Provident Financial plc

Pillar III regulatory capital disclosures – April 2012

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1. Introduction

1.1 Background

The Provident Financial plc group (the group) comprises two principal trading operations:

- The Consumer Credit Division (CCD) providing home credit to the non-standard UK consumer credit market; and

- Vanquis Bank which provides credit cards to the non-standard UK consumer credit market.

Vanquis Bank holds a banking licence, accepts retail deposits and is regulated by the Financial Services Authority (FSA). In its supervisory role, the FSA sets specific requirements relating to capital adequacy, liquidity management and various controls and procedures set out in the FSA BIPRU handbook. In addition, Vanquis Bank holds a consumer credit license and is regulated by the Office of Fair Trading (OFT).

CCD operates under a number of consumer credit licences granted by the OFT but is not regulated by the FSA. However, the group, incorporating both CCD and Vanquis Bank, is the subject of consolidated supervision by the FSA by virtue of Provident Financial plc being the parent company of Vanquis Bank. The FSA sets specific requirements for the consolidated group in respect of capital adequacy and is regulated under the FSA GENPRU handbook.

1.2 BASEL II

The BASEL II regulatory framework revised the BASEL I regulatory framework. The aim of BASEL II is to make regulatory capital requirements more risk sensitive and representative of risk management controls and procedures in place within firms.

The BASEL II regulatory framework was implemented in the European Union via the Capital Requirements Directive (CRD). The group and Vanquis Bank adopted the CRD with effect from 1 January 2008. The CRD comprises three Pillars:

- Pillar I is the calculation of minimum regulatory capital requirements which firms are required to hold against risk, the most significant elements for the group being credit risk and operational risk.

- Pillar II requires an Internal Capital Adequacy Assessment Process (ICAAP) by firms to assess whether additional regulatory capital over and above Pillar I should be held based on the risks faced by a firm and the risk management processes in place. A firm's Individual Capital Guidance (ICG) is set by the FSA based on the ICAAP.

- Pillar III complements Pillars I and II and aims to encourage market discipline by developing a set of disclosure requirements which allow market participants to assess key pieces of information on a firm's capital, risk exposures, risk management processes and remuneration.

The Basel III regulatory framework was finalised in December 2010 by the Basel Committee on Banking Supervision. The impacts of the framework are to be phased in globally between 2013 and 2019 but have yet to be formally implemented in the UK. The 2012 Pillar III regulatory capital disclosures have therefore been produced based on the Basel II framework.

1. Introduction (continued)

1.3 Pillar III disclosure policy

The group's Pillar III disclosure policy is as follows:

Frequency of disclosures

Pillar III regulatory capital disclosures will be made on an annual basis using the group's year-end date of 31 December. The disclosures will be published by 30 April each year. More frequent disclosures will be made if there is a material change in the nature of the group's risk profile during any particular year.

Media and location of Pillar III disclosures

The Pillar III regulatory capital disclosures will be published on the group's corporate website www.providentfinancial.com.

Board approval

The group's Pillar III regulatory capital disclosure policies were approved by the Board of Directors (the Board) on 19 June 2008.

1.4 Basis of Pillar III disclosures

The Pillar III disclosures have been prepared for the group as a whole in accordance with the rules laid out in the FSA Handbook BIPRU Chapter 11. The disclosures provide information on the capital adequacy and risk management processes of the group.

The results of all subsidiary undertakings have been included in the Pillar III disclosures. Vanquis Bank's requirement to maintain regulatory capital above a level determined by the FSA could restrict the ability and size of dividend payments made to Provident Financial plc. There are no other current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayments of liabilities between Provident Financial plc and its subsidiary undertakings.

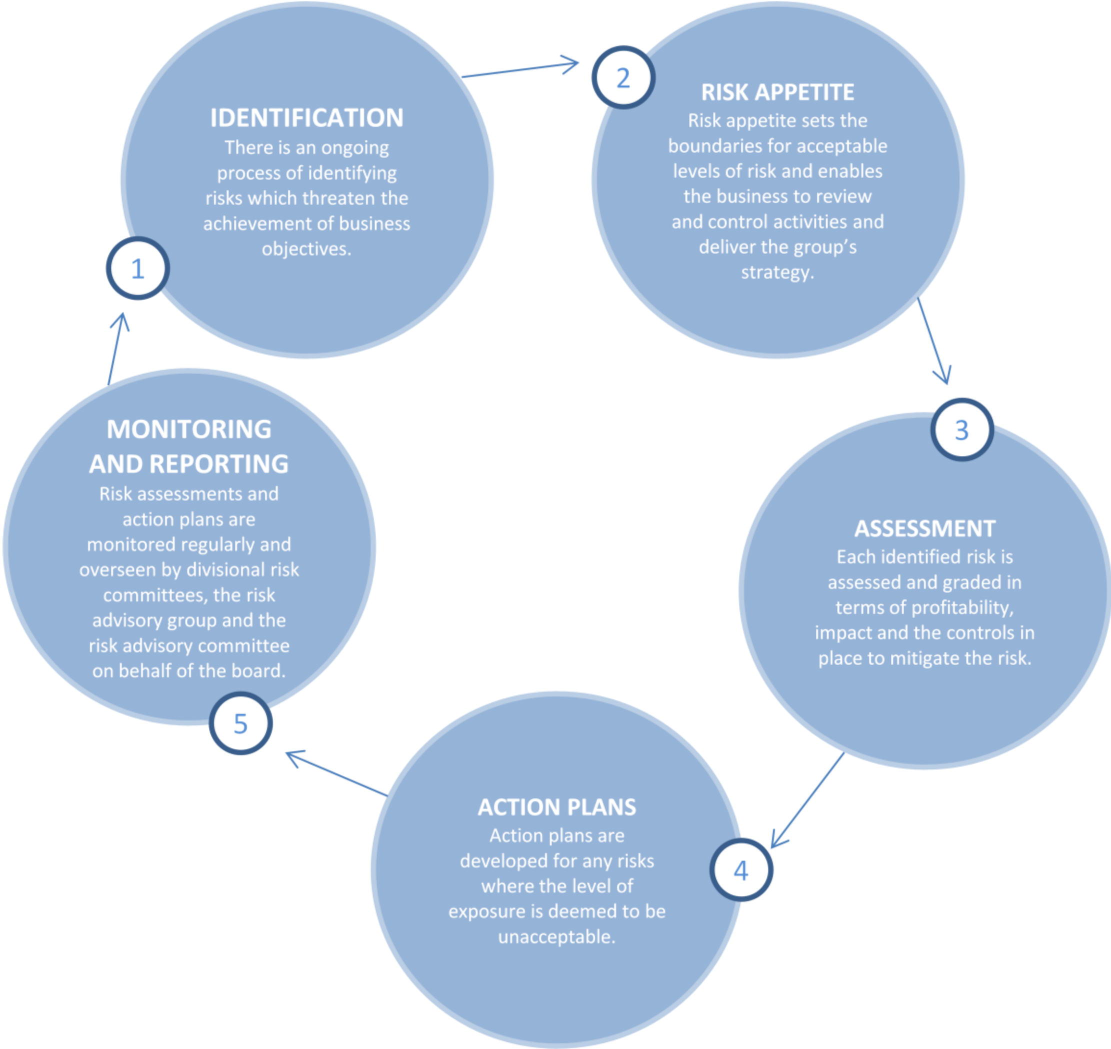
The Pillar III disclosures were approved for publication by Provident Financial plc and Vanquis Bank on 26 April 2012.

From 2011, Vanquis Bank have been required to prepare remuneration code Pillar III disclosures in addition to the regulatory capital disclosures. These disclosures are the subject of a separate and stand-alone document and are published on the Vanquis Bank website, www.vanquis.co.uk, on an annual basis.

2. Risk management objectives and policies

2.1 Risk management objectives

The board is responsible for the alignment of strategy and risk, and for maintaining a sound-system of risk management and internal controls. The system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and maintain a sufficient level of regulatory capital in excess of the Individual Capital Guidance (ICG) set by the FSA. The framework incorporates a five-stage process as detailed in the diagram below:



2.2 ICAAP

In accordance with the CRD, the group is required to conduct an ICAAP on an annual basis or more frequently if there is a material change in the nature, trading status or risk profile of the group. The ICAAP allows the Board to assess whether the group's risk management objective is being met.

The key output of the ICAAP is a document which:

- Provides a background to the group including the group structure, strategy, key management and the internal control framework and risk management processes;

2. Risk management objectives and policies (continued)

- Calculates the minimum capital required for credit risk and operational risk under Pillar I of the CRD for both the group and Vanquis Bank;
- Identifies the various additional risks facing the group and Vanquis Bank not included in Pillar I and considers the required level of additional capital to be held against those risks (Pillar II of the CRD);
- Calculates the overall regulatory capital requirement of the group and Vanquis Bank as a result of Pillar I and Pillar II; and
- Performs stress testing on the group's budget projections to ensure that the group's calculated regulatory capital requirement is sufficient even under extreme scenarios.

The group and Vanquis Bank operate to the ICGs set by the FSA in June 2011.

The ICAAP is embedded into the group and Vanquis Bank's risk management framework. The group and Vanquis Bank's risk registers are periodically updated to ensure each of the risks are allocated into the FSA risk categories. In addition, estimates are made of the level of regulatory capital, if any, that should be held against each risk and then, after aggregating these amounts, this total is compared to the group and Vanquis Bank's regulatory capital requirement as set by the FSA and the group and Vanquis Bank's actual level of regulatory capital. On an annual basis, or more frequently if required, the group's ICAAP document is updated and approved by the Board.

Sections 2.3 and 2.4 of this report set out:

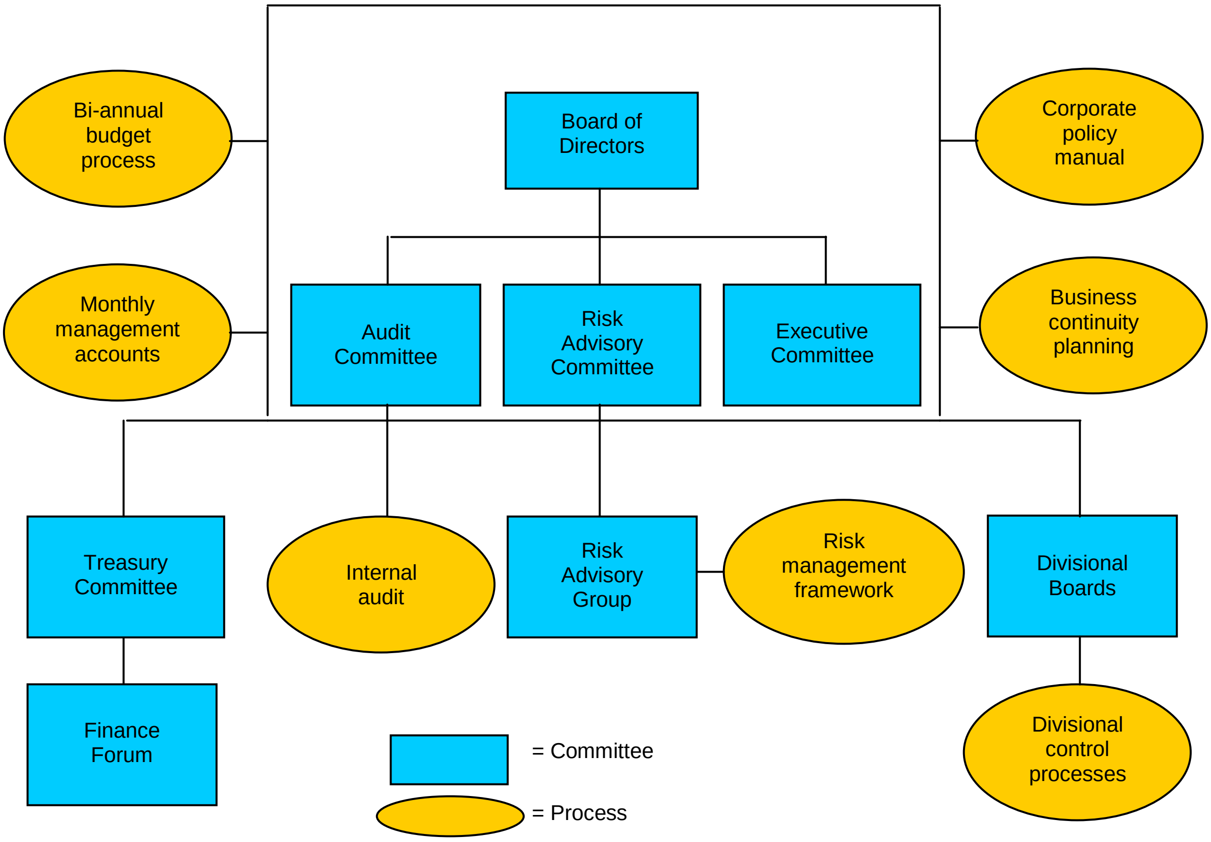
- The key features of the group and Vanquis Bank's internal control and risk management framework that are assessed as part of the ICAAP; and

- The key risks which are considered within the ICAAP to assess the overall level of regulatory capital required to be held by the group and Vanquis Bank after taking account of the adequacy of the group's internal control and risk management framework.

2.3 Internal control and risk management framework

The overall group internal control and risk management framework is the responsibility of the group Board. Certain responsibilities in respect of internal control and risk management are delegated to various sub-committees who report directly to the group Board. The group Board and its committees are supported by various policies, procedures and reporting mechanisms as set out in the following chart:

2. Risk management objectives and policies (continued)



The group's risk appetite is defined by the policies, controls and approval limits determined within the internal control and risk management framework. This ensures that the group has an effective system of internal control and risk management to manage the group prudently within its regulatory capital requirements and to mitigate the potential for material financial loss to the business. Taking each of the above control mechanisms in turn:

Board of Directors

The Board is responsible for the group's overall system of internal control and for reviewing its effectiveness. The Board comprises three executive directors, three non-executive directors and a non-executive Chairman and normally meets nine times a year including an annual two day planning conference. The Board delegates authority to a number of formal sub-committees including the Audit Committee, the Risk Advisory Committee and the Executive Committee.

The Board is considered to be well-balanced and has significant financial services and public company experience.

2. Risk management objectives and policies (continued)

Audit Committee

The Audit Committee comprises the non-executive directors and is chaired by Manjit Wolstenholme. The Finance Director, Chief Executive, Managing Director of CCD, Head of Audit & Risk, Group Financial Controller and the external audit partner from PricewaterhouseCoopers normally attend all meetings by invitation. The Audit Committee meets four times a year and is responsible for monitoring group-wide internal financial controls, appointment and appraisal of the external auditors, agreeing the internal audit plan each year, reviewing the reports produced by internal audit and reviewing the group's whistle-blowing policy. The Audit Committee also reviews the financial statements, interim reports and preliminary announcements of the group including any significant accounting judgements made in preparing them.

Internal audit

The group's internal audit function is provided by an in-house team led by the Head of Audit & Risk. The internal audit function is supplemented by external advisors where appropriate.

An annual programme of work is established and approved by the Audit Committee which targets and reports on higher risk areas as identified by the group's key risk registers. The Board and Audit Committee papers include a summary of the results and recommendations from each internal audit review and a follow-up of previously reported recommendations.

Risk Advisory Committee (RAC)

The group's risk management framework is managed by the RAC on behalf of the Board. The RAC comprises the three non-executive directors and the Finance Director and is chaired by Rob Anderson. The remaining executive directors, Head of Audit & Risk and Group Financial Controller normally attend by invitation. The RAC keeps the group's risk registers under review, considers the most important risks facing the group and is responsible for approving the group's annual Documented Risk Assessment (DRA) and ICAAP document prior to submission to the Board. The RAC meets at least three times a year and delegates a number of responsibilities to the Risk Advisory Group (RAG).

Risk Advisory Group (RAG)

The RAG comprises the executive directors, the Company Secretary, the Head of Audit & Risk and the Group Financial Controller. Divisional risk directors attend by invitation. The RAG is chaired by the Finance Director and formally meets at least four times a year and considers the group's risk management framework and risk appetite including the extent and nature of the risks facing the group, the extent and categories of risk which are acceptable to bear, the likelihood of the risk materialising, the group's ability to mitigate the risk, and the costs of operating particular controls relative to the benefits obtained. It also reviews the risk registers prepared by the divisional risk committees each quarter, challenging and making changes where appropriate. In addition, it has primary responsibility for producing the DRA and the ICAAP document. It submits a schedule of key risks, divisional key risk registers, the DRA and the ICAAP document to the RAC for review and approval.

2. Risk management objectives and policies (continued)

Executive Committee

The Executive Committee comprises the three executive directors and is chaired by the Chief Executive. The committee normally meets at least once a week, and more frequently as required, and deals with matters relating to the general running of the group. These matters include monitoring the weekly performance of the group's businesses, approving capital expenditure projects and long-term contracts subject to certain limits, approving treasury related transactions and annually reviewing corporate and accounting policies.

Treasury Committee

The Treasury Committee is chaired by the Finance Director and comprises the Group Treasurer, the divisional finance directors, the Group Financial Controller, the Head of Tax and the Group Accountants. The Treasury Committee manages the treasury activities of the group and meets at least six times a year. The Treasury Committee is not a formal sub-committee of the Board but it regularly reports to the Board on compliance with treasury policies and other treasury matters. The Treasury Committee is also responsible for monitoring the group's capital adequacy and liquidity positions.

Finance Forum

The Finance Forum is chaired by the Finance Director and comprises the heads of finance, treasury, tax and legal within the group. The role of the Finance Forum is to monitor and discuss accounting and internal control issues, trading performance, tax and investor relations matters. The Finance Forum meets at least six times a year in conjunction with the Treasury Committee.

Divisional Boards

The group has two divisional Boards; CCD and Vanquis Bank. Each divisional Board is responsible for the day-to-day operations of their division. The divisional Boards have implemented various controls to mitigate the risks specific to their business. Further information on the Vanquis Bank board has been included on page 8 below.

Divisional control processes

The divisions have a number of important controls to manage risk as follows:

<u>CCD</u>

In addition to the control from the divisional Board and those group-wide controls set out above, the most significant divisional controls within CCD are as follows:

- *Project Governance* – A governance framework to oversee significant business projects.
- *Risk, Governance and Compliance Committee (RGCC)* – Responsible for the management and reporting of risk and for updating the divisional risk register on at least a quarterly basis.
- *Risk management function* – Supports the RGCC in the identification and management of risks.
- *Credit and Consumer Portfolio Management Committee (CCPMC)* – Implements credit policy and monitors credit performance.
- *Field risk* – Responsible for the detection of fraud in the field operations.

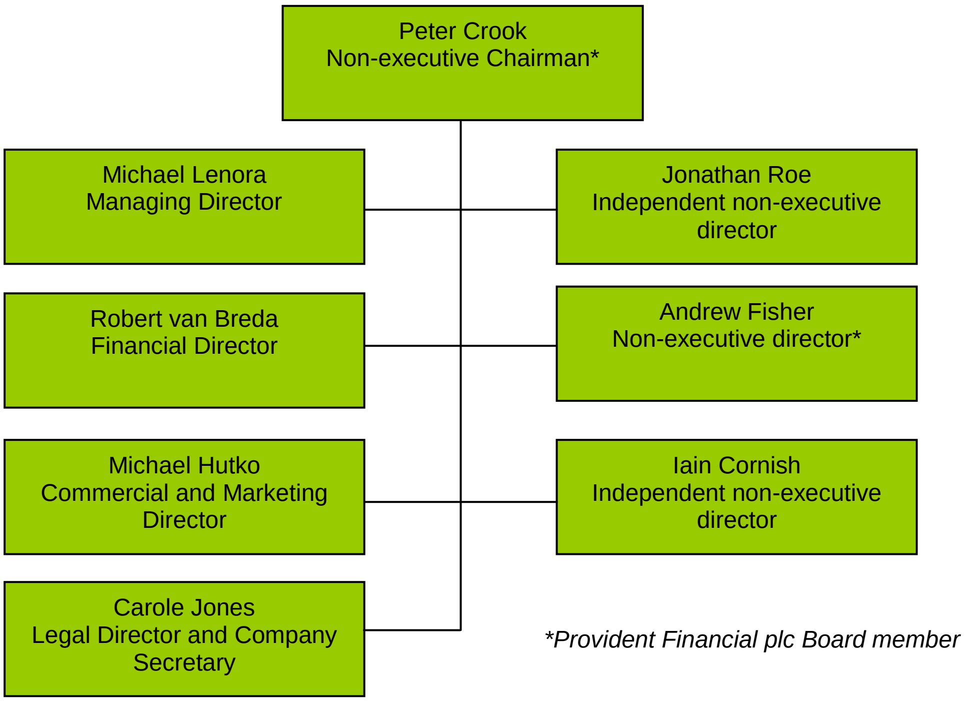
2. Risk management objectives and policies (continued)

- *Compliance function* – Responsible for assessing compliance with laws and regulations.
- *Hierarchy of field structure* – Well-established hierarchical structure to manage and control the field workforce.
- *Field Audit* – Responsible for the auditing of the field network covering locations over a 3 year cycle.
- *Financial and Operational Performance Committee (FOPCO)* – Responsible for the challenge and monitoring of significant financial and operational matters.
- *Modernisation and Strategic Planning Group (MASP)* – Oversees the modernisation programme.
- *Agent Policy Steering Group* – Monitors compliance with policies relating to the self-employed status of agents.

<u>Vanquis Bank</u>

As a regulated entity with a banking licence, Vanquis Bank replicates a number of the internal control and risk management processes typically only held at a group level in many organisations.

The Board of Vanquis Bank is as follows:



**Provident Financial plc Board member*

The Vanquis Bank Board comprises four executive directors, two independent non-executive directors and two non-executive directors. The Board of Vanquis Bank is considered to be well-balanced with significant financial services and public company experience.

2. Risk management objectives and policies (continued)

In addition to the group-wide controls set out above, the most significant controls within Vanquis Bank are as follows:

- *Project Governance* – An executive sign-off committee to oversee project justification and execution.
- *Audit Committee* – Responsible for monitoring internal controls and accounting policies/issues. Chaired by an independent non-executive director.
- *Risk Committee* – Responsible for the management and reporting of risk and for updating the divisional risk register on at least a quarterly basis. Chaired by an independent non-executive director.
- *Treasury Committee* – Responsible for the day-to-day monitoring of liquidity and capital requirements and responsible for the monitoring and control of retail deposit taking activity in line with the strategic targets set by the group Treasury Committee.
- *Deposits Committee* – A sub-committee of the Vanquis Bank Treasury Committee with delegated responsibility for retail deposit pricing, tranche size and product changes.
- *Remuneration Committee* – Responsible for remuneration policy implementation and compliance.
- *Risk management function* – Supports the Risk Committee in the identification and management of risks.
- *Credit Committee* – Implements credit policy and monitors credit performance.
- *Risk identification and controls self assessment framework* – Ongoing self assessment of control effectiveness against identified risks facing each business area.
- *Compliance Committee* – Responsible for compliance and TCF.
- *Compliance function* – Responsible for assessing compliance with laws and regulations.
- *In-house reviews* – An internal audit function which performs specific Vanquis Bank audit reviews and works with group internal audit function in determining risk areas for review.
- *Early warning bulletin* – A pre-determined process to escalate potential business issues throughout the business.
- *Change Advisory Board* – Provides control over business change.

The governance framework of Vanquis Bank was reviewed by the FSA as part of an ARROW visit at the end of 2009 with no specific action points being raised in respect of a risk mitigation plan.

Bi-annual budget process

Each division produces a formal budget in November each year covering the current year out-turn, the budget for the following year and the forecast for the four subsequent years. The budgets are fully aligned with the group's strategy. Each division presents its budget to the executive directors before the budgets are consolidated and submitted to the Board for approval at the December Board meeting. A formal budget update is produced in May of the following year which is again approved by the Board at its June Board meeting.

2. Risk management objectives and policies (continued)

Monthly management accounts

Monthly management accounts are prepared comparing actual trading results by division to budget and the prior year. Capital adequacy, funding and economic trends are also reported monthly. A rolling forecast of the full year out-turn is produced as part of the management accounts pack. Management accounts are distributed to the executive directors and senior members of the management team on a monthly basis and are distributed to the Board for each Board meeting.

Corporate policy manual

The group has a corporate policy manual which is fully aligned with the group's risk management framework and risk appetite and sets out authority levels within the group. The corporate policy manual is distributed to the divisional Boards which are required to confirm compliance with these policies on a bi-annual basis and outline any areas of non-compliance during the year.

Risk management framework

The group has a risk management framework which details how the group meets the requirements of the corporate policy on risk management, describes the group's approach to risk management and outlines the key roles and responsibilities for the management of risk. The key elements of the risk management framework include the group's risk universe, risk appetite, risk assessment processes and risk management and monitoring. The risk management framework is formally reviewed and approved by the RAC annually.

Business continuity planning

Each division is responsible for preparing, maintaining and testing its own business continuity plans and ensuring that their plans are fit for purpose within the framework and strategy agreed by the RAG.

2.4 Key risks faced by the group

In the course of its business, the group is exposed to a wide range of risks. For the purposes of undertaking the ICAAP, the group's risks are categorised into the group's risk universe categories which are:

- Credit risk;
- Business/strategic risk;
- Operational risk;
- Financial risk; and
- Regulatory risk.

As part of the ICAAP process, the group's risk universe categories are mapped to the FSA's GENPRU 1.2.30 risk classes to ensure that all GENPRU risk categories have been considered.

The definition of these risks and the associated controls and procedures in place to mitigate the risks are as follows:

2. Risk management objectives and policies (continued)

2.4.1 Credit risk

Credit risk is the risk that the group will suffer loss in the event of a default by a customer or bank or other counterparty. A default occurs when the customer or a counterparty fails to honour repayments as they fall due. Customer defaults in the non-standard credit market are typically higher than in more mainstream markets although demonstrate greater stability if properly managed. In addition, current economic conditions remain challenging which has led to pressure on customers' disposable incomes from food, fuel and utility price inflation and increased levels of unemployment and under-employment.

CCD

Credit risk within CCD is managed by the CCD credit committee which meets at least every two months and is responsible for approving product criteria and pricing.

Credit risk is managed using a combination of lending policy criteria, credit scoring (including behavioural scoring), policy rules, individual lending approval limits, central underwriting, and a home visit to make a decision on applications for credit.

The loans offered by the weekly Home Credit business are short-term, typically a contractual period of around a year, with an average value of approximately £500. The loans are underwritten in the home by an agent with emphasis placed on any previous lending experience with the customer and the agent's assessment of the credit risk based on a completed application form and the home visit. Once a loan has been made, the agent visits the customer weekly, or in some cases monthly, to collect payment. The agent is well placed to identify signs of strain on a customer's income and can moderate lending accordingly. Equally, the regular contact and professional relationship that the agent has with the customer allows them to manage customers' repayments effectively even when the household budget is tight. This can be in the form of taking part-payments, allowing missed payments or occasionally restructuring the debt in order to maximise cash collections.

Agents are almost entirely paid commission for what they collect and not for what they lend, so their primary focus is on ensuring loans are affordable at the point of issue and then on collecting cash. Affordability is reassessed by the agent each time an existing customer is re-served, or not as the case may be. This normally takes place within 12 months of the previous loan because of the short-term nature of the product. Arrears management within Home Credit is a combination of central letters, central telephony, and field activity undertaken by field management. This will often involve a home visit to discuss the customer's reasons for non-payment and to agree a resolution.

CCD tightened the underwriting criteria for both new and existing customers during 2011 and has enhanced its arrears management processes during the year.

Vanquis Bank

Credit risk within Vanquis Bank is managed by the Vanquis Bank credit committee which meets at least quarterly and is responsible for ensuring that the approach to lending is within sound risk and financial parameters and that key metrics are reviewed to ensure compliance to policy.

2. Risk management objectives and policies (continued)

A customer's risk profile and credit line is evaluated at the point of application and at various times during the agreement. Internally generated scorecards based on historic payment patterns of customers are used to assess the applicant's potential default risk and their ability to manage a specific credit line. For new customers, the scorecards incorporate data from the applicant, such as income and employment, and data from external credit bureaus. Initial credit limits are low, typically £250. For existing customers, the scorecards also incorporate data on actual payment performance and product utilisation and take data from an external credit bureau each month to refresh customers' payment performance position with other lenders. Credit lines can go up as well as down according to this point-in-time risk assessment.

All Vanquis Bank customers receive a welcome call as part of the acceptance process, which is unique in the credit card industry. The call provides the opportunity to gather additional information which is useful to help manage the customer's account at a later date. It is also an important element of the underwriting in that an application will generally be turned down if contact cannot be made with a potential customer.

Arrears management is a combination of central letters, text messages, inbound and outbound telephony and outsourced debt collection agency activities. Contact is made with the customer to discuss the reasons for non-payment and specific strategies are employed to support the customer in returning to a good standing.

Vanquis Bank continue to maintain tight underwriting controls for new accounts and credit line increases following progressive tightening between 2007 and mid-2009 in light of economic conditions.

Bank counterparties

Counterparty credit risk arises as a result of cash deposits placed with banks and the use of derivative financial instruments with banks and other financial institutions which are used to hedge interest rate risk and foreign exchange rate risk.

Counterparty credit risk is managed by the group's treasury committee and is governed by a board approved counterparty policy which ensures that the group's cash deposits and derivative financial instruments are only made with high quality counterparties with the level of permitted exposure to a counterparty firmly linked to the strength of its credit rating. In addition, there is a maximum exposure limit for all institutions, regardless of credit rating. This is linked to the group's regulatory capital base in line with the group's regulatory reporting requirements on large exposures to the FSA.

2.4.2 Business/strategic risk

The group's business/strategic risk category comprises reputational risk, business risk, market risk and concentration risk. Risk descriptions together with the key controls in place to mitigate the risks are set out below:

Reputational risk

Reputational risk is the risk that an event or circumstance could adversely impact on the group's reputation. Operating in the non-standard market leads to greater scrutiny of the group's activities and any adverse publicity from the activities of legislators, pressure groups and the media could potentially have a detrimental impact on the group's sales and collections activities. In particular, media and pressure group activity can increase during an

2. Risk management objectives and policies (continued)

economic downturn or when the group is performing well. In addition, there is currently significant media interest in the non-standard sector primarily focussed on the activities of the fast growing payday lending industry.

Reputational risk is managed in a number of ways. At a group level there is a dedicated team and established procedures for dealing with media issues. Credit and collection policies are designed to ensure that both businesses adhere to responsible lending principles. In Vanquis Bank, a Compliance Committee oversees the application of the FSA's treating customers fairly regime. In addition, a pro-active communication programme to foster a better understanding of the group's products is co-ordinated at a group level.

Both divisions regularly conduct customer satisfaction surveys to ensure that customer's needs are being met and that customers are satisfied with the service they are receiving. Customer satisfaction in the Home Credit business is 91% (2010: 91%) and in Vanquis Bank is 84% (2010: 84%). In addition, customer complaints remain low in both businesses.

The group is very proud to have received a maximum rating score of 100 and was ranked joint first globally amongst financial services companies in the FTSE4Good Index Series which measures the environmental, social and governance ratings of over 2,300 publicly listed companies worldwide. This achievement reflects the continued investment that the group and its employees have made in embedding the corporate responsibility programme across all areas of the business.

Continued investment and focus on corporate responsibility and investment in a group co-ordinated community programme helps to foster good relations with customers and the areas in which they live.

Business risk

Business risk is the risk of loss arising from the failure of the group's strategy or management actions over the planning horizon. Continued pressure on customers' incomes from rises in fuel, food and utility costs and a protracted period of weak or negative growth in the UK economy could impact the demand for credit, impairments and the group's growth plans.

The group has developed a clear strategy to grow the business by focusing on being the leading lender to the c.10 million people in the UK who make up the non-standard market. To deliver the strategy the group aims to grow its existing businesses in a controlled manner by developing new distribution channels; developing or acquiring new products and services to meet the changing needs of customers; and enhancing business processes to ensure that the group remains efficient and competitive.

The business risk associated with failure to deliver the group strategy is mitigated by a number of actions:

- A board strategy and planning conference is held annually;
- Central resource is in place to develop corporate strategy;
- New products or processes are thoroughly tested prior to roll-out;
- There is comprehensive monitoring of competitor products, pricing and strategy;
- Robust business change functions oversee change programmes;
- The group has comprehensive monthly management accounts, a monthly rolling forecast and a biannual budgeting process;
- Loans are short term in nature and, in Home Credit, agents visit customers in their homes and are therefore able to stay up to date with customer circumstances.

2. Risk management objectives and policies (continued)

- The group has demonstrated the ability to manage the business through many cycles including the deterioration seen in the UK economy and employment market during 2008 and 2009.

Market risk

Market risk is the risk of loss due to adverse market movements caused by active trading positions taken in interest rates, foreign exchange markets, bonds and equities.

The group's corporate policies do not permit it to undertake position taking or trading books of this type and therefore it does not do so.

Concentration risk

Concentration risk is the risk arising from the lack of diversification in the group's business either geographical, demographic or by product.

The group's operations are concentrated wholly in the non-standard consumer credit market in the UK and Republic of Ireland which may indicate concentration risk. However, the group's customer base is well diversified throughout the UK and the Republic of Ireland and is not concentrated in a particular region. In addition, the group offers a number of different products within CCD in addition to the Vanquis Bank credit card to ensure that there is not an over reliance on a particular product.

2.4.3 Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems.

The group manages operational risk as part of the risk management process which is overseen by the RAC. Each division has the responsibility for putting in place appropriate controls to mitigate operational and other risks. Both CCD and Vanquis Bank operate their own risk functions whose responsibility it is to monitor operational risks at a divisional level, monitor the controls in place to mitigate those risks and determine the likelihood, value and impact of the risks. Regular reporting of all risks, including operational risk, is presented to the divisional boards and to the RAG on a quarterly basis by means of updated risk registers.

The principal operational risks and the key controls in place to mitigate those risks are as follows:

- **IT systems** - Like any other financial services organisation, the group's divisions rely on the effective and efficient use of IT systems. IT is managed on a divisional basis by experienced management teams with the use of third party contractors and by experienced management teams with the use of third party contractors and consultants where necessary. Vanquis Bank is reliant on a third party provider (FDI) for its core IT platform and Newcastle Building Society (NBS) for its retail deposit platform, and IT systems in Home Credit are hosted by an external third party provider (Node4).

  The group has disaster recovery procedures and policies in place which are designed to allow the group to continue trading in the event of such a disaster. These policies and procedures are tested on a regular basis.

2. Risk management objectives and policies (continued)

Significant changes to IT systems are managed by dedicated project teams in each division. This ensures that specialist resource is utilised to plan, test and deliver new systems enabling other resources to continue with business as usual activities.

- **Health and safety** - Agents in Home Credit are required to carry cash to operate as agents. The health and safety of employees and agents is a key concern for the group. As a result, the group invests a considerable amount of time ensuring staff are safety conscious. It also assists agents to ensure that they are safety aware. Induction sessions and regular updates are provided on safety awareness and safety awareness weeks form part of the annual calendar.

- **Fraud** - The group can be the subject of fraud by customers, employees and agents. Both CCD and Vanquis Bank operate specialist departments to identify, investigate and report on fraudulent activity. Fraud reports are presented to the divisional boards and the group Audit Committee.

- **Data loss** – Both Home Credit and Vanquis Bank utilise and store sensitive personal data as part of their day to day operations. The group ensure that dedicated resources are in place to support the management of information security and maintain stringent IT and physical security policies. In addition, security related incidents are reported to divisional risk committees and regular fraud reporting is made to the divisional boards and to the group audit committee.

- **Recruiting and retaining highly skilled management and staff** - The group is dependent on the executive directors and the senior management team to deliver the group's strategy. The group maintains effective recruitment, retention and succession planning strategies and monitors remuneration and incentive structures to ensure that they are appropriate and competitive. The group also ensures that there are training and development opportunities and effective staff communication throughout the business.

In addition to the above mitigating controls, the group also maintains a range of insurance policies to cover eventualities such as business interruption, loss of IT systems and crime.

2.4.4 Financial risk

Financial risk is the risk of financial loss, whether in the form of profit, cash or capital, due to inadequate financial controls and processes. The group's financial risk category comprises liquidity risk, tax risk, interest rate risk, foreign exchange risk and pension risk. Risk descriptions together with the key controls to mitigate these risks are set out below:

Liquidity risk

Liquidity risk is the risk that the group will have insufficient liquid resources available to fulfil its operational plans and/or to meet its financial obligations as they fall due particularly as a result of the wider ongoing restriction of credit available from banks and institutional investors continues.

Liquidity risk is managed by the group's centralised treasury department through daily monitoring of expected cashflows in accordance with a board approved group funding and liquidity policy. This process is monitored regularly by the treasury committee.

2. Risk management objectives and policies (continued)

The group's funding and liquidity policy is designed to ensure that the group is able to continue to fund the growth of the business. The group therefore maintains headroom on its committed borrowing facilities to fund growth and contractual maturities for at least the following 12 months, after assuming that Vanquis Bank will fund 80% of its receivables book through retail deposits.

The group is less exposed than other mainstream lenders to liquidity risk as the loans issued by the Home Credit business, the group's largest business, are of short-term duration (typically around one year) whereas the group's borrowings extend over a number of years.

Headroom on committed facilities as at 31 December 2011 was £288m which, together with the retail deposits programme at Vanquis Bank and the renewal of syndicated bank facilities of £382.5m in February 2012, is sufficient to meet growth and contractual maturities until May 2015. The group's committed borrowing facilities had a weighted average maturity of 3.5 years as at 31 December 2011 (2010: 3.5 years) which was extended to 4.6 years following the renewal of syndicated bank facilities.

The group has continued to make excellent progress in diversifying its funding base. Vanquis Bank commenced taking retail deposits in July 2011 and had raised £140m of retail deposits by the end of 2011 which had increased to over £200m during February 2012. The business is on target to achieve funding up to 80% of its receivables with deposits by the end of 2012. In addition to the deposits programme, the group issued a retail bond of £50m and £140m of private placements in the first half of 2011, including £100m from M&G Investments. The group remains an investment grade credit, with a credit rating maintained at BBB with a stable outlook.

As part of its obligations as a Simplified Individual Liquidity Adequacy Standards (ILAS) Firm under the FSA's liquidity regime, Vanquis Bank undertakes stress testing and produces an Individual Liquidity Systems Assessment (ILSA) at least annually that informs liquidity policy. Key elements of this policy are to maintain sufficient buffers and committed facilities to meet obligations should stress events occur to funding inflows (for example suspension of deposit taking activities) and outflows (for example increased level of customer transactions). The ILSA also incorporates the company's Contingency Funding Plan which documents mitigating actions and procedures to be followed in the event of liquidity stress events.

In addition to these policies, Vanquis Bank maintains a liquid assets buffer which is calculated based on undrawn credit card commitments and the maturity of deposits, and in accordance with the FSA's transitional arrangements. As at 31 December 2011, the liquid assets buffer amounted to £17.5m (2009: £10.0m).

Tax risk

Tax risk is the risk of loss arising from changes in tax legislation or practice, or the risk of loss arising from non-compliance with existing legislation.

The group has a Board approved tax strategy. The group's overall tax risks are managed by an in-house tax team who are responsible for managing the group's tax affairs. In addition, advice from external professional advisors is sought for all material transactions and, where possible, tax treatments are agreed in advance with any relevant authorities.

The group's in-house tax team works closely with external advisors on key corporate and indirect tax matters.

2. Risk management objectives and policies (continued)

Interest rate risk

Interest rate risk is the risk of a change in external interest rates which leads to an increase in the group's cost of borrowing.

The group's exposure to movements in interest rates is managed by the Treasury Committee and is governed by a board-approved interest rate hedging policy which forms part of the group's treasury policies.

The group seeks to limit the net exposure to changes in interest rates. This is achieved through a combination of issuing fixed-rate debt and by the use of derivative financial instruments such as interest rate swaps.

Compared to other lenders, the group's interest cost is a relatively small part of the group's cost base, representing only 9.3% of total costs in the year ended 31 December 2011.

Foreign exchange rate risk

Foreign exchange rate risk is the risk of a change in foreign currency exchange rates leading to a reduction in profits or equity.

The group's exposure to movements in foreign exchange rates is monitored monthly by the Treasury Committee and is governed by a board-approved foreign exchange rate risk management policy which forms part of the group's treasury policies.

The group's exposures to foreign exchange rate risk arise solely from: (i) the issuance of US dollar private placement loan notes, which are fully hedged into sterling through the use of cross-currency swaps; and ii) the Home Credit operations in the Republic of Ireland, which are hedged by matching euro-denominated net assets with euro-denominated borrowings as closely as practicable.

Pension risk

Pension risk is the risk that there may be insufficient assets to meet the liabilities of the group's defined benefit pension scheme.

There is a risk that the liabilities within the scheme materially exceed the assets in the scheme due to changes in corporate bond yields, inflation, equity and bond returns (investment risk) and mortality rates (mortality risk). The current economic environment has led to volatile movements in equity markets and corporate bond yields. In addition, mortality rates in the UK continue to improve.

In order to mitigate the pension risk, the defined benefit pension scheme was substantially closed to new members joining the group after 1 January 2003. All new employees joining the group after 1 January 2003 are invited to join a stakeholder pension plan for which the group has no investment or mortality risk. In addition, during 2006, new pension arrangements were incorporated into the group's defined benefit scheme which gave active members the choice of (i) paying higher contributions into the scheme and retaining final salary benefits; or (ii) paying reduced contributions and joining the 'cash balance' section of the scheme. The aim of the new arrangements is to reduce the group's exposure to improving mortality rates. The scheme's investment strategy is to maintain a balance of assets between equities and bonds in order to reduce the risk of volatility in investment returns.

2. Risk management objectives and policies (continued)

As at 31 December 2011, the group had a pension asset, calculated in accordance with IAS 19 'Employee benefits', of £13.5m (2010: £41.0m) on its balance sheet. The group, in conjunction with its advisors, continues to monitor investment strategy carefully.

2.4.5 Regulatory risk

Regulatory risk is the risk of loss arising from a breach of existing regulation or regulatory changes in the markets in which the group operates. The volatile economic environment of recent years has resulted in a greater focus on regulation, and there has been an increase in the level of scrutiny placed upon lenders in the non-standard market. In particular, HM Treasury/Department for Business Innovation and Skills have commissioned research into a cap on the total cost of credit, the results of which are expected in mid-2012. In addition the BASEL III regulatory regime for determining regulatory capital and liquidity requirements is to replace the current BASEL II regime in 2015.

The group's operations are subject to various forms of regulation originating from Europe, the UK and the Republic of Ireland. These regulations are subject to continual modification which could adversely affect the group's operations if they are not effectively anticipated and responded to. Changes to legislation could include the introduction of interest rate caps, changes to regulations on doorstep lending, more stringent consumer credit legislation or changes in the employment status of CCD's self-employed agents.

In order to effectively manage the risk associated with changing regulation, the group has a central in-house legal team which, working closely with the CCD and Vanquis Bank compliance functions, seeks to ensure that the group's operations are compliant with current legislation and manages the implementation of future changes to legislation. Expert third party legal advice is taken where necessary. Divisional compliance functions are in place which manage compliance and report to divisional boards. In addition, both directly and through its trade body, the Consumer Credit Association, the group aims to maintain a constructive level of dialogue with its regulators to ensure that its businesses are fully understood. The group as full and active participation in all relevant regulatory review and consultation process in the UK and EU.

3. Capital adequacy

3.1 Controls

The group prudently manages its regulatory capital to ensure that it is always maintained at a sufficient level in excess of the ICG set by the FSA. The key controls in achieving this objective are:

- Monitoring the level of regulatory capital against the ICG on a monthly basis as part of the group's management accounts;
- Producing a rolling forecast, as part of the management accounts, projecting regulatory capital against the ICG for the remainder of the financial year;
- As part of the budget and budget update processes, forecasting regulatory capital for the following five years and comparing this to the group's ICG;
- Assessing the impact that strategic projects could have upon regulatory capital;
- Submitting regulatory capital reports to the FSA periodically; and
- Assessing the appropriateness of the ICG as part of the group's ICAAP process, including stress and scenario testing, and reporting to the FSA if it is no longer considered to be appropriate.

3.2 Composition of regulatory capital resources

The group's regulatory capital resources comprise tier 1 and a small amount of lower tier 2 capital. The table below sets out the composition of the group's regulatory capital resources as at 31 December 2011:

	Note	2011 £m	2010 £m
Core tier 1 capital:			
Called-up share capital		28.5	28.1
Share premium account		146.0	144.0
Retained earnings and other reserves	1	152.6	125.1
		327.1	297.2
Deductions from tier 1 capital:			
Intangible assets	2	(15.0)	(19.5)
Investment in own shares	3	(4.6)	(10.6)
		(19.6)	(30.1)
Total tier 1 capital after deductions		307.5	267.1
Tier 2 capital:			
Lower tier 2 capital - Subordinated loan notes	4	4.8	6.0
Total regulatory capital resources		312.3	273.1

1. Retained earnings and other reserves for regulatory capital purposes represent the group's equity reserves, adjusted to exclude the group's pension asset, net of deferred tax, and fair value movements in respect of derivative financial instruments, net of deferred tax. The group's retained earnings and other reserves included in tier 1 regulatory capital can be reconciled to the amounts disclosed in the 2011 and 2010 financial statements as follows:

3. Capital adequacy (continued)

	2011 £m	2010 £m
Retained earnings	142.3	136.4
Other reserves:		
Profit retained by subsidiary	0.8	0.8
Capital redemption reserve	3.6	3.6
Hedging reserve	(6.4)	(7.2)
Share-based payment reserve	16.0	14.3
Retained earnings and other reserves included in the financial statements	156.3	147.9
Regulatory capital adjustments:		
Pension asset	(13.5)	(41.0)
Deferred tax on pension asset	3.4	11.1
Fair value of derivative financial instruments	8.5	9.9
Deferred tax on fair value of derivative financial instruments	(2.1)	(2.7)
Other	-	(0.1)
Retained earnings and other reserves included in tier 1 regulatory capital	152.6	125.1

2. Intangible assets comprise goodwill and capitalised software and software development costs. These are required to be deducted from capital for regulatory capital purposes.

3. The investment in own shares represents shares in Provident Financial plc which have been purchased to satisfy grants and awards made under the group's share incentive schemes. These are required to be deducted from capital for regulatory capital purposes.

4. The group's lower tier 2 capital represents subordinated loan notes which are repayable on 15 June 2015 and accrue interest at 5.5594%. The subordinated loan notes are hybrid instruments which have attributes of both debt and equity which, subject to certain criteria, allow the loan notes to qualify as eligible lower tier 2 capital. The criteria include the need for the loan notes to be long-term in nature, subordinated to all other borrowings and liabilities upon winding up of the company and not contain financial ratio covenants which may trigger early redemption by the note holders. There are two further restrictions on the recognition of the subordinated loan notes as eligible lower tier 2 regulatory capital:

   (i) Lower tier 2 regulatory capital cannot exceed 50% of tier 1 capital; and
   (ii) When the loan notes have more than 5 years until maturity, they are fully eligible, subject to (i) above, as lower tier 2 regulatory capital. However, when they have less than 5 years until maturity, the amount eligible for recognition as lower tier 2 regulatory capital reduces by 20% per annum for each year below 5 years.

   As at 31 December 2011, the subordinated loan notes were not in excess of 50% of tier 1 capital and had 4 years until maturity. Accordingly, 80% of the full amount of the loan notes was eligible as lower tier 2 capital.

3. Capital adequacy (continued)

3.3 Pillar I minimum capital requirement

In calculating the Pillar I minimum capital requirement, the group has adopted the standardised approach to credit risk and the alternative standardised approach to operational risk.

An analysis of the Pillar I minimum capital requirement as at 31 December 2011 is as follows:

	2011	2010
	£m	£m
Credit risk:		
Retail – not past due	68.6	62.8
Retail – past due	16.6	14.7
Other	5.0	5.4
Total credit risk	90.2	82.9
Operational risk	7.9	7.4
Counterparty risk	0.4	0.4
Pillar I minimum capital requirement as at 31 December	98.5	90.7

3.4 Capital adequacy ratio

The ICG set by the FSA is expressed as a percentage of the minimum regulatory capital required under Pillar I of the CRD together with certain additional capital add-ons to cover other risks.

As at 31 December 2011, the group's total regulatory capital resources of £312.3m (2010: £273.1m). This was comfortably in excess of the ICG set by the FSA.

4. Credit risk

4.1 Accounting policy for customer receivables

All customer receivables are initially recognised at the amount loaned to the customer plus directly attributable incremental issue costs. After initial recognition, customer receivables are subsequently measured at amortised cost. Amortised cost is the amount of the customer receivable at initial recognition less customer repayments, plus revenue earned calculated using the effective interest rate, less any deduction for impairment.

The group assesses whether there is objective evidence that customer receivables have been impaired at each balance sheet date. The principal criterion for determining whether there is objective evidence of impairment is delinquency in contractual payments.

Within the weekly Home Credit business of CCD, objective evidence of impairment is based on the payment performance of loans in the previous 12 weeks as this is considered to be the most appropriate indicator of credit quality in the short-term cash loans business. Loans are deemed to be impaired when the cumulative amount of two or more contractual weekly payments have been missed in the previous 12-week period since only at this point do the expected future cashflows from loans deteriorate significantly. Loans with one missed weekly payment over the previous 12-week period are not deemed to be impaired. The amount of impairment loss is calculated on a portfolio basis by reference to arrears stages and is measured as the difference between the carrying value of the loans and the present value of estimated future cashflows discounted at the original effective interest rate. Subsequent cashflows are regularly compared to estimated cashflows to ensure that the estimates are sufficiently accurate for impairment provisioning purposes.

Within the monthly Vanquis Bank credit card business, customer balances are deemed to be impaired as soon as customers miss one monthly contractual payment. Impairment is calculated as the difference between the carrying value of receivables and the present value of estimated future cashflows discounted at the original effective interest rate. Estimated future cashflows are based on the historical performance of customer balances falling into different arrears stages and are regularly reassessed.

4. Credit risk (continued)

4.2 Analysis of credit risk exposures

The group's maximum exposure to credit risk on customer receivables is the carrying value of customers receivables recorded in the group's balance sheet.

All customer receivables are classed as retail exposures. Vanquis Bank exposures are revolving retail exposures.

Exposures analysed by business division are as follows:

	2011	2010
	£m	£m
CCD	879.3	874.3
Vanquis Bank	453.4	345.0
Total	1,332.7	1,219.3

The average exposure in the year to 31 December 2011 was £1,151.5m (31 December 2010: £1,178.9m).

Exposures analysed by geographical area are as follows:

	2011	2010
	£m	£m
UK	1,274.7	1,165.0
Republic of Ireland	58.0	54.3
Total	1,332.7	1,219.3

The group's exposures are well dispersed across the United Kingdom (UK) and Republic of Ireland (ROI).

The following table shows the residual maturity of exposures by business on a contractual basis:

			2011			2010
	Due within one year	Due within one to two years	Total	Due within one year	Due within one to two years	Total
	£m	£m	£m	£m	£m	£m
CCD	791.3	88.0	879.3	776.9	97.4	874.3
Vanquis Bank	453.4	-	453.4	345.0	-	345.0
Total	1,244.7	88.0	1,332.7	1,121.9	97.4	1,219.3

4. Credit risk (continued)

4.3 Credit quality of customer receivables

In the Home Credit business, past due but not impaired balances relate to loans which are contractually overdue. However, contractually overdue loans are not deemed to be impaired unless the customer has missed two or more cumulative weekly payments in the previous 12-week period, since only at this point do the expected future cash flows from loans deteriorate significantly.

Within Vanquis Bank, customer balances are deemed to be impaired as soon as customers miss one contractual monthly payment. Therefore, within Vanquis Bank, there are no accounts/balances which are past due but not impaired.

The credit quality of customer receivables is as follows:

	2011	2010
	£m	£m
Neither past due nor impaired	712.4	611.4
Past due but not impaired	138.5	139.6
Impaired	481.8	468.3
Total	1,332.7	1,219.3

The credit quality of customer receivables analysed by business division is as follows:

			2011			2010
	CCD	Vanquis Bank	Total	CCD	Vanquis Bank	Total
	£m	£m	£m	£m	£m	£m
Neither past due nor impaired	309.0	403.4	712.4	313.0	298.4	611.4
Past due but not impaired	138.5	-	138.5	139.6	-	139.6
Impaired	431.8	50.0	481.8	421.7	46.6	468.3
Total	879.3	453.4	1,332.7	874.3	345.0	1,219.3

The credit quality of customer receivables analysed by geographical area is as follows:

			2011			2010
	UK	ROI	Total	UK	ROI	Total
	£m	£m	£m	£m	£m	£m
Neither past due nor impaired	683.7	28.7	712.4	584.0	27.4	611.4
Past due but not impaired	130.8	7.7	138.5	133.1	6.5	139.6
Impaired	460.2	21.6	481.8	447.9	20.4	468.3
Total	1,274.7	58.0	1,332.7	1,165.0	54.3	1,219.3

4. Credit risk (continued)

4.4 Movement in impairment provisions

The impairment charge to the income statement in respect of customer receivables analysed by business division is as follows:

	2011	2010
	£m	£m
CCD	223.8	232.7
Vanquis Bank	76.9	63.9
Total	300.7	296.6

The movement in the impairment allowance account within Vanquis Bank in the year is as follows:

	2011	2010
	£m	£m
At 1 January	45.9	40.0
Charge for the year	76.9	63.9
Amounts written off during the year	(71.0)	(64.1)
Amounts recovered during the year	10.6	6.1
At 31 December	62.4	45.9

For CCD, impairment charges are deducted directly from the carrying value of receivables without the use of an impairment allowance account. Accordingly, it is not possible to disclose movements in an impairment allowance account for CCD.

5. Counterparty credit risk

Details of the group's counterparty credit risk and the controls in place to mitigate the risk are set out in section 2.4.1 on page 12.

5.1 Counterparty exposure limits

The counterparty credit limits that are applied to banks and similar institutions are based on:

- Credit rating limits; and
- An assessment of excess risk.

The group uses credit ratings as an independent measure of an institution's capacity for timely payment of debt. The group relies principally on two UK rating agencies; Moodys and Fitch Ratings. Rating limits are determined by reference to the lower of the long-term rating granted to an institution by Moodys and Fitch Ratings. In each case the institution must also have the highest short-term credit rating of P-1 to be acceptable.

Excess risk is considered by the Board on a case by case basis. It is normally only applicable for institutions with whom the group has a strong lending relationship to offset the exposure.

It is the group's policy that exposures maturing in less than one year do not exceed 5% of the group's regulatory capital, and that exposures maturing in more than one year do not exceed 10% of the group's regulatory capital.

5.2 Exposures to counterparties

The group measures exposure value on counterparty credit exposures under the counterparty credit risk (CCR) mark-to-market method. This exposure value is derived by adding the gross positive fair value of the contract (replacement cost) to the contract's potential credit exposure, which is derived by applying a multiple based on the contract's residual maturity to the notional value of the contract.

The group uses derivative financial instruments to hedge the interest rate risk and foreign exchange rate risk on its borrowings. The group does not enter into speculative transactions or positions.

The contractual/notional amounts and the fair value of derivative financial instruments are set out below:

			2011			2010
	Contractual /notional amount	Fair value of assets	Fair value of liabilities	Contractual/ notional amount	Fair value of assets	Fair value of liabilities
	£m	£m	£m	£m	£m	£m
Interest rate swaps	590.0	-	(9.5)	685.0	-	(14.8)
Cross-currency swaps	84.9	11.9	-	117.9	15.9	(1.4)
Foreign exchange contracts	6.7	0.3	-	9.8	-	(0.1)
Total	681.6	12.2	(9.5)	812.7	15.9	(16.3)

5. Counterparty credit risk (continued)

Due to the high-quality nature of the group’s counterparties, the group does not secure collateral and does not establish credit reserves. The group does not provide collateral to counterparties and there is no requirement to provide collateral in the event of a downgrade in the group’s own credit rating (currently BBB with a stable outlook by Fitch Ratings) or any other circumstances. The group has no wrong-way risk exposures or credit derivative hedges.

6. Interest rate risk

Details of the group's interest rate risk and the controls in place to mitigate the risk are set out in section 2.4.4 on page 17.

The group measures its interest rate exposure by quantifying the impact of an immediate and sustained movement of 200bp in LIBOR rates upon its forecast profit.

In calculating this exposure, the group assumes that it will re-price products for new lending. It is possible for Vanquis Bank to re-price its receivables at 2 months' notice and for CCD loans to be issued at re-priced levels within 1 month. Given the short duration of the receivables book, on average the group would be able to re-price its receivables portfolio within 6 months to mitigate the impact upon forecast borrowing costs.

The level of fixed and floating rate receivables and borrowings beyond the next 6 months are forecast to be matched, resulting in a neutral interest rate position.

The level of downside risk resulting from exposure to interest rates calculated on the basis set out above as at 31 December 2011 and 31 December 2010 is as follows:

	2011	2010
	£m	£m
Sterling	0.5	0.6
Euro	0.4	0.2
Total	0.9	0.8