed review, with the emphasis on non-performing assets where the Bank's actions will have most impact. Large performing connections are monitored closely to help anticipate any problems occurring. Overall Pillar 2 Rule

Additional capital is held under Pillar 2 for risks either not captured or not fully captured under Pillar 1.

At least annually the Group will undertake a detailed, forward-looking assessment of capital adequacy in order to assess the Pillar 2 capital requirement. This exercise is known as the Internal Capital Adequacy Assessment Process (ICAAP). Based on the results of the ICAAP the PRA determines the Group's required Individual Capital Guidance (ICG) and Capital Planning Buffer (CPB). It is the Group's policy to hold capital resources in excess of the higher of what is implied by the Group's ICAAP and the sum of the ICG and CPB.

On a monthly basis the capital forecasts are refreshed and reviewed by the ALCO, the Risk Committee and the Board. The refreshed projections will reflect the impact of actual performance to that time and will consider whether key assumptions are still valid. Capital forecasts will also be produced in circumstances where a potential impact to capital may occur such as revised budget forecasts or in the course of evaluating a substantial acquisition.

Capital is not formally allocated to the businesses with lending targets and limits based instead on gross volume. However, return on equity is a key metric in product design and lending decisions and management can adjust targets and limits depending on capital availability.

6.3 Counterparty risk

Group wholesale counterparty risk through Treasury dealing is concentrated in two main areas. Deposits with institutions and to a lower extent mark to market exposures with derivative counterparties.

Cash deposit exposures are controlled through Board approved limits to highly rated banks and selected building societies. Counterparty ratings are monitored by Treasury and reviewed monthly by ALCO.

Counterparty risk is mitigated with derivative counterparties that have CSA collateral agreements in place. Regular derivative valuations allow the Bank to assess exposures and call for margin when it exceeds threshold tolerances.

6.4 Credit risk

This section provides detailed information regarding the Group’s exposure to credit risk.

6.4.1 Definition of past due and impaired

For regulatory purposes, a financial asset is considered as past due when the contractual payment is due for more than three months. For accounting purposes, a financial asset is treated as past due and then impaired when there is objective evidence that impairment exists either individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. Provisions under regulatory rules are calculated on the same basis as impairment provisions, and so all provisions for impaired loans and advances are referred to as impairment provisions.

6.4.2 Approaches and methods for value adjustments and provisions

The Group regularly assesses whether there is evidence that a financial asset or a portfolio of financial assets that is not carried at fair value through profit or loss is impaired. A financial asset or portfolio of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more loss events that occurred after the initial recognition of the asset and prior to the balance sheet date ('a loss event'), and that loss event or events has / or have had an impact on the estimated future cash flows of the financial asset or the portfolio that can be reliably estimated.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the Group determines that no objective evidence of impairment exists for an individually-assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment. An individual provision is also considered where an account is not in arrears but the Group has exercised forbearance in the conduct of the account. Any provision is based on a management assessment of the propensity for the account to realise a loss had forbearance not been shown taking account of the amount recoverable on mortgage indemnity cover and additional security.

For loans, receivables and held-to-maturity investments, the amount of impairment loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows discounted at the asset's original effective interest rate (EIR).

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure and any costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar risk characteristics, taking into account asset type, industry, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the counterparty's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the Group and historical loss experience for assets with credit risk characteristics similar to those in the Group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not currently exist. In addition, the Group uses its experienced judgement to estimate the amount of an impairment loss. This incorporates amounts calculated to overcome model deficiencies and systemic risks where appropriate and supported by historic loss experience data.

The following tables analyse impaired loans as treated for accounting purposes and past due loans as treated for regulatory purposes at 31 December 2013.

Table 6: Impaired, past due, provisions and provision charges by counterparty type

Counterparty type	Gross impaired loans £'000	Gross past due loans £'000	Impairment provisions £'000	Charges for impairment provisions during the year £'000
Corporates	12,088	6,387	6,327	4,687
Retail	54,055	123,965	21,206	2,642
Other	-	-	-	-
Total	**66,143**	**130,352**	**27,533**	**7,329**

Notes:

1. Counterparty type analysis is based on mapping all relevant loans to either Corporates or Retail as classified by the PRA

2. Impairment provisions include both collective and specific provisions

Table 7: Impaired, past due, provisions and provision charges by geographic area

Geographic area	Gross impaired loans £'000	Gross past due loans £'000	Impairment provisions £'000	Charges for impairment provisions during the year £'000
UK	49,714	111,753	22,210	5,912
Channel Islands	16,429	18,599	5,323	1,417
Rest of the World	-	-	-	-
Total	**66,143**	**130,352**	**27,533**	**7,329**

Note: Impairment provisions include both collective and specific provisions

Table 8: Reconciliation of changes in provisions for impaired exposures

Impairment provisions	£'000
Opening balance as at 1 January 2013	30,972
Charge for the year	7,329
Amounts written off net of recoveries	(10,768)
Closing balance as at 31 December 2013	**27,533**

Note: Impairment provisions include both collective and specific provisions

6.4.3 Credit risk exposure breakdowns

The following tables analyses the credit risk exposure of the Group as at 31 December 2013.

Table 9: Year end and average exposure by exposure class

Standardised Exposure Classes1	Exposure at 31/12/2013 £'000	Average exposure in 2013 £'000
Central government and central banks	408,748	362,079
Regional governments or local authorities		
Administrative bodies and non-commercial		
Multilateral development banks	96,778	73,768
International organisations		
Institutions2	77,943	160,582
Corporates2		
Retail	199,171	99,585
Secured by mortgages on residential property	2,606,860	2,354,142
Secured by mortgages on commercial real estate	148,044	142,267
Past due	130,352	95,584
Regulatory high-risk categories		
Covered bonds		
Securitisation positions	21,442	21,691
Short-term claims on institutions and corporates		
Collective Investment Undertakings (CIUs)		
Other items	25,954	25,797
Total	**3,715,292**	**3,335,495**

Notes:

1 Credit risk categories shown reflect FSA/PRA reporting.

2 Excluding those assessed as short-term claims on institutions and corporates

Table 10: Exposures by geographic area and material exposure classes

Standardised Exposure Classes1	UK £'000	Channel Islands £'000	Rest of the World £'000	Total £'000
Central government and central banks	408,748	-	-	**408,748**
Regional governments or local authorities	-	-	-	**-**
Administrative bodies and non-commercial	-	-	-	**-**
Multilateral development banks	-	-	96,778	**96,778**
International organisations	-	-	-	**-**
Institutions2	72,933	-	5,010	**77,943**
Corporates2	-	-	-	**-**
Retail	199,171	-	-	**199,171**
Secured by mortgages on residential property	2,055,677	551,183	-	**2,606,860**
Secured by mortgages on commercial real estate	126,014	22,030	-	**148,044**
Past due	111,753	18,599	-	**130,352**
Regulatory high-risk categories	-	-	-	**-**
Covered bonds	-	-	-	**-**
Securitisation positions	21,442	-	-	**21,442**
Short-term claims on institutions and corporates	-	-	-	**-**
Collective Investment Undertakings (CIUs)	-	-	-	**-**
Other items	25,954	-	-	**25,954**
Total	**3,021,692**	**591,812**	**101,789**	**3,715,292**

Notes:

1 Credit risk categories shown reflect FSA/PRA reporting.

2 Excluding those assessed as short-term claims on institutions and corporates

Table 11: Exposures by significant counterparty type and exposure classes

Standardised Exposure Classes1	Corporate £'000	Retail £'000	Other £'000	Total £'000
Central government and central banks	408,748	-	-	**408,748**
Regional governments or local authorities	-	-	-	**-**
Administrative bodies and non-commercial	-	-	-	**-**
Multilateral development banks	96,778	-	-	**96,778**
International organisations	-	-	-	**-**
Institutions2	77,943	-	-	**77,943**
Corporates2	-	-	-	**-**
Retail	-	199,171	-	**199,171**
Secured by mortgages on residential property	-	2,606,860	-	**2,606,860**
Secured by mortgages on commercial real estate	-	148,044	-	**148,044**
Past due	-	130,352	-	**130,352**
Regulatory high-risk categories	-	-	-	**-**
Covered bonds	-	-	-	**-**
Securitisation positions	21,442	-	-	**21,442**
Short-term claims on institutions and corporates	-	-	-	**-**
Collective Investment Undertakings (CIUs)	-	-	-	**-**
Other items	-	-	25,954	**25,954**
Total	**604,911**	**3,084,427**	**25,954**	**3,715,292**

Notes:

1 Credit risk categories shown reflect FSA/PRA reporting.

2 Excluding those assessed as short-term claims on institutions and corporates

3 Counterparty type analysis is based on mapping all relevant loans to either Corporates or Retail as classified by the PRA

Table 12: Exposures by residual maturity breakdown

Standardised Exposure Classes1	< 3 months £'000	3 months to 1 year £'000	1 to 5 years £'000	> 5 years £'000	Total £'000
Central government and central banks	332,128	76,620	-	-	**408,748**
Regional governments or local authorities	-	-	-	-	**-**
Administrative bodies and non-commercial	-	-	-	-	**-**
Multilateral development banks	-	29,735	67,044	-	**96,778**
International organisations	-	-	-	-	**-**
Institutions2	42,400	30,537	5,006	-	**77,943**
Corporates2	-	-	-	-	**-**
Retail	1,593	11,552	184,034	1,992	**199,171**
Secured by mortgages on residential property	13,154	19,339	162,399	2,411,968	**2,606,860**
Secured by mortgages on commercial real estate	1,731	2,225	15,965	128,123	**148,044**
Past due	-	-	-	130,352	**130,352**
Regulatory high-risk categories	-	-	-	-	**-**
Covered bonds	-	-	-	-	**-**
Securitisation positions	-	-	-	21,442	**21,442**
Short-term claims on institutions and corporates	-	-	-	-	**-**
Collective Investment Undertakings (CIUs)	-	-	-	-	**-**
Other items	-	-	-	25,954	**25,954**
Total	**391,006**	**170,008**	**434,448**	**2,719,831**	**3,715,292**

Notes:

1 Credit risk categories shown reflect FSA/PRA reporting.

2 Excluding those assessed as short-term claims on institutions and corporates

6.4.4 Use of External Credit Assessment Institutions (ECAIs)

The Bank subscribes to Fitch Ratings (Fitch), a PRA recognised ECAI. Ratings assessments provided by Fitch are used by the Bank to establish counterparty credit risk weightings using the PRA standardised approach.

The tables below map the ECAI's credit assessment ratings to credit quality steps in order to establish the appropriate risk weightings for the rated credit exposures.

Table 13: Exposures by Credit Quality Step

Institutions (incl. banks)[1]

Credit Quality Step	Fitch's assessments	Moody's assessments	S&P's assessments	Risk Weight	Exposure £'000
1	AAA to AA-	AAA to AA-	Aaa to Aa3	20%	15,420
2	A+ to A-	A+ to A-	A1 to A3	50%	6,022
3	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	100%	-
4	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	100%	-
5	B+ to B-	B+ to B-	B1 to B3	100%	-
6	CCC+ and below	CCC+ and below	Caa1 and below	150%	-
Total					**21,442**

Notes:

1 Excluding those assessed as short-term claims on institutions and corporates

Short term claims on Institutions and Corporates

Credit Quality Step	Fitch's assessments	Moody's assessments	S&P's assessments	Risk Weight	Exposure £'000
1	AAA to AA-	AAA to AA-	Aaa to Aa3	20%	-
2	A+ to A-	A+ to A-	A1 to A3	20%	70,870
3	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	20%	-
4	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	50%	-
5	B+ to B-	B+ to B-	B1 to B3	50%	-
6	CCC+ and below	CCC+ and below	Caa1 and below	150%	-
Total					**70,870**

6.5 Operational Risk

The Group calculates its operational risk capital requirement using the Basic Indicator Approach but is developing its framework in accordance with the standards relevant to firms adopting the Standardised Approach (as described in BIPRU 6)[6].

In addition, the Group maintains levels of operational risk capital consistent with any Pillar 2 adjustment that might be identified through the ICAAP process.

6.6 Remuneration

In accordance with the principles of SYSC 19A, a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management. Policies and procedures must be comprehensive and proportionate to the nature, scale and complexity of the firm's activities.

A firm must maintain a record of its remuneration Code Staff (including senior management, risk takers, control functions and staff whose activities may have a material impact on the firms risk profile) and take reasonable steps to ensure they understand the implication of the code.

The Group has a Remuneration Committee which ensures that the Group operates a remuneration process and implements a remuneration policy which is consistent with the

[6] 31 December 2013 was the last day this BIPRU section was in force. From 1 January 2014, this capital requirement is covered under Article 192 of the CRR.

principles of SYSC 19A and the Remuneration Code. The Remuneration Committee at the end of the financial year consisted of T. Hanford (Chair), M. McCaig and D. Mills.

The Committee recognises the need to be competitive within the UK financial services market, however the Committee's policy is to ensure that the executive directors, senior management and employees are fairly and responsibly rewarded in return for high levels of individual and business performance.

The policy focuses on ensuring sound and effective risk management through:

- A stringent governance structure for setting goals and communicating these to employees;
- Performance assessment metrics for executive and other Code Staff are reviewed and agreed by the Chief Risk Officer and include both financial and non-financial goals; and
- Making all variable remuneration awards at the discretion of the Committee and subject to individual, business unit, overall Group performance and stated risk appetite.

The Group General Counsel & Company Secretary also has significant input into remuneration policy to provide an independent review.

6.7 Remuneration of Code Staff

Code Staff remuneration comprises a number of elements: basic salary, performance incentive pay and benefits:

Basic Salary

Basic salary is determined by levels of responsibility, external market competitiveness and individual performance in the role. The Group's policy is to position salaries so that on average, they are in line with salary packages for comparable positions in similarly performing financial institutions, taking account of the level of other benefits provided;

Performance incentive pay

The executive directors, the former Chairman (in his role as the Bank's lead on merger and acquisition activity) and other senior managers (all of whom are Code Staff) participate in a non-pensionable medium term incentive plan under which cash bonuses are awarded at the discretion of the Board, when determined appropriate, according to success in the delivery of corporate and individual objectives, elements of which include risk, compliance and control metrics. A proportion of the cash bonuses are deferred, and are subject to claw back in the event that financial targets are not met or if there is a material financial downturn or failure of risk management before the end of the deferral period.

In addition, a long-term incentive plan ('LTIP') has been approved by the B shareholder and OSB Board and has been offered to the executive directors, other executives and Chairman. The aim of the LTIP is to provide an appropriate balance between short, medium and long-term objectives in the overall remuneration package.

No other bonuses were paid to other code Staff in 2013.

Benefits

All of the executive management team receive car allowances and are members of a contributory defined contribution pension scheme.

The Remuneration Committee is provided with executive remuneration and benefits data from comparative organisations across the financial services industry and banking sector and procures such other relevant data from independent expert sources as appropriate, although no specific external advice was received by the Remuneration Committee in 2013.

Table 14: Aggregate information in respect of code staff

	Code Staff Aggregate Remuneration £'000
Fixed Remuneration: • Salaries Paid £2,530 • Employer Pension Contribution £260 • Other Benefits £84	£2,875
Variable Remuneration: Cash Bonus • Paid £357 • Deferred £302	£659 (includes paid and deferred bonuses)
Number of Code Staff	23

Figures are for remuneration in respect of the 2013 Financial Year and include bonuses actually paid in 2014 but earned in respect of the 2013 Financial Year.