Close Brothers

Close Brothers Group plc

Pillar 3 disclosures for the year ended 31 July 2010

Contents

Should you have any queries please e-mail pillar3@cbgplc.com

1. Overview

Background

The aim of Basel II and the EU Capital Requirements Directive (referred collectively as Basel II) is to promote safety and soundness in the financial system. Basel II is structured around three 'pillars': Pillar 1 on minimum capital requirements; Pillar 2 on the supervisory review process; and Pillar 3 on market discipline. Pillar 3 aims 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 and risk assessment process. The disclosures contained in this document cover the qualitative and quantitative disclosure requirements of Pillar 3 and are based on data as at 31 July 2010 with comparative figures for 31 July 2009 where relevant.

Scope

The Financial Services Authority ("FSA") supervises Close Brothers Group plc ("CBG" or "the group") on a consolidated basis and receives information on the capital adequacy of, and sets capital requirements for, the group as a whole. In addition a number of subsidiaries are directly regulated by the FSA or overseas regulators. Details of the group's principal subsidiaries are included in note 26 of the group's annual report. There are no differences between the basis of consolidation of the group for accounting and regulatory purposes except where the group's associates are accounted for on an equity basis for accounting purposes and consolidated in proportional to the participation of the group for regulatory purposes.

Other than restrictions due to regulatory capital requirements for regulated entities, there are no current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities when due between the group and its subsidiaries.

The group has not applied for any IRB (Internal Ratings Based) waivers and consequently no specific Pillar 3 IRB disclosures are included in this document.

Policy

Disclosures will be issued as a minimum on an annual basis and will be published on the group's website as soon as practicable after the publication of the group's annual report. These disclosures are not subject to audit except where they are equivalent to those prepared under accounting requirements for inclusion in the group's annual report.

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. They do not constitute any form of financial statement and must not be relied upon in making any judgement about the group.

Solo-consolidation

Close Brothers Limited ("CBL"), the group's regulated banking subsidiary makes use of the provisions laid down in the FSA handbook BIPRU Chapter 2.1 and reports to the FSA on a solo-consolidated basis. This solo-consolidated group includes CBL and its subsidiaries other than its debt collection subsidiary (Close Credit Management) and the offshore banks in Guernsey, Isle of Man and Cayman. CBL publishes its Pillar 3 disclosures on the group's website.

2. Risk management objectives and policies

The Group's risk management framework

Risk management is the process of identifying the principal business risks to the group achieving its strategic objectives, establishing appropriate controls to manage those risks and checking that appropriate monitoring and reporting systems are in place. Robust risk management is fundamental to the success of the group and a comprehensive risk management framework ensures that the risks associated with each of the businesses are identified, quantified, managed and mitigated. This includes continual benchmarking against industry best practice.

The risk framework is overseen by group risk which is independent from the business units. Group risk provides co-ordination, monitoring, advice and challenge on the management and reporting of risks to ensure that the group stays within the stated appetite as mandated by the CBG board ("the board").

The risk management framework is based on the concept of "three lines of defence":

- Line one is risk management: primary responsibility for strategy, performance and risk management lies with the board, the chief executive and the heads of each division and operating business.
- Line two is risk oversight: risk oversight is provided by the group risk and compliance committee ("GRCC") and the head of group risk working with counterparts in the divisions and operating businesses and with group compliance. This is supplemented by a range of risk related committees at divisional and operating business levels.
- Line three is independent assurance: independent assurance on the effectiveness of the risk management systems is provided by group internal audit reporting to the Audit Committee.

There are clear reporting lines and defined areas of responsibility at board, divisional and business level. This structure is designed to ensure, amongst other things, that key issues and developments are escalated on a timely basis. The group's risk management framework requires that all of the group's divisions and operating businesses establish a process for identifying, evaluating and managing the key risks that they face.

The board has overall responsibility for ensuring the adequacy of the group's risk management arrangements with the chief executive charged with day to day responsibility for the group-wide management of risk. The GRCC is a committee established by the chief executive to assist him in the group wide management of risk. Its membership is made up of the group's executive committee members and the heads of group risk, compliance and internal audit. It meets monthly and is responsible for:

- The group's risk management strategy, approach and policy;
- Recommending for board approval the group's risk appetite;
- The approval of group wide policies in respect of risk management and regulatory compliance including limits of authority; and
- Reviewing regular reports on significant risk management, regulatory compliance and internal control issues and for monitoring their analysis and resolution.

The head of group risk and general counsel report to the chief executive. The head of group compliance reports to the general counsel. The head of group internal audit reports functionally to the Audit Committee through the chairman of that committee and to the finance director.

2. Risk management objectives and policies continued

Risk oversight is further provided by a number of specialist risk committees at divisional or business level. The principal such risk committees and their objectives in relation to risk management are as follows:

Division	Committee	Objective
Banking	CBL Board	Overall responsibility for ensuring the adequacy of the banking division's risk management.
	Credit Committees	Loan underwriting, credit policy control and monitoring in accordance with centrally established limits of authority.
	CBL (Banking) Risk and Compliance Committee	A sub-committee of the CBL board. It is the primary forum to permit the directors of CBL to exercise their fiduciary, statutory and regulatory oversight responsibilities in respect of risk management, internal control and regulatory compliance within CBL and its subsidiaries. This committee also has oversight of the approval of new products.
	Liquidity and Funding Committee	Establishment of policies in respect of funding and liquidity management for the treasury activities of the division.
	Treasury Risk and Compliance Committee	A sub committee of the CBL Risk and Compliance Committee it is a primary forum to discuss Treasury related risk and compliance issues. In particular key risk indicators relating to liquidity and funding.
Securities	Board (Winterflood and Seydler)	Overall responsibility for ensuring the adequacy of the business' risk management including specifically oversight of market and counterparty risk.
	New Client and Business Committees	Business level committees responsible for the approval of new clients and transactions. May require CBG approval.
Asset Management	Management Committee	Overall responsibility for ensuring the adequacy of the division's risk management.
	CAM Risk and Compliance Committee	Establishment of divisional level risk and regulatory compliance policies and oversight of compliance with those policies.
	New Product Committees	Business level committees responsible for: approval of new products; review of existing products.
	Investment Review Committee	Review of investment performance and associated risk.
	Client Acceptance Committees	Business level committee responsible for approval of new clients. May require divisional and/or CBG approval.

2. Risk management objectives and policies continued

Risk assessment

The board considers that the principal risks and uncertainties facing the group have the potential to have a significant detrimental impact on its financial performance and future prospects and are described in the 2010 Annual Report under Principal Risks and Uncertainties.

The group's exposures under each of these risks are reviewed and reassessed on a bottom-up and top-down basis by senior executives at operating business, divisional and CBG levels at least annually in an exercise coordinated by the group risk function. The group uses a probability and impact scoring system linked to the group's risk appetite to assess the significance of individual risks and the adequacy of risk controls.These risk assessments are reviewed and approved by the board responsible for the management of those risks with the board approving the CBG risk assessment. A high level summary of those risk assessments is set out below:

Key risk and uncertainty	Description of risk	Risk mitigation and management
Economy and competitive environment Demand for the group's products and services are sensitive to global economic conditions and those within the UK in particular. Underlying economic conditions also impact the levels of competition the group's businesses face and their ability to trade profitably.	Due to the diversified nature of the group's activities, variable and/or volatile economic conditions could impact the group in a number of different ways. Specific examples of how this could impact on performance include but are not limited to: • Lower demand for the group's products and services in the Banking and Asset Management divisions. • Reduced retail and/or institutional securities trading activity leading to lower trading volumes in the Securities division. • Failure of a material institution where group or client funds are deposited and/or invested. • High bad debt charges within the Banking division due to customers inability to repay loans and reductions in asset values held as security for those loans. • Goodwill or other asset write downs as a result of lower present values of future cash flows due to reduced economic activity.	The group's businesses typically trade in niche areas where they have developed significant market knowledge and expertise. Across the divisions, the group aims to be "there when it matters" and to build long-term relationships with its customers adding resilience to trading performance in difficult economic conditions. The Banking business model is based on conservative loan to value ratios, relatively short-term loan duration and is predominantly secured on accessible and identifiable assets. The Securities division's primary activity is to be a market-maker in short-dated exchange traded products, thereby providing liquidity to the markets within conservative trading limits, rather than proprietary trading. The Asset Management model focuses on managing, protecting and enhancing the wealth of private and corporate clients. Historically the group's conservative model has enabled it to trade profitably through economic downturns.

2. Risk management objectives and policies continued

Key risk and uncertainty	Description of risk	Risk mitigation and management
Funding The group requires access to funding in order to support its client lending in particular within the Banking division but also trading and growth initiatives within the Securities and Asset Management divisions.	The vast majority of the funding requirement for the group relates to the Banking division. Following the credit crisis of 2008, access to credit markets has become more uncertain. Inability to source sufficient funding could constrain growth and in extreme circumstances require the Banking division to reduce lending levels.	The group remains soundly funded with access to total funding of £5.6 billion at 31 July 2010 and funding a loan book of £2.9 billion. Since the banking crisis, the group has diversified its sources of funding and currently utilises the following: • Shareholder funds; • Public bond markets; • Wholesale facilities; • Term retail deposits; and • Short dated customer deposits. Although the cost and availability of these sources continues to be volatile, the group is confident it will be able to access sufficient funding to support its operations.
Counterparty risk The failure or default of one or more financial institutions could materially impact the financial position of the group.	The group places material amounts of its customer deposits and client monies and assets with other financial institutions either by purchasing CDs and FRNs or by placing funds on deposit. The group also enters into derivative contracts in order to hedge interest rate and foreign exchange exposures with counterparties creating an exposure throughout the life of those contracts. In addition the securities businesses trade securities and rely on counterparties. As such, the group is at risk of financial loss if one of its counterparties defaults or fails.	The Risk and Compliance Committee within the Banking division monitors the credit quality of the counterparties with whom the group places deposits or whose debt securities are held, within approved limits. The Securities division exposure is limited as the businesses trade in the cash markets with regulated counterparties on a delivery versus payment basis such that any credit exposure is limited to price movements in the underlying securities. Counterparty exposure and settlement failure monitoring controls are in place. The Asset Management Risk and Compliance Committee maintains an approved list of banks and custodians for client money and assets which it controls.

2. Risk management objectives and policies continued

Key risk and uncertainty	Description of risk	Risk mitigation and management
Credit risk The risk of default or untimely payment of amounts due by customers leading to the write off or write down of assets.	The group's Banking division advances loans to a range of corporates, SMEs or individuals. Failure to recover the amounts lent or the interest and fees associated with that loan could result in a significant bad debt charge.	The group's lending businesses have a dual approach to mitigate credit risk: • Aiming to lend to customers with the lowest likelihood of defaulting by giving due consideration of the credit quality and covenant of the underlying borrower; and • Lending on a secured basis with significant emphasis on the quality of the underlying security to minimise any loss should the customer not be able to repay. These are supplemented by timely and rigorous collections and arrears management processes. In addition much of the Banking division's lending is short-term and average loan size is small with the result that few individual loans have the capacity to materially impact the group's earnings.

2. Risk management objectives and policies continued

Key risk and uncertainty	Description of risk	Risk mitigation and management
Regulation, tax and legislation The group operates in a highly regulated environment. Changes in regulation or the basis of taxation, particularly in the UK, could materially impact the group's performance.	The impact on the group's businesses caused by changes in regulation or the tax system is potentially material particularly in the aftermath of the credit crisis. Significant changes to the regulatory and legislative environment are currently being introduced and more are expected. These include: • Changes to the types and levels of liquidity banks are required to hold; • Amendments to the regulatory capital regime including changes to the level and type of capital required ("Basel III"); • Required enhancement to risk management and governance processes; and • Revisions to the Financial Services Authority ("FSA") remuneration code. Although many of the proposed changes are aimed primarily at larger institutions, the impact on the group's business model and earnings is potentially significant. The more intensive approach to supervision adopted by the FSA following the credit crisis, and an increased focus on certain issues in the securities market, could lead to a greater degree of regulatory intervention in financial services businesses generally. The recently announced changes in UK regulatory structure may result in a period of increased uncertainty, with the potential for disruption of established regulatory relationships.	The group monitors regulatory developments and engages in dialogue with regulatory authorities on a regular basis and continues to maintain a conservative model with a strong, well capitalised balance sheet and believes it is well placed to react to regulatory change. The group has a central tax function which liaises regularly with the tax authorities and has developed a group tax policy to ensure a consistent approach is taken to tax issues across the group.

2. Risk management objectives and policies continued

Key risk and uncertainty	Description of risk	Risk mitigation and management
Operational risk Operational risk is the risk of loss or other material adverse impact resulting from failed internal processes, people or systems, or from external events.	In common with any financial services group, operational risk is inherent to the group. The group considers the key risks relate to employees and information technology. The group's success is closely aligned to the abilities and experience of its employees. The ability of the group to attract and retain key personnel is critical to the group's prospects in the medium and long-term. The group's activities are highly reliant on their IT infrastructure in their daily operations. Failure to respond to new technology, develop existing systems and ensure a robust infrastructure could have a material effect either competitively or operationally on the group's earnings and reputation.	The group has implemented an operational risk management framework designed to ensure that operational risks are assessed, mitigated and reported in a consistent manner across the group. The group is also exposed to fraud risk both internal and external and has continued to review and enhance its fraud prevention controls. The group has implemented a performance management framework and reviews the reward and incentive schemes regularly to ensure the group is successful in attracting and retaining the calibre of employees necessary to meet its objectives, while aligning such schemes with risk, compliance and treating customers fairly objectives. The group has succession plans for key employees. Each of the businesses continually invest in its IT platforms to ensure they are up-to-date and fit for purpose for the markets they operate in. Additionally, business continuity plans are in place with alternative business locations maintained to enable the businesses to respond in a timely manner to a disaster event. The group's overall exposure is further mitigated by individual businesses maintaining discrete IT systems rather than group wide IT platforms.

2. Risk management objectives and policies continued

Key risk and uncertainty	Description of risk	Risk mitigation and management
Market risk The group's activities are exposed to losses arising from equity or fixed income price movements and changes to foreign exchange and interest rates.	The group's securities businesses are exposed to market movements deriving from trading in equity and fixed income securities. Interest income is a substantial proportion of the group's revenues. Movements in interest rates have the potential to materially affect the group's earnings. The majority of the group's activities are located in the British Isles and are transacted in sterling. The group does however have material currency assets and liabilities primarily due to a range of currency services offered by the Banking division. These currency assets and liabilities are principally CDs, FRNs and lending as well as borrowings and customer deposits. The group also has a number of overseas subsidiaries, a US dollar investment in its associate Mako and two seed capital investments within currency denominated funds.	Senior management within the Securities businesses are closely involved in risk management processes which are also monitored at group level. There are controls, supplemented by cash limits, on individual large or slow moving equity or fixed income positions. Real time controls on the size and risk profile of trading books and of individual books within these are maintained. Treasury operations do not trade actively in money market instruments although they are held for liquidity purposes. The group's policy is to match fixed and variable interest rate liabilities and assets utilising interest rate swaps where necessary. Interest rate mismatch policies are established by the Banking division's Risk and Compliance Committee with compliance monitored daily. Returns from the group's capital and reserves are necessarily subject to interest rate fluctuations and as a matter of policy are not hedged. The foreign exchange exposures arising from the Banking division's assets and liabilities are managed by matching assets and liabilities by currency and the limited use of foreign currency swaps. Exposures are monitored daily against centrally authorised limits. The group does not take speculative proprietary positions in foreign currency. The group does not hedge its currency exposure to its overseas subsidiaries and currency investments since it is relatively modest. A sensitivity analysis on foreign currency exposures is shown on page 97 of the group's annual report.

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3. Capital resources

The table below summarises the composition of regulatory capital as at 31 July 2010, at which point the group's individual entities and the group complied with all of the externally imposed capital requirements to which they are subject.

	Notes	**2010 £ million**	2009 £ million
Core tier 1 capital			
Called up ordinary share capital		**37.4**	37.4
Share premium account		**275.9**	274.5
Retained earnings and other reserves	1	**490.6**	477.8
Minority interests		**2.5**	4.3
Deductions from tier 1 capital			
Intangible assets	2	**(107.5)**	(107.6)
Goodwill in associates		**(51.9)**	(49.0)
Investment in own shares		**(43.7)**	(50.9)
Unrealised losses on available for sale equity shares		**-**	(4.6)
Core tier 1 capital after deductions		**603.3**	581.9
Tier 2 capital before deductions			
Subordinated debt	3	**75.0**	75.0
Unrealised gains on available for sale equity shares		**7.6**	-
Tier 2 capital after deductions		**82.6**	75.0
Total tier 1 and tier 2 after deductions		**685.9**	656.9
Deductions from total of tier 1 and tier 2			
Investments that are not qualifying holdings		**(1.8)**	(4.8)
Other regulatory adjustments		**(0.3)**	(0.5)
Total regulatory capital		**683.8**	651.6

Notes:

1. Retained earnings and other reserves consist of the profit and loss account, the share-based awards reserve, the exchange movements reserve and excludes unrealised gains or losses on cash flow hedges and available for sale debt securities.

2. Intangible assets include goodwill, capitalised software and intangible assets arising on acquisition.

3. All the subordinated loan capital has been issued by CBL and is denominated in sterling. The subordinated loans have over five years until the final maturity date and the option for prepayment is solely at CBL's discretion therefore the full subordinated loan capital total of £75m has been included as lower Tier 2 capital.

3. Capital resources continued

There has been no change from 31 July 2009 and the terms are as follows:

Final maturity date	Prepayment date	Initial interest rate	**2010 £ million**
2020	2015	7.39%	**30.0**
2026	2021	7.42%	**15.0**
2026	2021	7.62%	**30.0**
			75.0

4. Capital adequacy

The group's policy has always been to be well capitalised and soundly funded. The group's approach to capital management is driven by strategic and organisational requirements, while also taking into account the regulatory and commercial environments in which it operates. In addition to maintaining a strong capital base to support the development of the business it is also important to ensure the group meets regulatory capital requirements at all times, and therefore maintains capital adequacy ratios comfortably above minimum regulatory requirements.

Internal capital adequacy assessment process ("ICAAP")

The introduction of Basel II has resulted in a formal requirement for the group, CBL and the offshore banks in Guernsey and the Isle of Man to each carry out internal capital adequacy assessments. A group-wide process has been developed to undertake this requirement and is now an integral part of the group's risk management processes. The board considers that given the group's risk profile an annual process is sufficient. The output from the process is a report for each entity required to carry out an ICAAP which addresses all material risks faced by the entity to determine the level of capital required against each major source of risk over a three-year time horizon which is the group's standard business planning timescale.

The group ICAAP was coordinated by the head of group risk reporting to the GRCC. Management at all levels within the group are involved by carrying out risk assessments for their business units, having input into stress testing and scenario analysis and where necessary approving inputs into the process. The ICAAP was subject to detailed review and approval by both the GRCC and by the board.

4. Capital adequacy continued

Capital requirement

The group's Pillar 1 capital requirement is set out in the table below. The Pillar 1 requirement in respect of credit risk is based on 8% of the risk weighted exposure amounts for each of the following standardised exposure classes in accordance with FSA rules.

	2010 £ million	2009 £ million
Credit risk - standardised approach		
Central governments or central banks	**-**	-
Regional governments or local authorities	**-**	-
Administrative bodies and non-commercial undertakings	**0.1**	0.5
Institutions	**10.8**	11.3
Corporates	**50.8**	33.4
Retail	**102.3**	84.7
Secured on real estate property	**34.4**	33.2
Past due items	**16.9**	13.5
Items belonging to regulatory high risk categories	**1.5**	2.5
Short-term claims on institutions and corporates	**15.7**	24.8
Collective investment undertakings	**0.6**	0.6
Other items	**16.0**	15.7
	249.1	220.2
Operational risk – basic indicator approach	**77.8**	79.5
Counterparty credit risk	**9.4**	7.0
Market risk - trading book		
Interest rate PRR[1]	**3.1**	2.0
Equity PRR[1]	**4.1**	2.7
Market risk - non trading book		
Foreign currency PRR[1]	**3.7**	3.5
Total Pillar 1 capital requirement	**347.2**	314.9

[1]Position Risk Requirement.

The operational risk requirement for 2009 has been rebased to include FY 2009 profits which had previously been excluded.

Counterparty credit risk requirement for 2009 has been re-classified to include securities financing transactions previously treated under credit risk.

5. Counterparty credit risk

Counterparty credit risk is the risk of loss as a result of a counterparty to a transaction defaulting before the final settlement of the transaction's cash flows.

Counterparty credit risk derives from securities financing transactions, namely a repurchase agreement in the Banking division and stock borrowing and lending in the Securities division. Additionally, the Securities businesses trade in the cash markets with regulated counterparties on a delivery versus payment basis such that any credit exposure is limited to price movements in the underlying securities.

The table in Section 4 shows that counterparty credit risk amounts to less than 3% (2009: less than 3%) of the overall capital requirement. Consequently, on the grounds of materiality, no further detail is provided on this risk.

6. Credit risk

Credit risk is the risk of loss if another party fails to perform its obligations or fails to perform them in a timely fashion. The following tables analyse regulatory credit risk exposures at 31 July 2010:

	2010 £ million	Average exposure in 2010 £ million
Standardised approach		
Central governments or central banks	**732.6**	607.4
Regional governments or local authorities	**0.2**	0.2
Administrative bodies and non-commercial undertakings	**1.2**	1.5
Institutions[1]	**508.6**	592.6
Corporates	**840.0**	790.4
Retail	**1,866.6**	1,766.7
Secured on real estate property	**623.9**	579.9
Past due items	**163.7**	159.5
Items belonging to regulatory high risk categories	**12.1**	15.9
Short-term claims on institutions and corporates[2]	**985.3**	975.8
Collective investment undertakings	**8.1**	8.2
Other items	**201.8**	189.7
	5,944.1	5,687.8

[1] Excluding those assessed as short-term claims on institutions and corporates.
[2] Where a short-term credit assessment is available.

The retail exposure class consists of loans to individuals and small and medium sized entities, which consist of a significant number of loans with similar characteristics. Past due items follows the regulatory definition as disclosed on page 15 and is net of any provisions made against such items. Short term claims on institutions are defined as exposures where a short term credit rating is held and the remaining maturity is less than twelve months.

6. Credit risk continued

Geographic distribution of exposures by regulatory exposure asset class at 31 July 2010:

	British Isles £ million	Europe £ million	Rest of world £ million	Total £ million
Standardised approach				
Central governments or central banks	732.6	-	-	**732.6**
Regional governments or local authorities	0.2	-	-	**0.2**
Administrative bodies and non-commercial undertakings	1.2	-	-	**1.2**
Institutions[1]	130.9	243.6	134.1	**508.6**
Corporates	775.5	34.4	30.1	**840.0**
Retail	1,807.3	58.2	1.1	**1,866.6**
Secured on real estate property	610.1	13.8	-	**623.9**
Past due items[2]	162.6	1.1	-	**163.7**
Items belonging to regulatory high risk categories	12.1	-	-	**12.1**
Short-term claims on institutions and corporates[3]	379.2	503.4	102.7	**985.3**
Collective investment undertakings	8.1	-	-	**8.1**
Other items	196.8	3.4	1.6	**201.8**
	4,816.6	**857.9**	**269.6**	**5,944.1**

[1] Excluding those assessed as short-term claims on institutions and corporates.
[2] Shown net of value adjustments and provisions.
[3] Where a short term credit assessment is available.

Residual maturity breakdown of regulatory exposure asset classes on a contractual basis at 31 July 2010:

	< 3 months £ million	3 months to 1 year £ million	1 to 5 years £ million	> 5 years £ million	Total £ million
Central governments or central banks	452.6	50.4	229.6	-	**732.6**
Regional governments or local authorities	-	-	0.2	-	**0.2**
Administrative bodies and non-commercial undertakings	0.1	0.3	0.8	-	**1.2**
Institutions[1]	10.0	-	498.4	0.2	**508.6**
Corporates	432.3	122.0	272.0	13.7	**840.0**
Retail	640.8	524.9	693.2	7.7	**1,866.6**
Secured on real estate property	249.8	244.1	130.0	-	**623.9**
Items belonging to regulatory high risk categories	0.1	-	12.0	-	**12.1**
Short-term claims on institutions and corporates[2]	489.1	496.2	-	-	**985.3**
Collective investment undertakings	-	-	8.1	-	**8.1**
Other items	111.0	24.0	63.6	3.2	**201.8**
	2,385.8	**1,461.9**	**1,907.9**	**24.8**	**5,780.4**

[1] Excluding those assessed as short-term claims on institutions and corporates.
[2] Where a short-term credit assessment is available.

The period greater than one year in institutions consists mainly of marketable securities. Past due items have been excluded from the above table.

6. Credit risk continued

Impairment of financial assets

Financial assets are assessed for impairment under three categories; loans and advances to customers, financial instruments classified as held to maturity and financial instruments classified as available for sale.

(a) Loans and advances to customers

Treatment

Impairment provisions are made if there is objective evidence of impairment as a result of one or more subsequent events regarding a significant loan or a portfolio of loans ("a loan") and its impact can be reliably estimated.

The amount of the loss is measured as the difference between the loan's carrying amount and the present value of estimated future cash flows, excluding future credit losses that have not been incurred, discounted at the original effective interest rate ("EIR"). All impairment losses are reviewed at least at each reporting date. If subsequently the amount of the loss decreases as a result of a new event, the relevant element of the outstanding impairment loss is reversed. Interest on impaired financial assets is recognised at the original EIR applied to the carrying amount as reduced by an allowance for impairment.

For loans that are not considered individually significant, the group adopts a formulaic approach which allocates a loss rate dependent on the overdue period. Loss rates are based on the discounted expected future cash flows and are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Differences in accounting and regulatory treatment

For accounting purposes, a financial asset is treated as impaired when a counterparty has failed to make a payment when contractually due. In contrast, under regulatory rules, a financial asset is treated as past due when the payment is ninety days past the contractual due date. Value adjustments and provisions required 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. The impairment provisions shown overleaf are the accounting values shown in note 33 of the group's annual report, where further relevant information can be found.

Analysis of impairment provisions

Impaired loans and advances to customers are analysed according to whether the impairment provisions are individually or collectively assessed.

Individually assessed provisions are determined on a case by case basis, taking into account the financial condition of the customer and an estimate of any potential recoveries and realisation of security or collateral. Broadly this methodology is applied by the property lending businesses and by the invoice finance business within Commercial.

Collectively assessed provisions are considered on a portfolio basis, to reflect the homogeneous nature of the assets. A percentage of the portfolio is impaired by evaluating the ageing of missed payments combined with the historical recovery rates for that particular portfolio. Broadly this methodology is applied by the Retail lending businesses and the asset finance business within Commercial.

The above outlines the group's approach towards provisioning and differs from FSA's definition of general/collective provisions. There are no general/collective provisions as defined by the FSA.

(b) Financial instruments classified as held to maturity

If there is objective evidence that a held to maturity asset is impaired, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's EIR.

6. Credit risk continued

(c) Financial instruments classified as available for sale

If there is objective evidence that an available for sale asset is impaired, the cumulative gains and losses recognised in equity are recycled to the income statement.

The following tables analyse impaired exposures as treated for accounting purposes and past due exposures as treated for regulatory purposes at 31 July 2010:

Gross impaired and past due exposures; impairment provisions, charges for impairment provisions by counterparty type at 31 July 2010:

	Gross impaired loans 2010 £ million	Gross past due loans 2010 £ million	Impairment provisions 2010 £ million	Charges for impairment provisions during the period to 2010 £ million
Corporates	198.2	170.8	52.0	31.9
Retail	83.7	52.3	30.5	27.4
Property	17.5	12.6	4.6	4.1
Total	**299.4**	**235.7**	**87.1**	**63.4**

Geographical analysis of gross impaired, gross past due exposures and impairment provisions at 31 July 2010:

	British Isles £ million	Europe £ million	Rest of world £ million	**Total £ million**
Gross impaired loans	296.5	2.9	-	**299.4**
Gross past due loans	232.0	3.7	-	**235.7**
Impairment provisions	84.5	2.6	-	**87.1**

Impairment provisions:

	£ million
Opening balance at 1 August 2009	71.2
Charge for the year	63.4
Amounts written off net of recoveries	(47.5)
Closing balance at 31 July 2010	**87.1**

7. Credit risk: standardised approach

The group uses external credit assessments provided by Moody's Investors Service ("Moody's") to determine the risk weight of rated counterparties in each standardised credit risk exposure class. Moody's is recognised by the FSA as an eligible external credit assessment institution for the purposes of calculating credit risk requirements under the standardised approach. The external ratings of Moody's are mapped to the prescribed credit quality step assessment scale that in turn produces standard risk weightings. Exposures to central governments and central banks have obtained a 0% risk weight from using external credit assessments and these are omitted from the tables below.

The tables below shows the exposure amounts associated with the credit quality steps and the relevant risk weightings as at 31 July 2010:

Institutions[1]

Credit quality step	Risk weight	Exposure
1	20%	385.4
2	50%	123.2
3	50%	-
4	100%	-
5	100%	-
6	150%	-
Total		**508.6**

Short-term claims on institutions and corporates[2]

Credit quality step	Risk weight	Exposure
1	20%	985.3
2	50%	-
3	100%	-
4	150%	-
5	150%	-
6	150%	-
Total		**985.3**

Corporates (rated exposures only)

Credit quality step	Risk weight	Exposure
1	20%	-
2	50%	24.8
3	100%	-
4	100%	-
5	150%	-
6	150%	-
Total		**24.8**

[1] Excluding those assessed as short-term claims on institutions and corporates.
[2] Where a short-term credit assessment is available.

8. Non-trading book exposures in equities

At 31 July 2010, the group had £28.4 million of equity investments in the non-trading book, of which £22.7 million were classified as available for sale and £5.7 million as held at fair value through profit or loss under the fair value option. Listed investments amounted to £11.5 million with the remainder being unlisted. Under regulatory rules one investment of £1.8 million was required to be deducted from capital. The capital requirement for the remainder amounted to £2.5 million, with £5.8 million of equity investments being classified as high risk for regulatory purposes. Cumulative gains from sales in the period were immaterial.

Equity investments classified as available for sale

These are recognised at fair value plus any directly attributable purchase costs, with changes being accounted for through equity. If such an asset is sold or there is objective evidence that they is impaired, the cumulative gains and losses recognised in equity are recycled through the income statement.

Equity investments designated at inception under the fair value option

These are equity shares fair valued where the resulting gains and losses are included in the income statement. Listed investments are valued at bid price. Unlisted investments comprise those made in various private equity limited liability partnerships. These partnerships themselves typically invest in unquoted companies via equity and loans and value each investment semi-annually in compliance with the International Private Equity and Venture Capital Valuation Guidelines, such valuations being externally audited annually.

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Movements in equity shares in the year to 31 July 2010 were as follows:

	Available for sale £ million	Fair value through profit or loss £ million
At 1 August 2009	25.4	12.6
Additions	-	0.2
Disposals	-	(10.9)
Currency translation differences	(0.3)	-
Disposals of subsidiary undertakings	-	-
Increase/(decrease) in carrying value of:		
Equity shares classified as available for sale	(2.4)	-
Listed equity shares held at fair value	-	-
Unlisted equity shares held at fair value	-	3.8
At 31 July 2010	**22.7**	**5.7**

9. Interest rate risk in the non-trading book

The group's exposure to interest rate fluctuations relates primarily to the returns from its capital and reserves which, as a matter of policy, are not hedged. The group's policy is to match fixed and variable interest rate liabilities and assets utilising interest rate swaps where necessary to secure the margin on its loans and advances to customers.

The sensitivities below are based upon reasonably possible changes in interest rate scenarios, including parallel shifts in the yield curve. At 31 July 2010 a 1% increase and 0.5% decrease in interest rates compared to actual rates would increase/(decrease) the group's annual net interest income by the following amounts, prior to mitigation:

	2010 **£ million**
1.0% increase	**3.1**
0.5% decrease	**(1.6)**

The above analysis is calculated in sterling as, apart from currency investments in subsidiaries and associates where the policy decision has been taken not to hedge such exposures, the group's exposure to foreign exchange risk is minimal.