

Virgin Money Holdings (UK) Limited

Pillar 3 Disclosures

31 December 2012



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1. Overview

1.1 Background

The Capital Requirements Directive (Basel II) was implemented in the UK by the Financial Services Authority (FSA) and enforced through the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU). The rules consist of three 'pillars'.

- Pillar 1** sets out the minimum capital requirements Firms are required to meet for credit, market and operational risk.
- Pillar 2** describes the supervisory review process and the assessment of additional capital resources required to cover specific risks faced by Firms that have not been covered by the minimum regulatory requirements as set out in Pillar 1.
- Pillar 3** 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 and risk assessment processes.

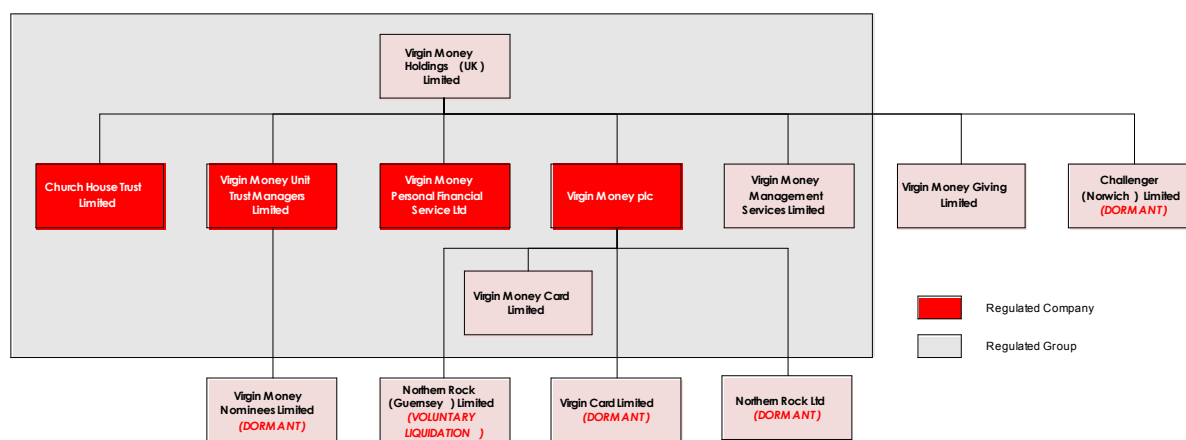
This document sets out the disclosures required under the Prudential Regulation Authority (PRA) handbook set out in BIPRU Chapter 11, which represent the Pillar 3 regulatory disclosure requirements in the UK under Basel II.

1.2 Scope of Application

This disclosure report is based on the consolidated corporate Group referred to and described as "Virgin Money" (Virgin Money Regulated Group). The Group has complied with the Prudential Sourcebooks throughout the year. This disclosure is presented in respect of the year to 31 December 2012.

On 1 January 2012, Virgin Money Holdings (UK) Limited acquired 100% of the ordinary share capital of Northern Rock plc, a savings and mortgage bank. On 12 October 2012 following a rebranding exercise, Northern Rock plc was renamed Virgin Money plc. Throughout this report the Group balances in 2011 do not include Northern Rock plc balances as the companies were not consolidated at this time.

The Group structure is set out below.



At 31 December 2012, the Virgin Money Regulated Group was made up of the following companies:

- Virgin Money Holdings (UK) Limited

Virgin Money Holdings (UK) Limited – Pillar 3 disclosures

- Virgin Money plc (previously Northern Rock plc)
- Virgin Money Unit Trust Managers Limited
- Virgin Money Personal Financial Service Limited
- Church House Trust Limited
- Virgin Money Management Services Limited
- Virgin Money Card Limited (left the Group 18 January 2013).

The following companies are special purpose entities ("SPEs") established in connection with the Group's securitisation programme. Although Virgin Money plc has no direct or indirect ownership interest in these companies, they are accounted for as subsidiaries in the Group. This is because they are principally engaged in providing a source of long term funding to the Group, which in substance means the Group has the rights to all benefits from the activities of the SPEs. They are therefore effectively controlled by the Group.

	Nature of business	Country of incorporation
Gosforth Funding plc	Issue of securitised notes	England & Wales
Gosforth Funding 2011-1 plc	Issue of securitised notes	England & Wales
Gosforth Funding 2012-1 plc	Issue of securitised notes	England & Wales
Gosforth Funding 2012-2 plc	Issue of securitised notes	England & Wales
Gosforth Mortgages Trustee Limited	Trust	England & Wales
Gosforth Mortgages Trustee 2011-1 Limited	Trust	England & Wales
Gosforth Mortgages Trustee 2012-1 Limited	Trust	England & Wales
Gosforth Mortgages Trustee 2012-2 Limited	Trust	England & Wales
Gosforth Holdings Limited	Holding company	England & Wales
Gosforth Holdings 2011-1 Limited	Holding company	England & Wales
Gosforth Holdings 2012-1 Limited	Holding company	England & Wales
Gosforth Holdings 2012-2 Limited	Holding company	England & Wales

1.3 Disclosure Policy

The following sets out the Group's Disclosure Policy as applied to Pillar 3 Disclosures:

1.3.1 Information to be disclosed

The Group's policy is to meet all required Pillar 3 disclosure requirements as detailed in Section 11 of the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU). The Group does not seek any exemption from disclosure on the basis of materiality or on the basis of proprietary or confidential information.

1.3.2 Frequency & Location

Virgin Money's policy is to publish the disclosures required on an annual basis. The information is published as soon as practical following publication of the annual Directors' Report and Financial Statements. The Pillar 3 disclosure document is published on the corporate website www.virginmoney.com.

The frequency of disclosure will be reviewed should there be a material change in any approach used for the calculation of capital, business structure or regulatory requirements.

1.4 Verification

The Group's Pillar 3 disclosures have been reviewed by the Audit Committee and approved by the Board. In addition, the remuneration disclosures as detailed in Section 12 of this document have been reviewed by the Remuneration Committee. The disclosures are not subject to audit except where they are equivalent to those prepared under accounting requirements and disclosed in the annual Directors' Report and Financial Statements for the period to 31 December 2012.

1.5 Recent developments

On 18 January 2013 the Group sold 100% of the ordinary share capital of Virgin Money Cards Limited to MBNA Europe Bank Limited ("MBNA") for an overall gain of £203.4m. The principal activities of Virgin Money Cards Limited were the marketing and direct distribution of Virgin Money branded personal credit cards issued by and under a partnership agreement with MBNA. Prior to the sale, all assets, liabilities and contracts not connected with the MBNA partnership agreement were transferred to Virgin Money Cards Limited's immediate parent, Virgin Money plc a wholly owned subsidiary undertaking of Virgin Money Holdings (UK) Limited.

Subsequently, on the same day the Group entered into a transaction to acquire approximately one third of the Virgin Money branded personal credit card book issued by MBNA, for a purchase consideration of £1,019.6 million which was paid in cash. The assets were previously managed jointly by MBNA and Virgin Money Cards Limited under a partnership agreement.

This transaction allows the Virgin Money Group to broaden the product set offered to consumers and provides further opportunities for growth.

2. Risk Management Objectives and Policies

Through its normal operations the Group is exposed to a variety of risks. The Board of Directors is responsible for determining strategies and policies for the Group. The Group maintains a risk governance structure that strengthens risk evaluation and management, in addition to positioning the Group to manage the changing regulatory environment in an efficient and effective manner.

Identification, measurement and monitoring of risks that Virgin Money is exposed to is a priority for the Group. Responsibility for oversight of risk positions lies with the Board. Responsibility for oversight of the Group's exposure to risk has been delegated to the Risk Management Committee (RMC).

Virgin Money has a comprehensive Risk Management Framework that clearly articulates the internal controls and governance structures that have been established for the management and control of risk.

Virgin Money has adopted the 'three lines of defence' model of governance with clearly defined roles and responsibilities:

- The **first line of defence** is front-line management and staff – people at the heart of the business who manage its risks. They understand their risk exposures in light of the business risk appetite and put in place appropriate risk mitigation. The first line of defence oversees key partners and outsourcers.
- The **second line of defence** is delivered through Virgin Money's risk and control functions. The Risk Management function encompasses Prudential and Financial Risk Management, Operational Risk, Compliance and Conduct Risk Management and Strategic Risk Management. These Risk Management functions facilitate the risk appetite dialogue, and design and operate the frameworks within which key risk classes are managed. They interpret the risk appetite articulated by the Board into practical policies, procedures and limits. Risk Management support the first line of defence, monitor the performance of the business and provide early warning of adverse trends.
- The **third line of defence** comprises External and Internal Audit, including other third party assurance providers. They provide assurance to the Board and senior management on the adequacy of design and operational effectiveness of the system of internal controls.

2.1 Risk Culture

The Group is committed to cultivating a consistent risk culture throughout the business to support transparency and trust, and to embed risk management into decision making at all levels. The Group's risk culture is founded on a clear articulation of risk appetite, an effective governance structure, committed leadership, rapid escalation of threats or concerns and the sharing of information across the organisation.

The Chief Risk Officer (CRO) reports directly to the Chief Executive Officer (CEO), and is responsible for the oversight of the principle risks to the Group, including compliance with risk appetite, and for providing assurance and challenge over standards and quality of risk management. The risk function maintains independence from front line staff who operate as the 'first line of defence' and are responsible for the everyday management of risk in the organisation.

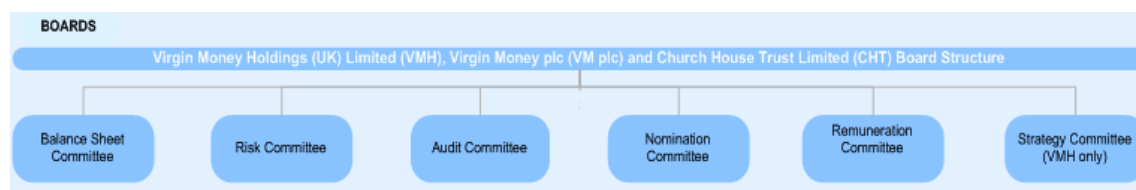
Various initiatives are underway to continue to embed the Group's strong risk culture. These include the delivery of necessary training in pertinent risk issues and ensuring that risk management responsibilities are appropriately embedded into role accountabilities and performance objectives. The co-ordination of risk culture initiatives with wider Virgin Money culture initiatives is managed by Virgin Money's Executive Culture Director.

2.2 Risk Culture

The Virgin Money Board sets the Group's risk appetite and reviews it at least annually. The Group Risk Appetite covers four primary areas, each supported by detailed underlying metrics and thresholds:

- Depositor Protection
 - As an authorised deposit taker, Virgin Money's primary obligations are to ensure that depositors are repaid in accordance with the terms and conditions governing their deposit and that those depositors' financial assets and personal data are protected.
- Fortress Balance Sheet
 - Virgin Money maintains a high quality capital base, targeting capital ratios in excess of the minimum levels set by the PRA.
 - Virgin Money operates an investment strategy for its treasury assets which prioritises liquidity and ensures that the Group holds a liquid assets buffer above minimum requirements.
 - Achieving target profitability across all business lines is essential to the sustainability of the Virgin Money customer proposition.
- Mature Control Environment
 - Ensuring that Virgin Money's control environment is fit for purpose, supporting the business as it grows in terms of people, processes and systems. A robust control environment provides the discipline and structure to achieve the Group's business objectives.
- Minimise Unrewarded Risks
 - Unrewarded risks only expose Virgin Money to downside risk. Unrewarded risks are avoided if possible or controlled as far as is economically feasible.
 - Risk Management Controls are well designed and rigorously executed.

2.3 Board and Executive Committee Structure



Since the acquisition of Northern Rock plc (now Virgin Money plc) on 1 January 2012, the Virgin Money Group's Board structures and corporate governance have been regulated principally in accordance with the terms of a shareholders' agreement (the "Shareholders' Agreement") agreed between Virgin Money Holdings (UK) Limited (the Company), and certain majority shareholders.

2.3.1 The Board

In accordance with the Shareholders' Agreement, there are certain matters reserved for the Board to determine and other matters for the Company shareholders to determine. The Company's Board has responsibility for business operations including the approval of Virgin Money Group's annual budget and business plan, maintaining a sound system of

internal control and financial risk management, the approval of certain strategic matters and significant transactions and the approval of the Company's annual report and accounts.

2.3.2 The Board Committees

The Board Committees for each Company, operate on a combined basis, meeting at the same time with the same member composition. The only exception to this as at 31 December 2012 is the Strategy Committee which operates only at Virgin Money Holdings level.

2.3.3 Balance Sheet Committee

The Balance Sheet Committee reviews and monitors, on behalf of the Board, the Virgin Money Group's balance sheet financial exposures and advises and makes recommendations to the Board on the management of the balance sheet, particularly with respect to liquidity adequacy, capital management and interest rate risk. The Balance Sheet Committee is responsible for considering any proposed dividend distribution with reference to the Group dividend policy and ensuring that there is an ongoing robust capital base. In addition, it is also accountable for monitoring and reviewing the effectiveness and resourcing of the Treasury function including oversight of the work and reports of the Asset and Liability Committee.

2.3.4 Risk Committee

The main role of the Risk Committee is to recommend to the Board the appropriate risk appetite for the Virgin Money Group. The Risk Committee also reviews the key risks inherent in the business and the systems of control that are necessary to manage such risks within the agreed risk appetite limits, and presents those findings to the Board. In addition, as part of the implementation of the International Convergence of Capital Measurement and Capital Standards: Revised Framework (commonly known as Basel II) it is responsible for monitoring the performance of the relevant company's advanced internal credit rating systems and reviewing reports prepared by the Group's Basel designated Committees.

2.3.5 Audit Committee

The Audit Committee considers and, where appropriate, advises the Board on all matters relating to regulatory and accounting requirements that affect the Virgin Money Group, and has delegated authority for reviewing the effectiveness of the Group's system of internal controls. The Audit Committee ensures that an objective and professional relationship is maintained with the external auditors and has responsibility for recommending the appointment, re-appointment and removal of the external auditors. It also reviews the independence, objectivity and effectiveness of the external auditors.

2.3.6 Nomination Committee

The purpose of the Nomination Committee is to develop and maintain a formal, rigorous and transparent procedure for making appointments and re-appointments to the Group Company Boards. Subject to compliance with the requirements of the Shareholders' Agreement, the Committee monitors and reviews the membership of and succession to the Board of Directors. One of its functions is to identify potential Executive and Non-Executive Directors.

2.3.7 Remuneration Committee

Subject to compliance with the requirements of the Shareholders' Agreement, the Remuneration Committee has responsibility for considering and advising the Board on the remuneration policy for Executive Directors and the Chairman, and for determining their remuneration packages. The Remuneration Committee also develops and maintains formal and transparent procedures for a remuneration framework, and reviews bonus and other reward programmes. Further discussion in respect of remuneration is detailed in section 12.

2.3.8 Strategy Committee (Virgin Money Holdings level only)

The Strategy Committee considers and, where appropriate, advises the Board on all matters relating to strategic issues for the Group, within the parameters agreed by the Board from time to time, including changes to the Group's retail-focused banking strategy, potential capital raising, potential acquisitions and disposals, discussions with regulators and rating agencies and involvement in the wider Virgin Group's international strategy and assignments.

2.3.9 The Executive Committee

The Board delegates authority to the Executive Committee to oversee the prudent day to day management of the Company's affairs. There is a range of Executive sub-Committees which cover all key aspects of the Group's business.

2.4 Principal Risks

The principal risks that the Group manages are as follows:

- Credit Risk
- Operational Risk

The Group also has an immaterial exposure to foreign exchange risk that is reported in the section on:

- Market Risk

In addition to these the Group is also exposed to the following principal risks

- Interest Rate Risk
- Liquidity Risk
- Legal Risk
- Regulatory Risk

Further information on each principal risk is provided in the sections below:

2.5 Credit Risk

Credit risk is the current or prospective risk to earnings or capital (expected and unexpected loss) arising when a borrower or counterparty defaults on their contractual obligations, including failure to perform obligations in a timely manner.

Credit risk comprises both retail and wholesale credit risk within the Group. Retail credit risk arises from secured (mortgages) and unsecured lending (current accounts). Wholesale credit risk arises through the placement of funds and investments by Treasury.

2.5.1 Retail Credit Risk

The following sections outline our approach to management of credit risk through the setting of appetite and policy and an overview of the measurement of credit risk in the Group.

2.5.1.1 Retail Credit Risk Appetite

Credit risk appetite is an expression of boundaries that provide clear guidance on the level of risk exposure that the Board considers acceptable and in line with corporate strategy. A revised credit risk appetite aligned to the current business strategy and external environment was approved by the Board in March 2012. Risk appetite is subject to an annual review process and limits are regularly monitored and reported to the Risk Management Committee.

The Board's high level expression of a desired credit risk appetite is also translated into specific maximum risk limits in relation to new product and new lending policy parameters within which Management must operate. In addition there are whole book parameters reflecting the inherent risks of previous lending, with trigger levels above which specific control actions may be initiated. Monitoring and reporting against the risk appetite and the associated limits and triggers were in place for both new lending and the whole book during 2012.

2.5.1.2 Retail Lending Policy Criteria

New lending is tightly controlled using an appropriate mix of statistical analysis and judgement. New business quality is monitored and controlled by the New Business Strategy team using scoring techniques and a number of other core control components as follows:

- Credit scoring. Automated statistically-based credit scoring methods are used in the decision making process for new and existing customers. These methods are subject to regular monitoring, review and approval.
- Affordability, underwriting and mandates. To lend responsibly, the Group employs affordability models based upon customers' income and outgoings, and experienced underwriters to determine the overall financial situation of customers and their ability to repay credit. The ability to agree a credit agreement with a customer is prescribed in Board delegated authority levels to specific individuals who have the requisite credit skills.
- Valuations. Property assets are independently valued at mortgage inception. Where a revaluation is required, this is led by specialist Property Risk personnel using a range of valuation methods.

In addition to the control of new lending the retail lending policy has key control components for the existing portfolio, including:

- Monitoring and performance. The credit portfolios are monitored regularly, with a range of prescribed reports distributed to key stakeholders. Detailed management information is provided to the Credit Risk Committee, Business Performance Committee and Risk Committee.
- Collections and recoveries. The Group's debt management process is led by the Chief Operating Officer. A team of specialists manage all aspects of collections and recoveries with the aim of helping customers who encounter financial difficulties to achieve a positive outcome for the customer and the Group.
- Stress testing and scenario analysis, to simulate a range of outcomes and calculate the risk impact of adverse macroeconomic conditions.

2.5.1.3 Retail Credit Risk Measurement

Internal rating based models are used to assess customers' probability of default, exposure at default and loss given default. The rating models use statistical analysis and are subject to internal monitoring and change control.

These credit risk models are used throughout the Group to support the analytical elements of the credit risk management framework, in particular the quantitative risk assessment part of the credit approval process, ongoing credit monitoring as well as portfolio level analysis and reporting.

Models used for credit risk measurement by the Group fall into three broad categories:

- Probability of Default (PD)/customer credit grade – these models assess the probability that a customer will fail to make full and timely repayment of credit obligations over a time horizon. There are a number of different credit rating models in use across the Group, each of which considers particular customer characteristics. The credit rating models use a combination of quantitative inputs, such as transaction characteristics, recent financial performance, credit bureau data and customer behaviour.
- Exposure At Default (EAD) – these models estimate an account's exposure, were it to default.
- Loss Given Default (LGD) – these models estimate the expected loss that may be suffered by the Group on a credit facility in the event of default. The Group's LGD models take into account the type of borrower and any security held.

2.5.2 Wholesale Credit Risk

Wholesale credit counterparty risk arises through Treasury hedging and investment activities and related balance sheet management requirements.

Wholesale credit risk can be broken down into two elements:

- The risk of default or rating migration of derivative counterparties
- The risk of default or rating migration of issuers in the Treasury investment portfolio.

The Board has approved a framework for maximum credit counterparty limits against which total exposures are continually monitored and controlled. The credit limit structure adopts a risk based matrix whereby lower rated counterparties are offered lower limits. Single counterparties are assigned maximum limits in accordance with the ratings matrix, based on the lowest rating afforded to any part of the counterparty group.

2.5.3 Credit Concentration Risk

Credit concentration risk is managed for retail and wholesale credit exposures at portfolio, product, and counterparty levels. This is carried out through the application of limits relating to geographical spread and the size of loan relative to property value (at counterparty and portfolio levels) and the concentration of borrowers in each risk band.

The Group has maintained its conservative approach to European sovereign debt. As at 31 December 2012 there are no outstanding exposures to Portugal, Ireland, Italy, Greece and Spain, either from a direct sovereign exposure or from institutions domiciled in that country. The only direct European sovereign debt exposure as at 31 December 2012 is a Finnish government bond with a carrying value of £100.1m (2011: £Nil).

2.6 Operational Risk

The Group defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events". This is in line with the Basel Committee's definition of operational risk. In managing operational risk, the Group considers indirect financial costs and regulatory, reputational and customer impacts.

During 2012, the Group operated under a waiver from the FSA, allowing it to adopt a combined approach to its Pillar I calculation, applying both Basic Indicator (BIA) and Standardised Approach (TSA) calculations. This recognised the fact that Virgin Money (a

BIA group) only completed the acquisition of Northern Rock (a TSA bank) at the start of 2012. The PRA has confirmed that TSA can be applied across the Group from Q2 2013.

The Group adopts the Standardised Approach to Operational Risk management and external benchmarking has confirmed that Virgin Money is in line with the PRA's related qualifying criteria. The business has a well documented risk management framework with appropriate reporting of risk events and risk exposures to the Operational Risk and Compliance Committee (ORCC) and Risk Management Committee (RMC). RMC is an Executive sub committee, its main role being to recommend to the Risk Committee and Board an appropriate risk appetite for the company and to oversee current and forecast exposures.

Business units and functions formally assess their operational risks on an ongoing basis via a prescribed Risk Control Self Assessment (RCSA) process. The RCSA analysis is reviewed and updated to reflect changes to the risk and control environment arising from changes in products, processes and systems.

2.7 Market Risk

Market risk is the risk that the value of, or net income arising from, the Group's assets and liabilities changes as a result of changes to interest rates or exchange rates. Market risk is managed and monitored on an ongoing basis against Board approved risk appetite and policy. The Group does not trade or make markets in any areas and market risk arises only as a consequence of carrying out and supporting core business activities.

2.7.1 Currency Risk

Currency risk arises as a result of the Group having assets, liabilities and derivative items that are denominated in currencies other than sterling as a result of normal banking activities, including wholesale funding.

The Group has a minimal appetite for foreign exchange risk but allows the purchase of both USD and EUR denominated assets that fall within the Funding & Liquidity and Wholesale Credit Risk policies. The Group minimises exchange rate exposures by using cross currency swaps and forward foreign exchange contracts, or by matching exposures with assets denominated in the same currency.

At 31 December 2012, assets exceeded liabilities denominated in € by €0.1m, or £0.1m after taking into account foreign currency derivatives. (2011: €Nil/£Nil).

2.8 Interest Rate Risk

Interest rate sensitivity arises from the relationship between interest rates and net interest income resulting from the periodic repricing of assets and liabilities. The Group offers fixed rate residential mortgages and savings products on which the interest rate paid by or to the customer is fixed for an agreed period of time at the start of the contract. The Group closely monitors mortgage redemption and repayment patterns and reduces the mismatch of the expected maturity profiles of its interest earning assets and interest bearing liabilities through the use of hedging strategies.

Interest Rate Risk within the Group can be subdivided into the following risks:

- Mismatch: The effect that variations in the relationship between different points on the yield curve have on the value of fixed rate assets and liabilities

- **Optionality:** The effect that variations in early repayment or mortgage drawdowns have on expected run off profiles of fixed rate loans and therefore on the effectiveness of hedging transactions
- **Basis:** Created where balance sheet assets and liabilities are sensitive to different underlying base reference measures e.g. indices or rates. Basis risk arises for example where mortgage interest rates are linked to the Bank of England Base rate but the liabilities funding them are linked to LIBOR
- **Reset:** Exposure to the timing of repricing of asset and liabilities or to a sudden spike in a key underlying base reference measure
- **Foreign Exchange (FX):** Volatility in earnings resulting from movements in exchange rates altering the sterling value of unmatched foreign currency income streams, assets and liabilities
- **Pipeline:** Created by the uncertainty around the actual volume of fixed rate products sold versus the volume forecast
- **Asset/Swap Spread:** The risk caused by the rate used to value an asset being different to the derivative used to hedge the interest rate risk of the asset.

Risk exposures are controlled using position limits which require the Group's Treasury function to manage exposure to movements in the market. Exposures are hedged as far as economically possible.

The Group uses a number of measures to monitor and control interest rate risk and sensitivity. One such measure evaluates the difference in principal value between assets and liabilities repricing in various gap periods.

2.9 Liquidity Risk

Liquidity risk represents the risk of being unable to pay liabilities as they fall due and arises from the mismatch in cash flows generated from current and expected assets, liabilities and derivatives. The Group has a liquidity management framework, with a liquidity risk appetite based on maintaining sufficient liquid resources to survive a variety of stress events.

Under the framework:

- The Group aims to ensure that there is adequate liquidity within the Group by operating within a clear and well defined risk appetite. The risk appetite statement directly reflects the overall liquidity adequacy rule to “at all times maintain liquidity resources which are adequate, both in amount and quality, to ensure there is no significant risk that its liabilities cannot be met as they fall due”. The Group assesses the amount of liquidity needed to be held by running potential stress scenarios and measuring these outcomes against the quality and quantity of its liquidity portfolios. The liquidity portfolio is held predominantly in regulatory eligible buffer liquidity as defined by the FSA.
- The minimum level of liquidity held in buffer liquid assets is defined by the Group's Internal Liquidity Requirement (ILR). This is sufficient to meet the core liquidity stress test. Additional liquidity is held over and above this and contingent liquidity capacity has been arranged to provide additional prudence over the Group's ILR level.
- The Company has made use of the Funding for Lending Scheme (“FLS”), a scheme launched by the Bank of England and HM Treasury in July 2012 which provides loans to

banks and building societies with the aim of stimulating lending within the economy. The Company has retained £3,075.1m of notes issued by securitisation Special Purpose Entities ("SPEs") in the Residential Mortgage Backed Securitisation programme. These notes are available for use as collateral for funding and liquidity purposes. This includes the Company's participation in the FLS. At 31 December 2012 the Company had FLS drawings of £510.0m.

2.10 Legal Risk

The Group defines legal risk as "the risk of legal sanction, material financial loss or loss to reputation the Group may suffer as a result of its failure to comply with the law, inadequately document its contractual arrangements or inadequately assess and implement changes required by forthcoming legislation or emerging case law".

The Risk Management Framework includes a Legal Risk Management Policy within which the Board has set a zero risk appetite (i.e. full compliance) in relation to legal risk, and standards that the business is expected to operate within. The framework also includes the governance and policy controls to enable identification of key legal risks, and of prevailing and emerging legal risk developments, issues and trends. The impacts of these developments on the Group are then assessed by the business and Legal function.

2.11 Regulatory Risk

Regulatory risk is defined as the risk of the Group failing to comply with the legal or regulatory requirements applying to its arrangements and activities, with the potential consequences of:

- Treating customers unfairly, potentially exposing them to financial or other detriment
- Being subject to legal or regulatory sanctions
- Suffering reputational damage
- Being used for the purposes of financial crime.

To manage the risk, the Group has a dedicated Regulatory Risk function reporting to the Chief Risk Officer. The Risk Management Framework includes a Regulatory Risk Policy within which the Board has set a zero risk appetite (i.e. full compliance) in relation to regulatory risk, and standards that the business is expected to operate within. The framework also includes the governance and policy controls to enable identification of key regulatory risks, and of prevailing and emerging regulatory risk developments, issues and trends. The impacts of these developments on the Group are then assessed by the business and the Compliance function.

In addition to ensuring compliance with new developments, the framework requires ongoing review and challenge of the Group's compliance related processes and practices. It also requires the monitoring of consistent application of policies, on a risk based approach. The results of the reviews are reported to the Operational Risk and Compliance Committee, Business Performance Committee and Risk Management Committee on a regular basis.

3. Capital resources

The following table set out the capital resources of the Group and its significant subsidiary Virgin Money plc at 31 December 2012:

	Group		Virgin Money plc	
	2012	2011	2012	2011
	£m	£m	£m	£m
Core Tier 1				
Ordinary share capital	-	-	1,400.0	1,400.0
Share Premium	509.2	509.2	-	-
Retained reserves	251.5	32.9	(536.9)	(230.1)
Pension scheme	-	-	-	(3.3)
	<u>760.7</u>	<u>542.1</u>	<u>863.1</u>	<u>1,166.6</u>
Non-Core Tier 1 Capital	150.0	-	-	-
Excess of expected losses over impairment provisions	(37.3)	-	(37.3)	(30.1)
Other regulatory deductions from and restrictions to Tier 1	(38.1)	-	(37.8)	(7.0)
Total capital resources	835.3	542.1	788.0	1,129.5

The Non Core Tier 1 Notes of £150m were issued to HM Treasury on 1 January 2012 as part consideration in the acquisition of Northern Rock plc (now Virgin Money plc). The notes have a discretionary coupon of 10.5% per annum, beginning on 1 January 2013.

4. Compliance with BIPRU and the overall Pillar 2 Rule

4.1 Assessment of the Adequacy of Internal Capital

Virgin Money undertakes an Internal Capital Adequacy Assessment Process (ICAAP) which is an assessment of the capital requirements of the business. The ICAAP is performed annually and is supplemented by a program of stress testing and sensitivity analysis to fully test the business plan. The ICAAP and base and stressed capital plans, are presented to the Risk Management Committee and the Board for challenge and approval.

The ICAAP assesses all material risks to determine the capital requirement over a five year horizon and includes stressed scenarios over a five year period.

Maintenance of adequate capital resources is fundamental to sound prudential management. The key internal and regulatory requirement is for the regulated companies and the consolidated Group to hold adequate capital at all times, in terms of both quantum and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due. Capital is held to absorb losses that unexpectedly materialise and is therefore a mitigant to the risks encountered by the Group.

The Group has in place sound, effective and complete processes, strategies and systems to:

- Identify and quantify the major sources of risk to which it is exposed.
- Calculate the quantum of capital resources deemed to be adequate, both in terms of the Group's own assessment and regulatory requirements.
- Ensure that the Group holds adequate capital resources, both in terms of amount and quality at the current time, and
- Analyse the risk that the Group will fail to hold sufficient capital at any future time.

The minimum capital ratio is conservatively set in line with a prudent business strategy and is based on the Group's financial and capital planning horizon, with an expectation that this is in excess of the minimum regulatory requirements.

The following table sets out the Pillar 1 Capital Requirement of the Group and its significant subsidiary:

	Group		Virgin Money plc	
	2012	2011	2012	2011
	Capital Requirement £m	Capital Requirement £m	Capital Requirement £m	Capital Requirement £m
IRB approach				
Retail exposures secured by real estate collateral	245.0	-	245.0	207.3
Standardised approach				
Retail exposure	0.6	0.6	-	-
Institutions	45.9	12.8	45.4	31.3
Securitisation positions	0.8	-	0.8	2.1
Other assets	16.5	6.2	13.8	5.6
Operational risk	26.5	12.2	11.0	13.7
Market risk	-	-	-	0.9
Total capital requirement	335.3	31.8	316.0	260.9

4.2 Operational Risk Capital Requirements

During 2012, the Group had a waiver from the FSA, to allow Virgin Money to adopt a combined approach to its Pillar I calculation in 2012, applying both Basic Indicator (BIA) and Standardised Approach (TSA) calculations.

In 2011 prior to acquisition of Northern Rock plc the Group used BIA.

	Group		Virgin Money plc	
	Dec 2012	Dec 2011	Dec 2012	Dec 2011
	£m	£m	£m	£m
Pillar 1 Operational Risk Capital Requirement	26.5	12.2	11.0	13.7

4.3 Market Risk Capital Requirements

Virgin Money's market risk is limited to its foreign exchange exposure which is immaterial and as such its Pillar 1 market risk capital requirement was less than £10,000 at the end of 2012 (2011: £nil).

5. Counterparty credit risk relating to derivatives

The following table sets out the gross positive fair value of derivatives contracts, and the potential credit exposures, at 31 December 2012.

	2012	2011
	£m	£m
Gross positive fair values of contracts	161.4	0.9
Potential credit exposure	33.5	-
Total exposure	194.9	0.9

Counterparty credit risk (CCR) is the risk that the counterparty to a derivative transaction could default during the life of the transaction.

The duration of the derivative and the credit quality of the counterparty are both factored into the internal capital and credit limits for counterparty credit exposures.

CCR is monitored daily by the Wholesale Credit Risk team and reported to Treasury Credit Committee (TCC) monthly. TCC is a sub-committee to ALCO (which is itself a sub-committee to the Balance Sheet Committee) and receives monthly updates on CCR.

Credit Support Annexes (CSA) exist for collateralising derivative transactions with counterparties to which the Group has its derivative exposures in order to mitigate the risk of loss on default. Although these CSAs are taken into consideration when setting the internal credit risk limits for derivative counterparties, they are not recognised as credit risk mitigation for reducing the exposure at default (EAD) on the derivative transactions in the Pillar 1 regulatory capital calculations.

Under the Group's Internal Liquidity Requirement a two notch ratings downgrade could result in the Group being required to post additional collateral.

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

Wrong way risk occurs where exposure to a counterparty is adversely correlated with the credit quality of that counterparty. The Group has no such exposure, as it has no appetite for credit derivative positions which are the key drivers of such a risk.

6. Credit risk and dilution risk

6.1 Credit Impairment

All credit portfolios are regularly reviewed to assess for impairment. A loan or portfolio of loans is considered to be impaired if there is any observable data indicating that there has been a measurable decrease in the estimated future cash flows or their timings. This will include identification of:

- Significant financial difficulty of the customer
- Default or delinquency in interest or principal payments
- The borrower entering bankruptcy or other financial reorganisation
- Adverse changes in the payment status of borrowers.

In the retail mortgage portfolio, individual impairments may occur where the Group has taken possession of the property or where specific circumstances indicate that a loss is likely to be incurred. In addition, collective impairment allowances across the retail credit portfolios are calculated on a portfolio basis using formulae which take into account the probability of default, the roll to possession and the loss given default, less the value of any security held. These parameters are kept under regular review to ensure that they reflect current economic circumstances and risk profile.

In addition the Group provides a number of forbearance tools to enable mortgage customers who are in temporary financial difficulty to remain in their property. The key forbearance tools used by the Group are as follows:

- Arrangement to pay less than the contractual payment
- Transfer to an interest only method of repayment
- Extension to the original mortgage term
- Capitalisation of arrears
- Arrangements with customers where the agreed mortgage term has expired and the mortgage loan is not repaid in full.

At 31 December 2012 residential mortgage loans of £ 534.8m (2011: £ Nil) that are neither past due nor impaired had benefited from a forbearance tool. The provisioning methodology recognises the use of forbearance tools and these mortgage loans attract a higher level of provision when compared to the rest of the up to date portfolio.

6.2 Exposures at default

For the purposes of these disclosures, credit exposure is the maximum loss that the Group may suffer in the event of default or loss in value of an asset. This may differ from the amounts disclosed in the balance sheet in the Annual Report and Accounts, because the balance sheet only discloses drawn balances whereas exposure at default includes amounts where customers have contractual rights to draw down further balances and estimates of interest accruals to the point of default.

The following table sets out the exposures at default for the various types of asset held by Virgin Money at 31 December 2012, and the average exposure at default during the year.

	Exposure at 31 December 2012	Average exposure in period	Exposure at 31 December 2011
	£m	£m	£m
IRB			
Retail exposures secured by real estate collateral	18,571.2	17,128.0	-
Standardised			
Retail exposures secured by real estate collateral	15.6	16.7	17.6
Other retail exposures	0.1	0.1	-
Central Governments and Central Banks	2,344.8	2,661.0	62.8
Multilateral development banks	505.1	544.9	4.0
Institutions	1,452.0	1,438.2	802.1
Local authorities	-	0.4	-
Securitisation positions	52.2	88.0	-
Covered Bonds	5.7	1.1	-
Other	223.8	202.9	77.9
	23,170.5	22,081.3	964.4

6.3 Geographical distribution of exposures at default

The table below gives details of the geographical distributions of exposures at 31 December 2012:

	Exposure at 31 December 2012			
	UK	Europe	Rest of the World	Total
	£m	£m	£m	£m
IRB				
Retail exposures secured by real estate collateral	18,571.2	-	-	18,571.2
Standardised				
Retail exposures secured by real estate collateral	15.6	-	-	15.6
Other retail exposures	0.1	-	-	0.1
Central Governments and Central Banks	2,244.7	100.1	-	2,344.8
Multilateral development banks	-	378.9	126.2	505.1
Institutions	423.1	103.5	925.4	1,452.0
Securitisation positions	47.7	-	4.5	52.2
Covered Bonds	5.7	-	-	5.7
Other	210.9	-	12.9	223.8
	21,519.0	582.5	1,069.0	23,170.5

All retail credit exposures in 2011 and 2012 were to the UK.

6.4 Exposure at default by residual maturity

The following table gives details of the contractual residual maturities of exposures at 31 December 2012:

Exposure at 31 December 2012				
Residual maturity				
	< 1 year	1-5 yrs	> 5 years	Total
	£m	£m	£m	£m
IRB				
Retail exposures secured by real estate collateral	82.1	719.0	17,770.1	18,571.2
Standardised				
Retail exposures secured by real estate collateral	0.6	2.9	12.1	15.6
Other retail exposures	0.1	-	-	0.1
Central Governments and Central Banks	1,893.0	100.1	351.7	2,344.8
Multilateral development banks	28.1	421.4	55.6	505.1
Institutions	1,160.6	234.3	57.1	1,452.0
Securitisation positions	-	-	52.2	52.2
Covered Bonds	-	-	5.7	5.7
Other	223.8	-	-	223.8
	3,388.3	1,477.7	18,304.5	23,170.5

Exposure at 31 December 2011				
Residual maturity				
	< 1 year	1-5 yrs	> 5 years	Total
	£m	£m	£m	£m
IRB				
Retail exposures secured by real estate collateral	-	-	-	-
Standardised				
Retail exposures secured by real estate collateral	0.6	3.0	14.0	17.6
Other retail exposures	-	-	-	-
Central Governments and Central Banks	62.8	-	-	62.8
Multilateral development banks	0.5	3.5	-	4.0
Institutions	802.1	-	-	802.1
Securitisation positions	-	-	-	-
Other	67.1	-	10.8	77.9
	933.1	6.5	24.8	964.4

6.5 Impairments by exposure class

The table below indicates the level of impaired and past due exposures by exposure class, and of the levels of provisions against them at 31 December 2012:

	31 December 2012		
	Impaired exposures	Past due exposures	Impairment provisions
	£m	£m	£m
Retail exposures secured by real estate collateral	11.2	193.6	7.7
Other retail exposures	-	-	0.1
	11.2	193.6	7.8

	31 December 2011		
	Impaired exposures	Past due exposures	Impairment provisions
	£m	£m	£m
Retail exposures secured by real estate collateral	0.7	2.9	0.3
Other retail exposures	-	-	-
	0.7	2.9	0.3

6.6 Geographical distribution of impairments

All impairment charges relate to exposures within the UK.

6.7 Movements in impairment provisions

Movements in impairment provisions in 2012 are detailed in the following table:

	Retail mortgages	Other retail exposures	Total
	£m	£m	£m
Impairment provisions			
At 1 January 2012	0.3	-	0.3
Acquired through business combinations	6.5	0.1	6.6
Increase/(decrease) in provision during year net of recoveries	3.0	-	3.0
Amounts written off during the year	(1.9)	-	(1.9)
At 31 December 2012	7.9	0.1	8.0

	Retail mortgages	Other retail exposures	Total
	£m	£m	£m
Impairment provisions			
At 1 January 2011	0.5	-	0.5
Increase/(decrease) in provision during year net of recoveries	-	-	-
Amounts written off during the year	(0.2)	-	(0.2)
At 31 December 2011	0.3	-	0.3

6.8 Exposures by credit rating

The allocation of capital to credit risk within the Treasury investment book is calculated under the standardised approach as per PRA regulations. For these exposures the Group uses credit ratings provided by the recognised credit rating agencies Standard and Poor's, Moody's and Fitch. Exposure by credit grading of the Group's treasury exposures is as follows:

Exposure at 31 December 2012				
Exposure value by external rating				
	AAA to AA-	A+ to A-	BBB+ to BBB-	Total
	£m	£m	£m	£m
Central Governments and Central Banks	2,344.8	-	-	2,344.8
Multilateral development banks	505.1	-	-	505.1
Institutions	195.9	1,255.6	0.5	1,452.0
Securitisation positions	52.2	-	-	52.2
Covered Bonds	5.7	-	-	5.7
	3,103.7	1,255.6	0.5	4,359.8

Exposure at 31 December 2011				
Exposure value by external rating				
	AAA to AA-	A+ to A-	BBB+ to BBB-	Total
	£m	£m	£m	£m
Central Governments and Central Banks	62.8	-	-	62.8
Multilateral development banks	4.0	-	-	4.0
Institutions	-	802.1	-	802.1
	66.8	802.1	-	868.9

All other exposures are not rated by credit agencies.

7. IRB disclosures for specialised lending and equity classes

Virgin Money has no specialised lending or equity exposures.

8. Interest rate risk in the banking book

Interest rate risk is assessed based on the sensitivity of net interest income to interest rate shocks over the next 12 months (or planning horizon) and the impact on the economic value of the balance sheet. Virgin Money's interest rate risk arises from the provision of financial products to retail customers and through exposure to wholesale assets and liabilities.

The table below shows the variation in economic value and the sensitivity of net interest income for a parallel 200 basis point shift upward in interest rates for the main currency within the retail banking book.

	Increase/(decrease) in	
	economic value	12 months earnings sensitivity
	31 December 2012	31 December 2012
	£m	£m
Currency		
£	(34.8)	(15.3)

9. Securitisation

9.1 Objectives in relation to securitisation

The principal objective of securitisation is to provide funding diversification, giving access to a wide range of investors in different geographic areas. Securitisation also serves to generate liquidity from different illiquid asset types, principally residential mortgage loans. During 2012, the Group has made use of the Funding for Lending Scheme (FLS), launched by the Bank of England and HM Treasury in July 2012.

9.2 Issued and retained securitisation positions

Prior to its acquisition of Northern Rock plc (now Virgin Money plc), the Group did not participate in securitisation.

9.2.1 Risks inherent in the issued and retained securitisation position

The principal risks that are inherent in securitised mortgage assets are as follows:

- Credit risk: the current or prospective loss to earnings and capital (expected and unexpected loss) arising from lending as a result of debtors defaulting on their obligations due to the Group.
- Market risk: the risk that changes in the level of interest rates, the rate of exchange between currencies or the price of securities or other financial contracts, including derivatives, will have an adverse impact on the results of operations or financial condition of the Group.
- Liquidity risk: the risk that the Group is unable to meet its obligations as they fall due.

The Group has retained some of the Notes issued by all of the Gosforth Funding securitisation transactions as detailed in the table below. Therefore the Group maintains some of its exposure to credit risk and market risk for the securitised mortgage assets. The ratings assigned to the retained notes are as follows:

Issuer	Notes	31 Dec 2012 £m	Moody's	S&P	Fitch
Gosforth Funding plc	Class A4	486	Aaa	AAA	n/a
Gosforth Funding plc	Class Z	174	Unrated	Unrated	n/a
Gosforth Funding 2011-1 plc	Class M	38	Aa2(sf)	n/a	AAsf
Gosforth Funding 2011-1 plc	Class Z	103	Unrated	n/a	Unrated
Gosforth Funding 2012-1 plc	Class A	222	Aaa	n/a	AAAsf
Gosforth Funding 2012-1 plc	Class M	32	Aa2(sf)	n/a	AAsf
Gosforth Funding 2012-1 plc	Class Z	85	Unrated	n/a	Unrated
Gosforth Funding 2012-2 plc	Class A1b	679	Aaa	n/a	AAAsf
Gosforth Funding 2012-2 plc	Class A2	1,021	Aaa	n/a	AAAsf
Gosforth Funding 2012-2 plc	Class M	88	Aa2(sf)	n/a	AAsf
Gosforth Funding 2012-2 plc	Class Z	147	Unrated	n/a	Unrated
Total		3,075			

There have been no changes to the ratings assigned to any of the notes since the date of issue.

During 2012, following the acquisition of Northern Rock plc by Virgin Money Group and the move from Government to private ownership, Northern Rock plc (now Virgin Money plc) was downgraded by Standard and Poor's. This required the appointment of a back-up issuer cash manager, a back-up trust property cash manager and a back-up administrator to maintain the ratings of the notes.

In order to mitigate market risk that the securitised assets are exposed to, the Group enters into interest rate swap agreements.

9.2.2 Participation by the Group in the Funding for Lending Scheme (FLS)

The Group has retained £3,075m of notes issued by the Gosforth Funding securitisation transactions. These notes are available for use as collateral for funding and liquidity purposes and includes the Group's participation in the FLS. At 31 December 2012 the Group had FLS drawings of £510m.

9.2.3 Roles played by the Group in the securitisation process

The Group is the originating entity and is the sole administrator in relation to the securitised loans and has serviced the loans on the same basis as the non-securitised loans. The Group also acts as the cash manager for the transactions and operates as the basis rate swap provider and the start up loan provider. Although services of investment banks and legal advisers were utilised in originating new transactions, the management of existing securitisations is undertaken by the Group.

9.2.4 Calculating risk weighted exposure amounts

As the Group's securitisations have not been undertaken in order to obtain a capital benefit, the Group does not exclude securitised exposures from its calculation of risk weighted exposures and expected losses. Risk weighted exposures and expected losses at 31 December 2012 for issued and retained securitised assets are calculated within the capital calculation of the overall mortgage portfolio, in line with the PRA Handbook under the IRB approach.

9.2.5 Accounting policies for issued and retained securitisation activities

Certain Group companies have issued debt securities in order to finance specific loans and advances to customers. Both the debt securities in issue and the loans and advances to customers remain on the Group balance sheet within the appropriate balance sheet headings unless:

- a fully proportional share of all or of specifically identified cash flows have been transferred to the holders of the debt securities, in which case that proportion of the assets are derecognised;
- substantially all the risks and rewards associated with the assets have been transferred, in which case the assets are fully derecognised; or
- a significant proportion of the risks and rewards have been transferred, in which case the assets are recognised only to the extent of the Group's continuing involvement.

The Group's results include the results and assets and liabilities of securitisation Special Purpose Entities ("SPEs"), Gosforth Funding plc, Gosforth Funding 2011-1 plc, Gosforth Funding 2012-1 plc and Gosforth Funding 2012-2 plc, none of which qualify for derecognition under IAS 39, on a line by line basis. Securitised advances are subject to non-recourse finance arrangements. These loans have been purchased at par from the company, and have been funded through the issue of mortgage-backed bonds by the SPEs.

Mortgages eligible for future securitisations are held in the Group's non-trading book and are at amortised cost using the effective interest method, less any provision for impairment.

In 2012 Virgin Money plc changed its approach for the presentation of retained notes in its financial statements. Previously the deemed loan liability to the SPEs and the purchased loan notes and their movements were presented on a net basis in Virgin Money plc's individual financial statements. In 2012 the loan note assets (classified as investment securities) and the deemed loan liabilities between Virgin Money plc and the SPEs were disclosed separately in the financial statements. In addition, Virgin Money plc previously included amounts in respect of the SPEs within customer accounts and loans and advances to banks. These have been reclassified and, along with the changes to the internally held securitised debt, required the restatement of the 2011 results for Virgin Money plc. These changes had no impact on the profit recorded by Virgin Money plc in 2011 or on the net assets as at 31 December 2011.

In addition to the above, Gosforth Funding 2010 plc and Gosforth Funding 2011-1 plc entered into a basis rate swap with Virgin Money plc. In prior years the basis rate swap was not recognised separately as a derivative financial instrument and instead was recorded within the deemed loan at amortised cost in Virgin Money plc. Virgin Money plc has changed its approach to record the derivative separately from the deemed loan, at fair value, with fair value movements being recorded in the income statement. An adjustment has therefore been made to restate the 2011 balances, in addition to changing the accounting treatment for 2012 and onwards. Accordingly, the basis rate swap is now recognised as a derivative in these SPE's, with fair value movements being recorded in the income statement.

Fair values are obtained from quoted market prices in active markets and, where these are not available, from valuation techniques including discounted cash flow models.

Gosforth Funding 2012-1 plc and Gosforth Funding 2012-2 plc have designated from inception to hold the deemed loan at fair value on the balance sheet, with changes in value being recorded in the income statement.

9.2.6 External Credit Assessment Institutions used for securitisations

The Group utilises the services of several External Credit Assessment Institutions (ECAIs) including Standard and Poor's, Moody's and Fitch to rate the securitisation transactions in issue. The ratings assigned assess the ability of the structure to allow for the timely payment of interest and the ultimate payment of principal of each of the rated notes. As part of the ratings process each of the agencies is committed to ongoing transaction monitoring to ensure that, in their view, the assigned ratings remain an appropriate reflection of the issued notes' credit risk.

9.2.7 Exposures securitised by the Group

All securitisation exposures are held within the non-trading book of the Group.

The following analysis of past due exposure details loans in arrears for each of the securitisation transactions, losses during the year and the book value of impaired assets included within each of the SPEs:

31 December 2012

	Exposures £m	Impaired and past due £m	Losses £m
Retail mortgages	5,375.5	46.7	0.1
Total	5,375.5	46.7	0.1

As at 31 December 2012 the total outstanding externally issued securitisation debt was £2,279m. This value represents the sterling equivalent taking into account the cross currency swaps in place and does not agree directly to the accounting disclosures in the Group Annual Report and Accounts which take into account movements in currency rates and fair values of the swaps. It is considered appropriate to disclose the exposures in terms of their economic value rather than their accounting values.

As at 31 December 2012 the total outstanding retained securitisation debt was £3,075m. All retained securitisation debt is in sterling and is detailed in the table within section 9.2.1.

As at 31 December 2012 there are no assets awaiting securitisation (2011 Nil).

9.2.8 Securitisation activity during 2012

During the year ended 31 December 2012, under the securitisation programme established in 2010, the Group, under the headings of Gosforth Funding 2012-1 plc and Gosforth Funding 2012-2 plc, undertook the issuance of listed residential mortgage backed securities to the value of £1,068m in July 2012 and £2,935m in November 2012. Of the £4,003m securities issued, securities totalling £2,302m were retained by the Group.

9.2.9 Synthetic securitisations

The Group has no synthetic securitisation transactions.

9.3 Purchased securitisation positions

9.3.1 Risks inherent in the purchased securitisation position

The principal risk that is inherent in the Group's purchased securitisation positions is credit risk.

The following table gives details of the positions in the securitised exposures of other issuers purchased by the Group and held at 31 December:

Risk weighting	2012 £m	2011 £m
20% (Credit Rating of AA- or higher)	52.2	-
	52.2	-

9.3.2 Roles played by the Group in the securitisation process

The Group is an investor that acquires SPV positions originated by non-Group entities as part of its balance sheet management activities.

9.3.3 Calculating risk weighted exposure amounts

Risk weighted exposures reported for purchased securitised assets at 31 December 2012 are calculated in line with the PRA handbook under the standardised approach.

9.3.4 Accounting policies for purchased securitisation positions

The Group's investments in SPV positions originated by non-Group entities are held as Investment Securities – Loans and Receivables and are at book value. Any gain or loss on sale is recognised in the Group's profit and loss account at the time of the sale.

10. Internal Ratings Based disclosures

The scope of the Group's retail IRB permission is as set out below:

10.1 Retail exposures secured by real estate collateral

The Group's IRB (Internal Ratings Based) Waiver Application Pack was approved by the FSA on 1 January 2010 for capital adequacy monitoring and reporting from 1 January 2010 onwards. The scope of this permission covers the retail business of retail exposures secured by real estate collateral.

A 31 December 2012, the areas of the business falling outside the scope of the Group's IRB permission are limited to exposures to central governments and banks, institutions, corporates and securitised positions. Asset classes not falling within the scope of the Group's IRB permission are treated under the standardised approach. The retail credit risk control function is responsible for the development, validation, implementation, monitoring and use of credit rating models for the Retail IRB approach. In order to ensure the integrity and independence of these models, the credit risk control function has clearly segregated duties from those responsible for originating exposures. The credit risk control function is responsible for monitoring the validity of its models and completeness of the supporting documentation and reporting on these to the Credit Risk Committee ('CRC'). CRC has been established as the principal forum for independently overseeing the Group's credit rating models, to ensure that the systems are producing consistent and accurate results in line with the Group's objectives and PRA minimum requirements.

10.2 Retail Internal Ratings Based models

The Group has extensive data histories, which have enabled it to build in-house credit rating models for the residential mortgage portfolio. These models facilitate an appropriate risk sensitive approach to risk management and capital allocation. The models determine long run average probabilities of default (PD), downturn loss given default (LGD) and exposures at default (EAD) for each segment in order to calculate expected losses and risk weighted assets. In addition, the models are used to inform risk appetite, support lending strategy, support determination of the level of impairment allowances and the provision of sophisticated management information.

The rating models group obligors into segments differentiated by a number of factors, which include product type, loan to value (LTV) and measures of affordability. For each segment a long run average PD, downturn LGD and EAD is estimated from a combination of recent and historic data. Data covering the period back to the early 1990s was utilised in the derivation of the PD, LGD and EAD. Internal data (including data obtained from Northern Rock (Asset Management) plc, the company operating these loans prior to 2010) was supplemented with external industry data sources where it was felt that there was not sufficient internal experience. EAD has been restricted to ensure that it can not be lower than 100% of the current exposure. An EAD for undrawn, off balance sheet, assets such as applications not yet taken up has also been built into the models through the use of credit conversion factors.

10.3 Exposures by exposure class

Retail IRB	2012	2011
	£m	£m
Retail exposures secured by real estate collateral	18,571.3	-
	18,571.3	-

The following table details the Group's exposures for its sole IRB exposure class of retail exposures secured by real estate collateral. These relate to exposure at default, and include all on and off balance sheet exposures.

2012						
Risk Band	LRA PD	Exposure (£m)	Downturn LGD	RWA%	RWA (£m)	Time on Book (months)
Standard1	0.65%	3,613	10.32%	6.99%	253	66
Standard2	1.05%	5,042	12.58%	11.24%	565	53
Standard3	1.50%	4,027	16.81%	18.80%	757	56
Standard4	1.79%	2,345	20.52%	25.84%	606	52
Standard5	2.26%	1,361	21.55%	33.69%	459	95
BTL1	0.60%	1,102	12.28%	7.33%	81	30
BTL2	1.33%	814	16.50%	18.34%	149	22
BTL3	2.71%	94	18.60%	38.11%	36	84
BTL4	4.06%	132	18.27%	46.15%	61	85
Default	100.00%	41	26.88%	228.84%	95	94
Total		18,571			3,062	

10.4 Impairment charges by exposure type

This table shows the impairment charges made in 2012 by Basel exposure class, and includes impairment charges for exposure classes under the standardised approach.

	2012	2011
	£m	£m
Retail exposures secured by real estate collateral	3.0	-
Other retail exposures	-	-
	3.0	-

10.5 Loss analysis – regulatory expected loss versus actual loss

This table shows the regulatory Expected Loss measure, compared with Actual Loss by IRB exposure class

2012			
Retail IRB	Regulatory		
	Expected	Actual	
	Loss	Loss	
	£m	£m	
Retail exposures secured by real estate collateral	36.5	3.0	

10.6 Credit model performance – estimated versus actual

This table shows the forecast and actual probability of default and loss given default by IRB exposure class.

2012				
Retail IRB	PD of		LGD	
	total portfolio		of defaulted assets	
	Estimated	Actual	Estimated	Actual
	%	%	%	%
Retail exposures secured by real estate collateral	1.30%	0.29%	26.0%	15.4%

Prior to its acquisition by Virgin Money Group, Northern Rock plc was formed through the successful legal and capital restructure of the former Northern Rock business, which took effect on 1 January 2010. At this time, the company acquired a high quality seasoned mortgage book from the former Northern Rock.

Levels of default emerging have been extremely low, and any comparison between predicted and actual levels of default at this time is subject to a level of volatility, due to the extremely small population of defaulted loans. The differences between actual and forecast shown in the above table reflect this volatility and the Group expects levels of actual and estimate to converge as the mortgage book seasons further.

11. Credit Risk Mitigation

11.1 Retail exposures

Of the Group's retail exposures at 31 December 2012, over 99.99% were secured on residential property. The personal unsecured portfolio made up the remaining less than 0.01% of retail exposures. The indexed average loan to value ratio of the mortgage book at the end of 2012 was 63%. The collateral held against mortgage exposures was valued at £32.2bn (2011: £43.6m). Of this, £15.4m was held against impaired loans with a book value of £11.2m (2011: £1.3m held against impaired loans with a book value of £0.7m).

11.2 Treasury exposures

Credit Support Annexes (CSAs) exist for collateralising derivative transactions with counterparties to which the Group has its derivative exposures in order to mitigate the risk of loss on default. The CSAs allow margin calls to be made on the net mark to market value of derivative exposures with a particular counterparty. All collateral held or paid under the CSAs is in the form of cash. Although these CSAs are taken into consideration when setting the internal credit risk limits for derivative counterparties, under the standardised approach the Group does not recognise the risk mitigating effect of these CSAs in its Pillar 1 capital calculations. At 31 December 2012, cash collateral of £3.8m (2011: £Nil) was held in relation to CSAs.

12. Remuneration

12.1 Approach to remuneration

In 2012 the Remuneration Committee developed a new Group Remuneration Policy for the combined group. This policy has been designed to comply with the Remuneration Code.

Through this Remuneration Policy, colleagues are provided with remuneration packages which encourage them to contribute to the success and profitability of the business in a meaningful and well balanced way, which is within our risk appetite.

The Code Staff population in 2012 totalled 53. The remuneration for these colleagues is governed under the Remuneration Policy.

12.2 The Remuneration Committee

The Remuneration Committee of the Board of Directors of Virgin Money Holdings (UK) Limited determines and recommends to the Board for approval a Group Remuneration Policy and framework. The Remuneration Committee undertakes an annual review of the Remuneration Policy to ensure continued compliance and alignment with the Remuneration Code.

During 2012 the Remuneration Committee consisted of three non-Executive Directors, two of whom are independent non-Executive Directors. The individuals are also members of the Board of Directors of Virgin Money plc and Church House Trust Limited. The Committee members during the year were*:

Mr C D Keogh	(Chairman)
Mr N C McLuskie	
Sir D C Clementi	

* Two directors (Mr J B Lockhart and Mr G D McCallum) resigned from the Remuneration Committee at its first meeting of 2012.

Only members of the Committee have the right to attend and vote at Committee meetings. However, other individuals are invited to attend meetings as and when appropriate and when deemed necessary (except where their own respective remuneration is under review). In addition, the Committee obtained external remuneration policy advice during the year from Towers Watson.

12.3 Design characteristics of the remuneration system

Salaries and total remuneration of colleagues were benchmarked using relevant external data against the financial services market to ensure competitiveness. Variable remuneration schemes have appropriate caps (as a proportion of basic salary) and deferral in line with the Remuneration Code.

The proportion of variable pay to be deferred was set to encourage colleagues to take a longer-term view, and the release of deferred amounts is supported by a robust risk framework.

Deferred variable remuneration for senior colleagues and Code Staff is deferred in line with the Remuneration Code. It is designed to embed long-term risk among colleagues.

In line with the Remuneration Code requirements, deferral is a key risk management and retention tool for senior management colleagues and Code Staff. The malus/clawback principle of pool allocation can be used by the Remuneration Committee to adjust for future and long-term risks.

Ex-post risk adjustments, both clawback and malus, could apply, to take account of subsequent risks and developments after bonuses were announced, paid or deferred. Such adjustments would apply if there were reasonable evidence of employee misbehaviour or material error; or the Group suffered a material downturn in its financial performance; or the Group or the relevant business unit suffered a material failure of risk management.

12.4 Link between pay and performance and the performance criteria used

Colleagues are appraised annually against the entirety of the role they perform, the behaviours they exhibit, the objectives they are set and their competencies. This holistic appraisal drives variable pay awards and any future pay increases.

Corporate performance was measured principally by the Board using a balanced scorecard, combining financial and non-financial metrics for the Group and each individual function. This encourages compliance and awareness of long-term risk and its relationship with remuneration and reward, balanced with protecting the Group's capital position. Non-financial performance metrics form part of the assessment process and include effective risk management and compliance with Remuneration Code requirements.

The following 'ex ante' risk assessments were used by the Committee in order to determine the size of the variable remuneration pool:

- The Committee considered the earnings performance for the financial year
- The Committee also reviewed underlying business performance against the corporate scorecard to ensure that outcomes are appropriate
- The Chief Risk Officer provided an independent risk assessment report of overall performance
- The People Director provided a risk assessment of individual performance to identify significant individual risk breaches and any individual malus

In addition, the following 'ex post' risk adjustments were incorporated in order to take account of subsequent or long-term risks which may appear after the end of the performance period. This facility was included as a final measure as a means of reclaiming bonuses already paid, whilst malus could be used to prevent deferred elements of variable remuneration from being paid in the event of:

- there being reasonable evidence of employee misbehaviour or material error; or
- the Firm or the relevant business unit suffers a material downturn in its financial performance; or
- the Firm or the relevant business unit suffers a material failure of risk management.

The Remuneration Committee retains the overall discretion on whether any adjustment is required and what level of adjustment is appropriate. This would ensure that there are no unreasonable outcomes from the adjustment process.

12.5 Remuneration for code staff

The following tables display the 2012 remuneration for Virgin Money's Executive, Non-Executive and Senior Management and colleagues whose professional activities may have a material impact on the risk profile of the Group (Code Staff).

12.5.1 Fixed and Variable Remuneration

The table below shows total fixed and variable remuneration awarded to Code Staff in 2012. The data has not been broken down by business area due to size and scale of operations.

Code Staff	2012	Senior Management	Other Code Staff
	£m	£m	£m
Total Fixed	9.1	4.2	4.9
Total Variable	7.8	5.4	2.4
Total Remuneration	16.9	9.6	7.3
Number of Code Staff	53	18	35