Tesco Personal Finance Group Ltd

Pillar 3 - Market Disclosure Report

1 Background

The European Union Capital Requirements Directive (Basel II) was introduced on 1 January 2007. Implementation of the Directive in the UK has been achieved through a series of rules introduced by the Financial Services Authority (FSA). The Basel II rules are set out in three ‘pillars’:

Pillar 1 - sets out the minimum regulatory capital requirements.

Pillar 2 - describes the supervisory review process and the assessment of additional capital resources required to cover specific risks faced by the Group that have not been covered by the minimum regulatory requirements as set out in Pillar 1.

Pillar 3 - aims to encourage market discipline by providing market participants with key information on the firm’s risk exposures and risk management processes.

This document has been produced to meet the requirements arising from Pillar 3, as laid out in the FSA Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU). TPF plc has adopted the standardised approach to the calculation of regulatory capital requirements.

2 Scope of Application

Tesco Personal Finance Group Limited (TPFG) is a UK based retail financial services organisation wholly owned by Tesco PLC.

Tesco Personal Finance plc (TPF plc), trading as Tesco Bank, is a wholly owned subsidiary of TPFG which provides a range of financial services and products to personal customers under the Tesco brand mainly through telephony, on-line and in a small number of in-store branches. The products currently offered by TPF plc include general insurance products, unsecured personal loans, savings accounts and credit cards. It also operates an ATM estate primarily located in Tesco stores. TPF plc has a small international presence in Ireland and Poland.

Tesco Personal Finance Compare Limited (Tesco Compare), an internet based aggregator business, is also a wholly owned subsidiary of TPFG.

TPFG and subsidiary companies are together referred to as “TPF” or “Group”.

All the risks and capital resources are in TPF plc, the main regulated entity, as such there is no material difference between the UK consolidated group requirement and the solo requirement of TPF plc. There is no material practical or legal impediment to the prompt transfer of capital resources or repayment of liabilities among the parent undertaking and its subsidiary undertakings.

Appendix 1 provides an overview of the constituent companies.

3 Introduction

3.1 Basis and Frequency of Disclosure

This disclosure report is based on TPF plc accounting data for the 12 month period to 28th February 2010.

3.2 Verification

The disclosures in this report have been approved by the Board along with the statutory accounts. The disclosures have not been audited except where the data also appears in the Group's Annual Report and Accounts.

4 Risk Management Objectives and Policy

4.1 Risk Appetite

TPFG defines risk appetite as the level of risk that TPFG is willing to accept in delivering the strategy. Risk appetite is set by the Board providing a linkage between strategic objectives and the risk management framework and acting as a key reference point for decision-making and planning across the business

Risk appetite is defined against a number of main activities undertaken by TPFG as being either: minimal, low, moderate or high. Performance is tracked against risk appetite using a suite of Key Indicators, which are reported frequently to the Board.

The Risk Appetite Statement is as follows:

> TPF has minimal appetite for risks relating to financial control and regulatory compliance.
>
> TPF has low appetite for risks that could result in reputational damage or material adverse customer impact.
>
> TPF has a moderate appetite for risks relating to business strategy, customer profile, marketing and the provision of customer services.

The business and financial objectives that form TPFG's business plans and risk appetite are approved by the Board.

4.2 Risk Model

The Chief Executive, with the support of the Finance and International Director and Risk Director has primary responsibility for identifying, assessing, monitoring, mitigating and reporting of risks for the TPF businesses and for designing and operating suitable systems and controls for TPF.

TPF recognises the 'Three Lines of Defence' Model, as follows:

> **First Line of Defence** – The business and functional units which, through the identification and assessment of risk and adherence to internal controls, effectively deliver the Risk Management Framework.
>
> **Second Line of Defence** – This comprises the Risk function, Treasury and other central functions including Legal and Information Security who have responsibility for the design and custodianship of the risk and internal controls frameworks. These areas devise the relevant policies, establish and communicate the processes and oversee effective implementation and adherence to each policy.
>
> **Third Line of Defence** – Internal Audit comprise the Third Line, providing independent assurance over the risk and internal controls framework. This is delivered via a programme of audit activity agreed with and overseen by the Board Audit Committee (AC).

The Board, the Board Risk Committee (BRC), Risk Management Committee (RMC) and Asset & Liability Management Committee (ALCo) approve the policies and monitor the performance and risk profile.

4.3 Risk Framework

TPF has established a risk framework to manage the risks arising across the Group's businesses. The risk framework recognises the following five primary risk types:

- Regulatory Risk;
- Operational Risk;
- Credit Risk;
- Insurance Risk; and
- Treasury Risk (including Market Risk, Interest Rate Risk, Liquidity and Foreign Exchange Risk).

Where appropriate each of these risk types is described in greater detail in sections 7, 8, 9 and 10

The Risk Management Framework comprises of the following primary segments:

4.3.1 Policy & Standards

This forms the basis for defining Risk Management and sets the requirements to be adhered to across the business. Policy and Standards are endorsed by the relevant executive bodies with risk policies being formally approved at the Board, BRC, RMC or ALCo.

Policy and Standards make clear what the requirements are on all staff, both in the business and in the Risk community.

4.3.2 Organisation & Structure

Organisation and Structure describes the way that risk is set up across the business, both in terms of the Risk team structure and the spread of responsibilities in the wider business. TPF recognises the Three Lines of Defence model in organising its risk resources, as outlined in Section 4.2.

4.3.3 Methodology & Processes

This describes the core processes applied across the business in managing risk. The Risk function is generally the owner of such processes and carries the responsibility for ensuring that they are 'fit for purpose'.

4.3.4 Analysis, Monitoring & Reporting

This describes the means by which the Risk function 'quantify' the level of risk being run by the business, how they track risk exposures and their oversight and monitoring responsibilities.

The outputs of this analysis and monitoring form the basis for external and internal reporting that should be timely, accurate, understandable and pertinent.

4.3.5 Technology & Data

This refers to the functionality, security, access and technical standards applicable to the software, applications and systems used by TPF in support of its deliverables. Such systems and applications include for example risk registers, alert systems, credit models, links into Finance systems.

This segment also recognises the importance of security protocols over sensitive data, including its use and access by third parties.

4.3.6 Communications, Internal & External Liaison

This segment recognises the importance of ensuring that there is appropriate awareness and understanding across the business to ensure that business decisions are informed by risk insight. This requires the use of both formal and informal channels across the business.

This segment also recognises the importance of the Risk function establishing relationships in the external risk and business community to benchmark against peers, understand emerging trends and meet the expectations of stakeholders (including regulators) in terms of ongoing dialogue.

4.4 Risk Management Governance

A committee structure including the Board, Board Audit Committee, Executive Committee, Risk Management Committee, and Asset & Liability Management Committee operated throughout the financial year, as described below. Subsequent to the year end a Board Risk Committee and a Remuneration Committee have been established inline with recommendations of the Walker Report. The Board has delegated responsibility for the day to day identification of risks and managing them effectively to the Executive Committee, Risk Management Committee, and Asset & Liability Management Committee.

4.4.1 The Board

The Board is responsible for approval of TPF's business plans; approval of the Internal Capital Adequacy Assessment Programme (ICAAP); approval of TPF's Risk Appetite; approval of Treating Customers Fairly policy; approval and oversight of the risk and control processes of TPF; and approval of any material new product lines.

The Board monitors the Group's risk management profile and capital adequacy position.

The Board has appointed Non Executive Directors who provide insight and challenge to TPF plans and performance.

4.4.2 Board Audit Committee (AC)

The role of the AC is to review TPF financial statements, its internal control systems and assurance, its internal audit function and the work undertaken by TPF external auditors.

4.4.3 Board Risk Committee (BRC)

The role of the BRC is forward looking to anticipate future risks and also to align the business strategy (including new products) with risk appetite and to satisfy itself that adequate policies and processes are in place to promptly identify, assess and control the risks.

4.4.4 Tesco Bank Remuneration Committee (RemCo)

The role of RemCo is to determine and approve remuneration arrangements for the TPF Leadership Team and approve a remuneration framework for employees below the leadership level; and to ensure the levels and structure of remuneration are designed to attract, retain, and motivate the management talent needed to run the business of TPF in a way which is consistent with the risk appetite and ongoing sustainability of the business and to be compliant with all applicable legislation and guidelines.

4.4.5 Executive Committee (EC)

This is the senior decision making forum below the Board. Its responsibilities include planning and monitoring of performance, product development and monitoring of risks. A number of sub-committees have been established, where appropriate, to oversee and monitor activity in specific areas. One change during the year was the creation of a sub-committee which focuses on the aspects of treating customers fairly.

4.4.6 Risk Management Committee (RMC)

RMC is a sub-committee of the EC. The role of the RMC is to co-ordinate the risk management activities within TPF, including regulatory, operational (including fraud), credit, insurance and treasury risks. The RMC approves appropriate policies and procedures to enable the effective management of risk for TPF and recommends them to the EC for approval on behalf of the Board. The RMC also monitors all risk exposures and is responsible for its effective management of them.

4.4.7 Asset & Liability Management Committee (ALCo)

ALCo is a sub-committee of the EC. The role of the ALCo is to ensure that the TPF balance sheet is managed effectively. The main areas of responsibility include: capital management, liquidity and funding risk management, large exposures, interest rate risk in the banking book, non trading foreign exchange risk management and intra group limits. ALCo approves policies and processes in this area and recommends them to EC for approval on behalf of the Board. ALCo also monitors performance against such processes and is responsible for the effective management of them

4.5 Role of Internal Audit

TPF has a dedicated Internal Audit function. The Internal Audit Director reports to the Chairman of the AC, who is a Non-Executive Director of the Board.

Internal Audit supports the AC in providing an independent assessment of the design, adequacy and effectiveness of internal controls.

4.6 Risk Management Disclosures

This document provides more detailed disclosures on Credit Risk in Section 7, Treasury Risk in Section 8, Operational Risk in Section 9, and Insurance Risk in Section 10. Definitions of each risk type are described in the relevant section.

5 Capital Resources

Total Available Capital

During the 12 month period to 28th February 2010, TPF plc complied with the capital requirements that were in force as set out by the FSA. The following table shows the breakdown of the total available capital for TPF plc as at 28 February 2010:

	February 2010 (£m)	February 2009 (£m)
Tier 1		
Permanent Share Capital	48	25
Share Premium	430	223
Profit and Loss account (including verified profits)	153	274
Intangible Assets	(60)	(1)
Total Tier 1 Capital	**571**	**521**
Tier 2		
Undated Subordinated Debt	45	45
Collective Provisions for Impairment	21	18
Dated Subordinated Debt	190	160
Total Tier 2 Capital	**256**	**223**
Deductions from total of Tiers 1 and 2		
Connected lending of a capital nature	(260)	(259)
Investments that are not material holdings or qualifying holdings	(3)	-
Total Capital after Deductions	**564**	**485**

The 2009 figures have been restated as they included Tesco Compare.

5.1 Tier 1 Capital

Tier 1 comprises the profit and loss reserve including externally verified net profits less unverified losses at the balance sheet date, share capital and share premium. Intangible assets are deducted from Tier 1.

5.2 Tier 2 Capital

Tier 2 capital comprises dated and undated subordinated loans and the collective provision for impairment.

Under FSA rules, qualifying subordinated loans cannot exceed 50% of the total of Tier 1 capital, and Tier 2 capital cannot exceed Tier 1 capital.

Subordinated loans are unsecured and rank behind the claims of all depositors and creditors. More details of the subordinated loans are included in the Notes to the Annual Report and Accounts for the period ended 28 February 2010.

6 Capital Adequacy

6.1 Capital Management

On 19 December 2008 Tesco PLC acquired the whole share capital of TPFG at which time TPF plc adopted the standardised approach to both credit and operational risk in order to calculate the Pillar 1 minimum capital requirement, under Basel II.

TPF plc determines its minimum Capital Resources Requirement in compliance with BIPRU rules. Regulatory Capital covers all Pillar 1 risks (ie, credit risk and operational risk).

Regulatory capital is reported monthly to the ALCo and the Board. Capital adequacy is monitored daily by Treasury.

6.2 Internal Capital Adequacy Assessment Process

TPF undertakes an Internal Capital Adequacy Assessment Process (ICAAP) which is an internal assessment of its capital needs. The ICAAP is performed annually and it is supplemented by a program of capital and liquidity stress testing. The ICAAP and stress testing scenarios are presented to ALCo, RMC, BRC and the Board for challenge and approval.

The outcome of the ICAAP covers all material risks to determine the capital requirement over a 12 month horizon and includes stressed scenarios over a three to five year period. Where capital is deemed as not being able to mitigate a particular risk, such as liquidity risk, alternative management actions are identified and described in the ICAAP document.

6.3 Minimum Capital Requirement: Credit Risk

The following table shows overall minimum capital requirement for credit risk under the standardised approach (expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes) as at 28 February 2010:

Minimum Capital Requirement - 8%	February 2010 (£m)	February 2009 (£m)
Retail Exposure Classes		
Retail	252	217
Past Due Items (net of provisions)	6	6
	258	223
Other Exposure Classes		
Sovereign / Multilateral Development Banks	-	-
Financial Institutions	5	19
Corporates	12	9
Collective Investment Undertakings	-	5
Securitisation positions	1	-
	18	33
Other		
Fixed and other assets	12	6
Credit risk minimum capital requirement under Pillar 1	**288**	**262**

The past due items as at 28 February 2009 has been restated from £24m (gross of provisions) to £6m (net of provisions).

6.4 Minimum Capital Requirement: Pillar 1

TPF plc total minimum capital requirement under Pillar 1 is calculated by adding the credit risk charge (above) to that required for operational risk using the Basel II standardised approach methodology.

The following table shows overall minimum capital requirement and capital adequacy position under Pillar 1 as at 28 February 2010.

Total minimum capital requirement	February 2010 (£m)	February 2009 (£m)
Credit Risk (Standardised)	288	262
Operational Risk (Standardised)	65	65
	353	327
Total own funds (per above)	564	485
Excess of own funds over minimum capital requirement under Pillar1	211	158

7 Credit Risk Measurement, Mitigation and Reporting

Credit risk is the risk of financial loss of a customer, client or a market counterparty defaulting on its contractual obligations. Credit risk arises principally from TPF's lending activities but also from placement of surplus funds with other banks and money market funds, investments in transferable securities, interest rate derivatives and foreign exchange. Credit risk may also arise when an adverse change in an entity's credit rating causes a fall in the fair value of TPF's investment in that entity's financial instrument.

TPF is exposed to country risk, and credit risk may arise when there are difficulties in the country where the exposure is domiciled, thus reducing the value of the assets, be it loans or investments, or where the counterparty is the country itself.

Credit risk activities are governed by a policy framework which defines the requirements across TPF.

7.1 Credit Risk Responsibilities

Primary responsibility for the management of credit risk lies with the commercial and operational teams as the ‘First Line of Defence’.

Credit Risk (CR) is a specialist function within the Risk function holding the following key responsibilities:

- Defining the credit risk framework through a suite of credit risk policies;
- Oversight of all credit risk activities;
- Reporting of credit risk management information to ALCo, RMC, BRC, the Board and other stakeholders;
- Development and monitoring of credit risk models; and
- Assessment of credit risk elements of ICAAP.

7.1.1 Consumer Lending

TPFG credit policy is defined via the credit risk policy framework. Through this the standards and limits are defined at all stages of the customer lifecycle, including new account sanctioning, customer management and collections and recoveries activity. Customer credit decisions are managed principally through the deployment of bespoke credit scorecard models and credit policy rules, which exclude specific areas of lending and an affordability assessment which determines a customer’s ability to repay an outstanding credit amount. Credit management policy is governed by and agreed through the RMC.

A dedicated credit risk management team have the day to day responsibility for managing the credit quality of the lending portfolio. The deployment and execution of credit strategies sits within The Royal Bank of Scotland Group plc (RBS) infrastructure, managed through the relevant Commercial Services Agreement; however, TPF has full ownership of its own credit policy. Regular reporting to the RMC, EC, BRC and the Board ensures that TPF has adequate oversight of this activity and sufficient insight to the performance of the portfolio.

Impairment loss provisions are managed according to IFRS standards, with portfolio provisions assessed on an incurred loss / collective basis, according to our agreed definition of default.

7.1.2 Counterparty Exposure

TPF operates a control framework relating to the placement of funds with individual banks, funds and the UK government, as well as the investment in high quality bonds. The framework sets limits on the amounts that can be lent to counterparties or bond investments (relative to the TPF plc capital base) based on their credit-worthiness. For Treasury credit risk exposures, TPF uses Fitch, Moody’s and Standard & Poor’s as External Credit Assessment Institutions (ECAIs) as part of the credit assessment criteria. All limits are approved via the RMC. Any exceptions or overrides to this policy must be explicitly agreed by the RMC.

Exposure Classes	Rating	February 2010 (£m)	February 2009 (£m)
Securitisation Positions	AAA/Aaa	97	
Multilateral Development Banks	AAA	99	
Collective Investment Undertakings	AAA/Aaa	-	302
Financial Institutions	AA		205
	AA-	147	512
	A+	3	381
	A-	50	72
UK Government	AAA	182	3
UK Government Guaranteed	AAA	148	
Zone A Governments	AAA	70	
Zone A Government Guaranteed	AAA	16	
	AA+	12	
	AA-	50	
Total:		874	1,475

The 2009 figures have been restated as they included an inter group bond of £26m issued by Tesco Compare and held by TPFG.

7.1.3 Counterparty Credit Risk

Counterparty credit risk can be defined as the risk of loss arising from a counterpart failing to settle an open/unsettled transaction. This includes unsettled bond transactions, foreign exchange, derivatives, and money market transactions. The risk associated with each type of instrument varies from instrument to instrument depending on market practice, nature of the settlement, collateral and netting arrangements, legal documentation, the existence of a central clearing house and other factors.

TPF in its ordinary course of business uses OTC derivatives and forward foreign exchange transactions to hedge exposures to market risk, eg interest rate and foreign exchange risk. Counterparty risk occurs when a counterparty defaults in its obligation to deliver under the respective transaction. The risk is mitigated by offsetting amounts due to the same counterparty ("Netting benefits").

The following table shows the net exposures using the counterparty credit risk mark to market method for OTC derivative contracts and foreign exchange as at 28th February 2010.

Exposure Class – OTC Derivatives and Foreign exchange	February 2010 (£m)	February 2009 (£m)
Interest rate swap contracts	1.3	0.7
Inflation swap contracts	0.0	0.0
Foreign exchange contracts	0.2	0.8
Gross positive fair value of contracts	1.5	1.5
Netting benefits	-	-
Net derivatives credit exposure:	-	-

At the year end the net exposure (market value) to any one OTC derivatives counterpart was zero.

7.1.4 Trade Debtors

TPFG has a number of ongoing commercial relationships from whom commission payments are due. The credit risk exposure to these trading companies is negligible.

7.2 Past Due and Impaired Exposures

TPF considers its assets as being past due when a customer does not make their minimum contractual monthly payment. For accounting purposes, an asset is considered impaired (bad book) when it is 90 days past due or where we have earlier objective evidence of impairment (for example insolvency or a declaration of financial hardship).

TPF applies a collective impairment provisioning model that segregates provisions from latent (good) book and the bad book based upon the approved definition of default operated on both the credit card and loan portfolios. Key drivers of the provision model are subject to significant controls testing.

Impairment provisions for loans and advances	February 2010 Total (£000's)	February 2009 Total (£000's)
At 1 March	249,578	184,395
Amounts written off	(118,394)	(88,387)
Recoveries of amounts previously written off	10,430	6,978
Charge to the income statement	176,633	153,519
Unwind of discount	(4,256)	(6,927)
At 28 February	313,990	249,578

7.3 Reporting and Monitoring

CR is responsible for the reporting and monitoring of the credit risk in consumer lending. Monthly management information reports are provided to the RMC for the main lending portfolios with a summary report provided to BRC. Key performance metrics are tracked against triggers and limits with adverse trends likely to breach any limits investigated and actioned appropriately.

7.4 Credit Concentration Risk

Credit concentration in the retail lending portfolio risk arises where there is concentrated exposure to a single counterparty, sector or geographic region. TPF is exposed to concentration risk in the following areas:

Sector Concentration Risk -TPF's credit risk is concentrated in credit card and unsecured personal loans.
Country Concentration Risk - TPF is primarily a UK institution and therefore is by definition primarily exposed to the risks in operating in the UK economy.

Total exposures as at 28th February 2010 are detailed below.

Exposure Class - Retail	Current		Past Due Items		Total
Geographic Sector	February 2010 (£m)	Average Balance (Mar 09 – Feb 10) (£m)	February 2010 (£m)	Average Balance (Mar 09 – Feb 10) (£m)	February 2010 (£m)
United Kingdom	4,210	3,950	365	344	4,576
Ireland	33	32	3	2	36
Total:	**4,243**	**3,982**	**368**	**346**	**4,611**

Exposure Class - Retail	Current		Past Due Items		Total
Geographic Sector	February 2009 (£m)	Average Balance (Jan 08 – Feb 09) (£m)	February 2009 (£m)	Average Balance (Jan 08 – Feb 09) (£m)	February 2009 (£m)
United Kingdom	3,616	3,460	290	266	3,905
Ireland	32	30	2	1	34
Total:	**3,648**	**3,491**	**291**	**268**	**3,939**

TPF assesses the risk created through portfolio concentrations and holds additional capital in line with this risk, which is over and above the Pillar 1 requirement.

7.5 Residual Maturity Breakdown

The residual maturity of exposures on a contractual basis is detailed below.

Retail						
Standardised Exposure Class	**< 3 months (£m)**	**> 3 months < 1 year (£m)**	**> 1 year < 5 years (£m)**	**> 5 years (£m)**	**Other (£m)**	**Total**
February 2009	2,180	41	1,149	560	10	3,939
February 2010	2,445	66	1,543	529	28	4,611

7.6 Securitisation

TPF has provided collateral by way of AAA rated asset-backed securities backed by credit card receivables to the Bank of England under the Special Liquidity Scheme. The Special Liquidity Scheme was launched in April 2008 and allows banks to provide high-quality asset-backed and other securities as collateral for liquid UK treasury bills.

This transaction has not been included in the disclosures as a credit risk transfer as the exposures securitised have not been recognised for the purposes of Pillar 1 capital requirements.

8 Treasury Risk

Interest Rate Risk in the Banking Book (IRRBB) arises where there is potential for changes in benchmark interest rates (that embed little or no credit risk) to result in a movement in the Banking Book net interest income.

TPF has established limits that describe its risk appetite in this area and stress tests are performed using sensitivity to fluctuations in underlying interest rates in order to monitor this risk.

The main risk control mechanism for IRRBB exposure is the calculation of Value at Risk (VaR) and Net Interest Income (NII) sensitivity. The VaR and NII are reported monthly to the Asset & Liability Management Committee (ALCo).

The main drivers of interest rate risk are:

- Differences in the re-pricing terms of an entity's assets and liabilities;
- Changes in the yield curve that lead to changes in income;
- Imperfectly matched offsetting positions in two similar but not identical markets – so-called basis risk; and
- Optionality, enabling a customer to exit a deal early prior to the contractual maturity date.

8.1 Policy

The IRRBB policy is owned by ALCo and executed by Treasury. The main policy objectives are to:

1. Manage the overall IRRBB of TPF by
   - Minimising the sensitivity at product, balance or business level of net interest income to changes in benchmark interest rates; and
   - Ensuring that IRRBB arising in TPF is transferred to the market or managed efficiently by Treasury within approved limits.

2. To ensure that compliance with evolving regulatory IRRBB requirements is maintained within each jurisdiction in which TPF operates, including requirements set out as part of an ICAAP.

8.2 IRRBB Risk Measurement

There are essentially two different risk measures that are used within TPF. These are:

- Value at Risk (VaR); and
- Net interest income sensitivity

The different methodologies can be summarised as:

VaR – is a technique that produces estimates of the potential negative change in the value of a portfolio over a specified time horizon at given confidence levels. For internal risk management purposes, TPF use a time horizon of one trading day and a confidence level of 95%.

TPF use historical interest rate models in computing VaR. This approach assumes that risk factor changes observed in the past are a good estimate of those likely to occur in the future and is, therefore, limited by the relevance of the historical data used..

NII Sensitivity – This measures the effect of a 1.0% interest rate shock on the next 12 months net interest income, based on the re-pricing gaps in the existing portfolio.

Measure	February 2010	February 2009
VaR	£74k	£96k
NII Sensitivity Analysis	(0.93%)	(1.45%)

9 Operational Risk

Operational risk is the risk of loss caused by human error, ineffective or inadequately designed processes, system failure or improper conduct (including criminal activity).

TPF has adopted the standardised approach for calculating the capital requirements for operational risk.

The services provided by Third Parties are managed through a series of Commercial Services Agreements (CSAs) covering operational, technology and support functions undertaken on its behalf by outsource partners. These CSAs describe servicing standards, performance reporting and escalation procedures.

TPF has established a formal governance structure with key partners to ensure compliance with terms of contract, in order to minimise any loss. It is impossible to implement processes for all eventualities therefore an additional capital requirement is maintained.

Ultimately, the CSAs provide TPF with termination rights in the event of material or repeated breaches of performance by outsource partners.

9.1 Operational Risk Management Framework

Operational Risk (OR) is a specialist function within the Risk function responsible for maintaining the Operational Risk Management Framework, ensuring that our statutory, regulatory and supervisory responsibilities are met. The Framework includes the following:

- A risk and control assessment process is used by the business to identify, assess, manage, monitor and report its operational risks. This information enables the Business to assess its residual risk exposure and determine its approach to managing risk;
- A formal escalation process to manage events which have or could have an adverse impact on our customers, staff, operational effectiveness, finances or reputation. This process enables the event to be managed effectively with the root cause established and addressed to reduce the likelihood of a recurrence;
- Contingency and business continuity plans to ensure TPF's ability to operate on an ongoing basis and limit losses in the event of severe business disruption;
- Loss data management process to capture, classify, record and analyse the business's operational risk losses;
- A change management process to ensure that all new products and all material variations to existing products are subject to a comprehensive risk assessment prior to launch;
- Policies and processes to minimise our exposure to financial crime, including fraud and money laundering;
- Control assurance testing to monitor the effectiveness of internal controls; and
- Information security policy and procedures.

Oversight is provided by the Risk Management Committee.

10 Insurance Risk

10.1 Current arrangements:

Insurance contracts entered into by customers of TPF are currently underwritten by a subsidiary of The Royal Bank of Scotland Group plc (RBS). TPF is exposed to insurance risk indirectly through its profit sharing commission arrangement with RBS. The profit sharing commission receivable by TPF is exposed to credit, regulatory and operational risk within RBS. The services of RBS in relation to insurance are closely monitored and the related capital reserving and operating risks are managed through the risk framework used across TPF.

TPF's key accounts are private Motor and Home insurance.

The Motor account's key risk exposures are:

- Frequency and severity of claims. The main causes of Motor insurance claims are third party injury, third party property damage, accidental damage and theft of vehicle. The key risk factors that drive claims experience are age of driver(s), sex, driving experience, type of vehicle, use of vehicle and area.
- Pricing of Motor insurance. Setting pricing levels at too low a level will result in writing unprofitable business, whilst setting prices too high will result in less business written. Both pricing outcomes affect overall profitability.
- External issues such as weather conditions and the social economic and legislative background.
- Reinsurance failure
- Adequacy of claims reserves

Home insurance is exposed to similar risks as the Motor account, in terms of pricing sensitivity and claims experience. The main causes of Home insurance claims are theft, flood, escape of water, fire, storm, subsidence and accidental damage.
The Home account's key risk factors are:

- Volatility of weather conditions.
- Exposure concentrated in certain geographic areas that could be affected by localised weather events.

10.2 Future arrangements:

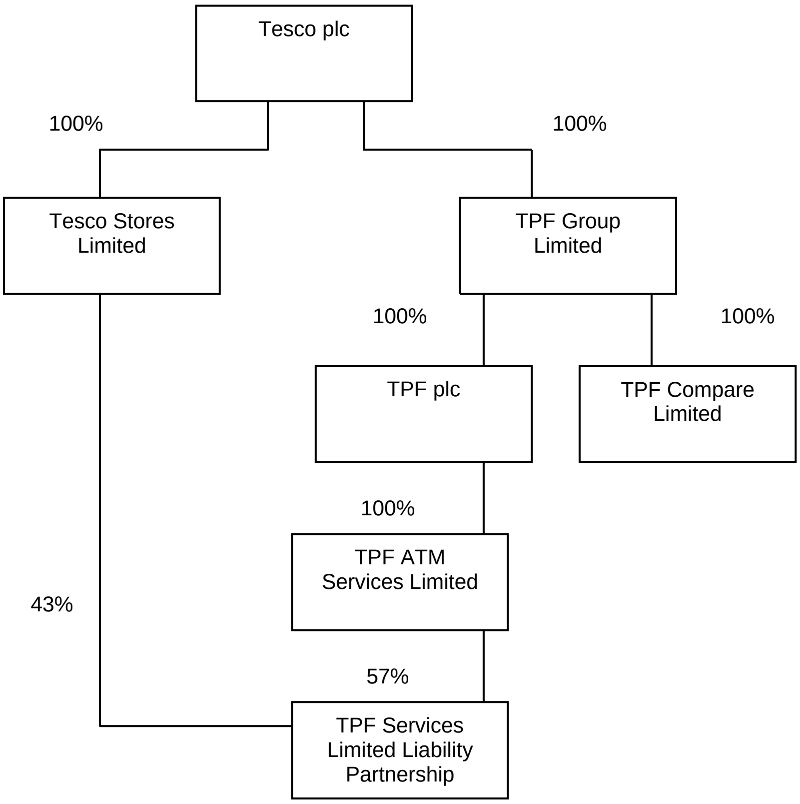
TPF has entered into an agreement with Fortis Insurance Limited (FIL) to establish Tesco Underwriting (TU). TU will underwrite Motor & Home insurance contracts, under the Tesco brand from the middle of the current financial year. TPF owns 49.9% of TU and will be exposed to that proportion of the insurance underwriting risk. TPF will, therefore, become directly responsible for a portion of this risk. TPF will itself undertake insurance intermediary activity, including sales, servicing and marketing of Motor products and Home products.

A range of other personal insurance products offered by TPF will continue to be sold, serviced and underwritten by insurance providers under white-label arrangements, replacing the existing RBS agreements. TPF will be paid a commission for the introduction of this business and will not undertake the underwriting risk.

TPF's risk management framework and policies are currently being adapted to operate under the new business model.

Appendix 1

Current Legal Structure as at 28 February 2010



Tesco Personal Finance Group Limited is wholly owned by Tesco PLC, the holding company of the Tesco group. The TPF plc has one wholly owned subsidiary, TPF ATM Services Limited which provides ATM services; the latter company has entered into a limited liability partnership, Tesco Personal Finance Services LLP, with Tesco Stores Limited. The partnership is engaged in the provision of ATMs and the end to end execution of ATM transactions in Tesco stores. These ATMs make a useful contribution to TPF plc overall profitability by generating fees through the LINK system.

Post year end, TPF Services LLP became a wholly owned subsidiary of TPF ATM Services Limited and subsequently both companies became dormant.