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## FINAL NOTICE

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To: **The Co-operative Bank PLC**  
**(FRN: 121885)**

Address: 1st Floor, St Paul's House, London EC4M 7BP

Date: 10 August 2015

### 1. ACTION

1.1. For the reasons set out in this Notice, the PRA hereby publishes, pursuant to section 205 of the Financial Services and Markets Act 2000 ("the Act"), a statement that The Co-operative Bank Plc ("Co-op Bank" or "the Firm") breached Principles 3 and 11 of the Principles for Businesses between 22 July 2009 and 31 December 2013 (the "Relevant Period")<sup>1</sup>. The statement will be issued on 11 August 2015 and will take the form of this Final Notice, which will be published on the PRA's website.

1.2. The PRA's general objective is to promote the safety and soundness of the firms which the PRA regulates. In the circumstances of this case, the PRA considered that imposing a financial penalty on Co-op Bank would not advance that objective. Were it not for this consideration, the PRA would have imposed a financial penalty of £121.86 million for the breaches (which would have been reduced to £85.3 million

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<sup>1</sup> Although the Principles for Businesses have now been replaced with effect from June 2014 by the PRA Fundamental Rules, the FSA Principles for Businesses applied to the Firm in the Relevant Period up to 31 March 2013 and the PRA's Principles for Businesses in the Relevant Period from 1 April 2013 to 31 December 2013.

through the application of a 30% discount because the PRA reached settlement with the Firm at Stage 1).

## **2. SUMMARY OF REASONS FOR THE ACTION**

### **Background**

- 2.1. Co-op Bank is a UK bank which provides high street and internet banking, current accounts, mortgages, savings accounts, credit cards and loans to individuals and businesses. The firm is regulated by the PRA for prudential purposes and by the FCA for conduct matters.
- 2.2. Until 20 December 2013, Co-op Bank was a wholly owned subsidiary of The Co-operative Banking Group, which in turn was a wholly owned subsidiary of the Co-operative Group Limited ("Co-op Group"). The Co-op Group is one of the UK's largest mutual businesses, owned by millions of UK consumers. It is a Registered Society within England and Wales and has interests across food, funerals, insurance and legal services.
- 2.3. On 1 August 2009, Co-op Bank merged with Britannia Building Society ("Britannia") and acquired all the assets and liabilities previously held by Britannia. The acquired assets included portfolios of loans which had been made by Britannia to commercial borrowers, many of which were secured on commercial real estate ("CRE"). Among the accounting liabilities taken on by Co-op Bank were a series of securities known as Leek Notes which Britannia had sponsored to raise funding. The Leek Notes were secured on the cash inflows from residential mortgages.
- 2.4. In 2006, Co-op Bank initiated a project to replace its legacy banking IT systems with a new software platform (called Finacle), with a view to migrating its operations to this system. Following the merger with Britannia, the scope of the Finacle project was increased to cover the IT re-platforming of both the Co-op and Britannia legacy businesses.
- 2.5. During 2012 and early 2013, Co-op Bank was involved in the consideration of, and negotiations and planning for, a proposed project to purchase 632 bank branches from the Lloyds Banking

Group, known as Project Verde. Co-op Bank decided in April 2013 not to proceed with Project Verde.

- 2.6. On 17 June 2013 Co-op Bank publically announced that the Firm required an additional £1.5 billion of Common Equity Tier 1 capital. Co-op Bank subsequently undertook a Liability Management Exercise to improve its capital position which completed on 20 December 2013. As a consequence of this exercise, the Co-op Bank ceased to be a wholly-owned subsidiary of the Co-op Group, although the Co-op Group continues to hold more than 20% of voting rights in general meetings of Co-op Bank.

### **Breaches and failures**

- 2.7. During the Relevant period, Co-op Bank failed to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management controls, in breach of Principle 3. This is because:

(1) Co-op Bank's control framework was inadequate. Firms typically employ a "three lines of defence" model based on appropriate management oversight of the business (first line), risk and compliance (second line) and internal audit (third line). Co-op Bank sought to put in place such a "three lines of defence" model but this was flawed both in design and operation. In particular:

(a) In the first line of defence, there was inadequate and inappropriate first line management oversight of the business.

(i) Businesses in the Corporate Division did not properly consider risk when conducting their day-to-day business. These businesses tended to see risk as a second line responsibility.

- (ii) Having set a risk appetite which was “cautious”, Co-op Bank failed to manage its finances and capital in line with that appetite. This meant that the Firm neither adequately considered the level of risk which it assumed nor had in place commensurate risk management capability. Examples of approaches which were not consistent with a cautious risk appetite included the Firm’s decisions on Fair Value Adjustment (“FVA”) and impairment on the Corporate Loan Book and accounting/capital treatment for the Leek Notes and Finacle.
- (iii) Co-op Bank failed adequately to identify and manage the risks associated with the Corporate Loan Book (the Firm’s combined corporate and commercial lending portfolio following the merger with Britannia) and to formulate and communicate a clear and comprehensive strategy for the management of that book until early-2013.
- (iv) Co-op Bank frequently overrode its own systems and controls when making decisions in relation to the Corporate Loan Book. For example, it failed to carry out regular valuations on security held, as prescribed by its internal policy, and routinely relied on exemptions to its Key Credit Criteria (“KCC”).
- (v) A number of key issues were not brought adequately to the attention of the Board on a timely basis, or at all. For example, Co-op Bank changed the assumption in its business plan in relation to the Leek Notes (which had significant implications for its capital outlook and market reputation) but the Board was not consulted on this decision prior to it being made.

- (b) The second line of defence did not provide proper independent challenge. It was poorly-structured and under-resourced. In particular, its structure was fragmented and, in some cases, the first and second line roles were blurred. For example, in relation to corporate lending and capital management, second line staff took responsibility for processes which should have been conducted within the first line, resulting in a lack of independent challenge.
  - (c) The third line of defence did not focus sufficiently on the high-risk areas of the Firm and when it did, it did not pick up on the key issues which it should reasonably have been expected to identify.
  - (d) Given the significant shortcomings in the control framework, there was an even greater need for an appropriate culture within Co-op Bank in order to manage risk in a manner consistent with its risk appetite and prudent bank management more generally. However, Co-op Bank had a culture which encouraged prioritising the short-term financial position of the Firm at the cost of taking prudent and sustainable actions for the longer-term.
- (2) Co-op Bank did not have adequate risk management framework policies or adequate policies and procedures in relation to corporate lending and capital management. Although the Firm, from mid-2012 onwards, took steps towards improving its risk management framework, including engagement of an external consultancy firm to assist in defining a revised framework, it was only towards the end of the Relevant Period, when new senior management had been appointed, that Co-op Bank began properly to address concerns around its risk management framework structures and policies and procedures around corporate lending and capital management.

(3) The management information produced by the Firm, including management information for its Board, was not adequate. It was not sufficiently forward-looking and did not sufficiently highlight the key issues. For example, until February 2013 no data was collected to allow the Firm to understand the number or pattern of KCC overrides. This meant that the Board was not appropriately apprised of key issues and information, which hampered its ability to deal with them in a timely manner.

2.8. Co-op Bank also failed to deal with its regulators (the FSA and subsequently the PRA) in an open and cooperative way, and to disclose appropriately matters relating to Co-op Bank of which the regulators would reasonably expect notice, in breach of Principle 11. From 25 April 2012 to 9 May 2013, Co-op Bank failed to notify the regulators of two intended personnel changes in senior positions at the Firm, and the reasons for those intended changes.

2.9. Annexes A and B set out the full particulars of Co-op Bank's breaches and failures.

### **PRA Powers**

2.10. On 1 April 2013, a new "twin peaks" regulatory structure came into being, under which the FSA was replaced by the FCA and the PRA. The effective date of that change, 1 April 2013, is known as the date of Legal Cutover ("LCO").

2.11. Although the conduct to which this matter relates began prior to, and ended after, LCO, Part 5 of the Financial Services and Markets Act 2012 (Transitional Provisions) (Enforcement) Order 2013 ("the Transitional Provisions Order") permits the PRA and/or FCA to take action in relation to contraventions occurring pre-LCO but for which the PRA and/or FCA would have been the appropriate regulator had the contravention occurred on or after LCO. The PRA therefore has the power to take action in relation to this matter.

2.12. Pursuant to section 210(7) of the Act, the PRA must have regard to any statement published at the time when the contravention occurred when considering whether to impose a financial penalty (and if so, in

what amount). Since the Relevant Period commenced before 1 April 2013 but continued after that date, pursuant to article 11(6)(b) of the Transitional Provisions Order, the PRA's Penalty Policy is the relevant policy to which the PRA must have regard.

### **PRA's rationale for taking action against Co-op Bank**

#### Principle 3

- 2.13. The PRA considers that a strong control framework and good risk management culture are of fundamental importance in ensuring a bank's safety and soundness. Further, open and cooperative disclosure of information by firms is crucial to the PRA's ability to supervise effectively, and hence to the success of the regulatory system.
- 2.14. Co-op Bank's failure to comply with Principle 3 during the Relevant Period was serious and wide-ranging. The Firm's failure to (i) maintain an adequate control framework, (ii) to put in place an adequate risk management framework policy or policies and procedures governing corporate lending and capital management and (iii) to prepare adequate management information resulted in Co-op Bank not managing its affairs responsibly and effectively, with adequate risk management systems. These failings had the clear potential to impact on the safety and soundness of the Firm. While it is not possible to determine whether the capital shortfall at Co-op Bank could have been avoided (partly as a result of the impact of the failings themselves), a more risk-aware culture and effective systems and controls would have significantly increased the prospects of dealing with the issues that the Firm faced more effectively and on a more timely basis.
- 2.15. Many of the failings by the Firm in breach of Principle 3 arose out of weaknesses in the way in which Co-op Bank organised and controlled its affairs which had been brought to the attention of the Firm by the regulators on a number of occasions over the Relevant Period. While Co-op Bank had taken some steps to address these concerns, the Firm failed to ensure that matters were remediated to a sufficient degree and in an appropriate timeframe. This permitted the failings described above to occur.

### Principle 11

- 2.16. The PRA's proactive and forward-looking supervisory approach requires an open dialogue with firms about the quality and conduct of their senior leadership team and how the firm's management team might change in the future.
- 2.17. During the Relevant Period, Co-op Bank was facing a number of challenges, including pressures on its financial and capital position and the pursuit of a major transaction. As a result, the regulator would have expected to be notified without delay of any intended changes to senior leadership. The failure of Co-op Bank to pass on important information in this regard was serious.

### **Sanction**

- 2.18. Taking into account the above facts and matters and the relevant factors set out in the PRA's Penalty Policy, the PRA considers that the breaches of Principles 3 and 11 by Co-op Bank warrant the imposition of a financial penalty of £121.86 million by the PRA. That penalty would have been reduced by a 30% discount to £85.3m for settlement with the Firm at Stage 1. The basis and computation for this penalty is set out in Annex C.
- 2.19. However, the PRA's Penalty Policy requires the PRA, when applying the Penalty Policy, to have regard to all relevant facts and circumstances, which may include the effect an action for penalty could have on the advancement of the PRA's statutory objectives.
- 2.20. These statutory objectives include the PRA's general objective which is to promote the safety and soundness of the firms which the PRA regulates. The PRA considers that imposing a financial penalty on Co-op Bank would not advance that objective. It therefore has decided not to impose a financial penalty on Co-op Bank in this instance but instead to publish a statement that the Firm breached Principles 3 and 11 of the Principles for Businesses during the Relevant Period.

## **3. PROCEDURAL MATTERS**

- 3.1. The procedural matters set out in Annex D are important.

Robert Dedman

Chief Counsel, Regulatory Action Division

for and on behalf of the PRA

## **Annex A**

### **1. BREACHES AND FAILINGS**

- 1.1. The facts and matters to which the following conclusions relate are set out in Annex B.

#### **Principle 3**

- 1.2. Principle 3 states that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- 1.3. During the Relevant Period, Co-op Bank breached Principle 3 as it:
- (1) did not have an adequate control framework in place;
  - (2) did not have adequate risk management policies or proper policies and procedures in relation to corporate lending and capital management; and
  - (3) did not produce adequate management information, including management information for its Board.

#### **Principle 11**

- 1.4. Principle 11 states that a firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.

- 1.5. During the Relevant Period, Co-op Bank also failed to deal with its regulators (the FSA and subsequently the PRA) in an open and cooperative way, and to disclose appropriately matters relating to Co-op Bank of which the regulators would reasonably expect notice, in breach of Principle 11. From 25 April 2012 to 9 May 2013, Co-op Bank failed to notify the regulators of two intended personnel changes in senior positions at the Firm, and the reasons for those intended changes. Where a firm forms a view in relation to the members, structure or effectiveness of its senior management, this is a matter of which the PRA would reasonably expect to be notified without delay as part of its day-to-day supervision of the firm. This is to enable the PRA properly to consider and assess the management at the firms which it regulates and the risks to safety and soundness which may arise from changes to the management team.

## Annex B

### PARTICULARS OF BREACHES AND FAILINGS

#### Facts and Matters relating to the Principle 3 breach

##### 1. Inadequate control framework

- 1.1. Co-op Bank had an inadequate control framework in place during the Relevant Period.
- 1.2. The Firm sought to put in place a “three lines of defence” model. This is a system which relies on there being an opportunity at three complementary and independent levels to identify and correct any control failures. At Co-op Bank, the first line of defence was management oversight and day-to-day procedures and controls in the revenue-generating areas of the business. The second line of defence comprised risk and compliance oversight of the business. The third line of defence was Internal Audit.
- 1.3. Co-op Bank’s “three lines of defence” model was flawed both in design and operation. The Firm’s failure to put in place an adequate control framework during the Relevant Period resulted in a failure to organise and control its affairs responsibly and effectively, with adequate risk management systems, in breach of Principle 3.
- 1.4. Further particulars on the flaws in the design and operation of the “three lines of defence” which the Firm sought to put in place are detailed in the following sections.

##### First line of defence

- 1.5. In the first line of defence, there was inadequate and inappropriate management oversight of the business, as follows:

##### *Failure of businesses to adequately consider risk*

- 1.6. Staff in business functions should manage risks as a central part of their role, and responsibility for risk should not be delegated to risk management and control functions.

- 1.7. Businesses in the Corporate Division did not properly consider risk when conducting their day-to-day business. Risk management was seen as a second line responsibility. For example, the businesses did not effectively monitor Relationship Managers (who were responsible for the origination and day-to-day management of performing loans) to ensure compliance with policies and procedures. This led to a lack of adequate control of overrides of policies and procedures as described further below.

*Failure to manage within stated risk appetite*

- 1.8. Co-op Bank's stated risk appetite was "cautious", as set out in papers produced for Co-op Bank's Risk Management Committee in November 2010 and in communications with the regulators during the Relevant Period. A firm's statement of its risk appetite is an important source of information for stakeholders of the firm and for the PRA in setting its risk-based approach to supervising firms.
- 1.9. Firms should have robust frameworks for risk management and financial and operational control, commensurate with the nature, scale and complexity of their business, and consistent with their safety and soundness. A firm's stated risk appetite is an important factor in determining whether a firm's risk and control framework is commensurate with nature of its business, and should be both integral to a firm's strategy and at the heart of its risk management framework. All the activities of the firm should be conducted within the context of that risk appetite.
- 1.10. Despite its statement of a "cautious" risk appetite, during the Relevant period Co-op Bank relied on applications of accounting standards<sup>2</sup> and regulatory capital requirements which were not in line with that risk appetite and thereby exposed the Firm to increased risks without proper consideration of their implications or of appropriate strategies for managing them. Examples of these behaviours included:

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<sup>2</sup> Requirements which apply to firms under accounting standards may entail a degree of subjectivity and often a range of approaches is capable of meeting the strict requirements of the relevant standard. Such approaches may range from the most

- (1) The accounting/capital treatment for Leek Notes;
- (2) The accounting/capital treatment for Finacle; and
- (3) The calculation of FVA and corporate impairment decisions made on the Corporate Loan Book.

Example 1: Accounting and capital decisions in relation to Leek Notes

1.11. The Leek Notes were mortgage-backed securitisations sponsored by Britannia before the merger with Co-op Bank and issued by special purpose vehicles. The Leek Notes were reflected as liabilities in Co-op Bank's balance sheet after the merger. There were a number of issues of the Leek Notes each with a maturity of up to 25 years. The Leek Notes paid a fixed rate of interest which was structured to increase to a higher rate commencing from a date five years from the date of issue (the "step-up" date). Early redemption of the Leek Notes at the option of the issuer was possible either at the step-up date or at the point at which the amount of the Notes in issue fell to a "de minimis" level (the "10% contract date")<sup>3</sup>.

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conservative or prudent application to one which is more optimistic. KPMG, Co-op Bank's auditors, maintained an indicative scale of 1 (most prudent) to 7 (most optimistic) to provide guidance to the Firm as to where an accounting decision might lie on the prudence spectrum, with a score of 7 being seen by KPMG as unacceptable.

<sup>3</sup> The "10% contract date" was the point at which the principal amount of Notes in issue fell to 10% or less of the principal amount of the date on which that issue originally closed.

- 1.12. At the time of the merger, the liabilities under the Leek Notes were measured for fair value. The fair value of these liabilities was calculated as less than the face (par) value and so a FVA<sup>4</sup> was recorded against them. The FVA was due to unwind<sup>5</sup> over the Useful Economic Life (“UEL”) of the Notes (or the assumed remaining period until redemption), causing a corresponding deduction to Co-op Bank’s income statement each year. The longer the UEL of the Notes, the more gradual the negative impact on the income statement (and, therefore, on the firm’s capital position).
- 1.13. Before the merger, the Leek Notes had always been redeemed at the step-up date. This meant that the UEL of the Leek Notes in issue was assumed to be five years. As market convention was to redeem at step-up, the reputational impact on Co-op Bank of not doing so would have been severe, potentially reducing its future ability to borrow from the market. As an entity ultimately wholly-owned by a mutual<sup>6</sup>, Co-op Bank had limited options for raising capital, and a lack of access to the capital markets was even more serious than it would be for other non-mutual organisations.

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<sup>4</sup> For accounting purposes, where two firms combine, one firm is treated as “acquiring” the other. At the date of the merger, the acquiring firm is required to take on the assets and liabilities of the acquiree firm at their “fair value” at the date on which the firms combine. “Fair value” is the price that would be received to sell an asset or paid to transfer a liability in an orderly, arms-length transaction between willing parties. As accounting standards may have required items to be held on the balance sheet of the acquiree on a non-fair-value valuation basis, there may be a need to “adjust” the value of those items to fair value so that they can be correctly recorded in the balance sheet of the combined entity. For the purposes of the Co-op Bank merger with Britannia, Co-op Bank was treated as the acquirer and so Britannia’s assets and liabilities had to be adjusted to fair value at the date of the merger (i.e. they were the subject of a FVA).

<sup>5</sup> Where a liability in issue is taken on to the balance sheet at a fair value which represents a discount to its face (or redemption) value, that difference will be recognised through the income statement (with such recognition being spread over the remaining life of the liability before redemption) to reflect the fact that the liability is expected to be repaid at par.

<sup>6</sup> As set out above, at this time Co-op Bank was a wholly-owned indirect subsidiary of Co-operative Group Limited which is a Registered Society (registered number 525R) in England and Wales.

- 1.14. In July 2009, shortly before the merger, in its capital forecast for the combined entity which would be created via the merger, Co-op Bank changed its assumption on the future redemption of Leek Notes from redeeming at the step-up date to redeeming at the 10% contract date, which was nearer the 25 year full life of the Leek Notes. This had the effect that, post-merger, the FVA would unwind much more gradually through the income statement, with a corresponding (short-term) positive impact on the Firm's capital position. This improved the forecasted performance of the combined entity in the years immediately following the merger.
- 1.15. The Board was not consulted about this change and was not briefed on the risks associated with it (although the change in assumption was referred to in the Audit & Regulatory Compliance Committee papers, which were provided to Board in November 2009 - after the merger). The Board was not notified of the significant market reputational risk of the change in assumption, nor its long term impact on capital, until May 2010.
- 1.16. In the Firm's 2010 ICAAP (the Firm's submission to the regulator on planning for its capital needs which the FSA/PRA reviews in setting the Firm's capital requirements), Leek Notes were recorded with the assumption of redemption at the 10% contract date. The corresponding regulatory capital benefit of this change in assumption over the next three years (2010 - 2012) was approximately £450 million compared to the position assuming redemption at step-up. There was also a large reputational risk attached to communicating this proposed timing for redeeming the Leek Notes to the market. However, in the ICAAP 2010, the Firm did not record any reputational risk value for this at all in the Material Risks section. Doing so may have increased the capital requirement. .
- 1.17. Despite now assuming for accounting and capital purposes that it would not redeem the Leek Notes until the 10% contract date, the Firm redeemed issues 14, 15 and 16 of Leek Notes at their step-up dates during 2009 and 2010.

- 1.18. The PRA considers that the accounting treatment adopted for Leek Notes by the Firm was not consistent with Co-op Bank's stated "cautious" risk appetite because it deferred the recognition of costs in the Firm's income statement and regulatory capital returns in a manner which exposed the Firm to additional risk.
- 1.19. There was a significant likelihood that the Leek Notes would be redeemed at step-up and that the balance of the face value of Leek Notes (in excess of the initial fair value and the unwind to date) would need to be recognised immediately on such redemption, creating a negative variance to budget because these amounts had not been accrued for.
- 1.20. In addition, the failure to ensure that Board was fully apprised on a timely basis of the effect of the change in assumption on reported performance and regulatory capital undermined the Board's ability to manage the Firm's capital position on a "cautious" basis.

Example 2: accounting and capital decisions in relation to Finacle

- 1.21. Co-op Bank made accounting and regulatory capital reporting decisions in relation to Finacle from 2009 until March 2013 which were not in line with Co-op Bank's stated "cautious" risk appetite. These had the effect of boosting the Firm's reported regulatory capital position and of deferring negative impacts on the Firm's income statement to a later period.
- 1.22. In 2006, Co-op Bank began a business transformation programme to re-platform its core banking software. A product called Finacle was chosen to be the platform software. This IT project was held on the balance sheet of a non-consolidating sister company called CFS Management Services Limited ("CFSMS") but was, in substance, always intended for Co-op Bank's benefit. Indeed internal presentation documents from 2008-2012 referred to at least 99% of the benefits of the new system being for the Firm and the costs of its development were in fact borne by the Firm. Save for very limited aspects, the Finacle system was never implemented, and in 2012 its development was paused whilst options were considered in relation to

the proposed Verde transaction. In June 2013, Finacle was scrapped and written-off fully.

1.23. Co-op Bank made two capital and accounting decisions in relation to Finacle which had the consequence of benefiting its capital position and which were not consistent with its stated “cautious” risk appetite:

- (1) Instead of deducting the value of Finacle from its capital declarations, as is required for intangible assets<sup>7</sup>, and as it did in its 2010 ICAAP submission, Co-op Bank chose not to deduct the value of Finacle in all other capital returns from 2009 until March 2013. Instead, Co-op Bank kept the full value of Finacle (as an intercompany debtor<sup>8</sup> with CFSMS) within its capital returns, including its FSA003 and FSA003+ Capital Adequacy Reports until 31 March 2013, and its 2012 ICAAP submission. This treatment as a debtor in regulatory capital returns submitted to the regulators did not reflect the substance of the Finacle project (because the debtor balance with CFSMS was backed only by the intangible asset being held for the benefit of the Co-op Bank by CFSMS and so would not have been available to cover losses of the Firm) but had the effect of artificially boosting Co-op Bank’s Core Tier 1 capital position by the value of the asset. In the 2012 ICAAP, this capital benefit was approximately £300 million (with a total Core Tier 1 capital after deductions of £2.029 billion)<sup>9</sup>.

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<sup>7</sup> Regulatory capital should be available to meet any unexpected losses incurred by a firm. Where losses arise, it is often difficult to quickly realise value for intangible assets (such as licenses, patents, software etc.) which are being used by a firm in its business and, for this reason, intangible assets should be deducted from assets taken into account for regulatory capital purposes.

<sup>8</sup> Debtors are usually permitted to be included in assets taken into account for regulatory capital purposes because it is assumed that debts owed to a firm can be recovered from the debtor within a reasonable timeframe and the proceeds used to cover losses at the firm.

<sup>9</sup> Subsequently, in its year-ended 31 December 2013 financial statements, Co-op Bank restated its 2012 comparatives, bringing Finacle onto its own balance sheet instead of that of CFSMS, and deducting Finacle from its 2012 capital position as an intangible asset.

- (2) In late 2012, despite strong indications and internal views that Finacle was not a viable option for Co-op Bank regardless of what happened with the Verde transaction, Co-op Bank decided not to fully-write off Finacle and instead opted only to make a £150 million provision for it in its financial statements for the year ended 31 December 2012. This avoided a further loss and Core Tier 1 capital reduction at the 2012 year-end. This optimistic treatment was noted by the auditor, who while ultimately signing off this provision, categorised it at the most optimistic end of its prudence scale (6 (highly optimistic) out of 7, with 7 being unacceptable). Co-op Bank finally wrote off the remaining £148.4 million of Finacle in its financial statements for period-ended 30 June 2013.

Example 3: Accounting decisions in relation to Corporate Loan fair values and impairments

- 1.24. A FVA exercise was to be carried out in order to establish what the actual value of the Britannia Corporate Loan Book<sup>10</sup> would be on the date of the merger, taking into account the future lifetime expected losses on the assets. This exercise was felt, by the Board, to provide comfort for the risks that the Britannia Corporate Loan Book posed. The final FVA, reached in March 2010, was £284 million. This exercise was completed in a tight timeframe, and performed on a risk-based basis, in order to be completed in time for the publication of Co-op Bank's financial statements for year-ended 31 December 2009 on 17 March 2010. The final FVA was at the optimistic end of the range of potential adjustments. Moreover, once the FVA amount was determined, it was not revisited and as a result the FVA exercise did not take into account many of the findings of the case-by-case review of Britannia's Corporate Loan Book which was underway and completed in July 2010. In the event, the FVA was a significant

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<sup>10</sup> Accounting standards require loans which a firm intends to hold to maturity to be held at amortised cost. Therefore, as described above, Britannia loans needed to be "adjusted" to fair value in the combined Co-op Bank balance sheet as at the date of the merger.

underestimate of the actual impairments which were to arise on the relevant assets.

- 1.25. In addition, for the 2011 interim and year-end financial statements, the auditor approved the corporate impairments as being within the tolerable range but generally categorised the Firm's prudence as being towards the optimistic end of the scale (5 (optimistic) out of 7, with 7 being unacceptable).
- 1.26. For the 2012 interim financial statements, the Firm's prudence was categorised as being 4 (balanced) out of 7. However, on 20 December 2012 the FSA sent a letter to banks and building societies on loan loss provisioning which sought to ensure that firms took an appropriate approach to loan loss provisioning by setting out the circumstances when a provision should be made. This letter caused Co-op Bank to change its practice significantly and led to a large increase in impairment provisions both for year-ended 31 December 2012 and in 2013.
- 1.27. The fact that the Co-op Bank consistently took an optimistic view of the expected performance of the Corporate Loan Book both at acquisition and subsequently resulted in the Firm being exposed to a significant risk that the actual performance of the Corporate Loan Book would fall short of the level for which the Firm had provided. Co-op Bank should reasonably have been aware that such a shortfall in performance on the Corporate Loan Book might be expected to lead to material and unexpected negative impacts on the Firm's income statement and capital levels to which, given the Firm's regulatory capital position, the Firm would then have limited opportunity to respond. Therefore, the PRA does not consider that these accounting decisions were consistent with Co-op Bank's stated "cautious" risk appetite.

*Inadequate controls around the Corporate Loan Book*

- 1.28. A firm should ensure that its systems and controls are commensurate with the nature, scale and complexity of its business. In considering the risks associated with a particular business activity, and hence the procedures and controls which are appropriate for the management of that business, firms should take account of all relevant circumstances, including the external environment in which they operate.
- 1.29. The Corporate Loan Book was a material part of the Co-op Bank's business. The Firm was also aware that the assets acquired through the merger with Britannia included items which were not always consistent with the type of commercial lending which had taken place at Co-op Bank prior to the merger. In addition, the external environment during the Relevant Period was particularly challenging with the continuing effects of the economic downturn, low interest rates and pressures on the CRE market. Therefore, Co-op Bank should reasonably have been aware that particular consideration needed to be given to ensuring that the control system governing the management of this book was adequate and commensurate with those risks.
- 1.30. After the merger with Britannia, Co-op Bank did not manage the Corporate Loan Book adequately. It failed to identify, document, communicate and manage the risks associated with this book to an appropriate standard and on a timely basis. It also failed to formulate and communicate a clear and comprehensive strategy for this book until early-2013.

- 1.31. In January 2009, before the signing of the merger agreement, a Co-op Bank in-house team spent two days considering around 30 (approximately 10% by volume of the total connections<sup>11</sup>) of what were considered<sup>12</sup> to be the largest Britannia corporate loans. This was carried out by a review of files which contained little information, often with no reference to the name of the borrower but to a reference number from which the borrower could not be identified. While it was understood by Co-op Bank that many of these loans were beyond its appetite in terms of loan-to-value (“LTV”), the Firm was, at that stage, unable to assess properly either connection risk (i.e. a number of loans extended to a single borrower or group of connected borrowers) or concentration risk (i.e. the extent to which multiple exposures related to a particular risk sector).
- 1.32. No written report was prepared or presented to the Board concerning the Britannia Corporate Loan Book, and it would appear that the Board took comfort from a very high-level oral report which did not raise significant concerns in relation to the Corporate Loan Book. Between January 2009 and 1 August 2009, when the merger took place, no further due diligence was carried out in respect of the Britannia Corporate Loan Book.
- 1.33. There was also no clearly-defined strategy in place to address the risks of the book which were known. Britannia’s Corporate Loan Book was recognised at £3.7 billion in the Britannia cessation accounts, and impairments had increased substantially from £14 million in 2007 to £58 million in 2008, having previously been fairly stable. The Corporate Loan Book included some large and highly-concentrated exposures. The total exposure of the top ten connections was £1.4 billion, with the average size of other connections being in the region of £10 million, substantially above the equivalent values in Co-op Bank’s Corporate Loan Book. Due to the limited scope of the due diligence, these concentration and connection risks associated with

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<sup>11</sup> A “connection” is a term used to refer to a borrower or group of connected borrowers which are regarded as a single exposure for credit risk management purposes.

<sup>12</sup> Based on what was known about the extent to which individual loans were linked to a single connection.

this book only became clear to Co-op Bank upon the initiation of the FVA exercise in late-2009/early-2010.

- 1.34. Even once these concentration and connection risks became clear and despite the value of the Corporate Loan Book's Watchlist (assets showing signs of distress) and Default (assets which were non-performing) exposures doubling between the fourth quarter of 2009 (£1.3 billion) and the first quarter of 2013 (£2.6 billion), the overall strategic direction for the Corporate Loan Book did not receive sufficient attention at the Firm's governing forums and committees. Committees considered individual customer treatment strategies but failed to consider the overall strategic direction for this book.
- 1.35. Throughout 2009-2012, Co-op Bank did not properly consider or articulate a clearly-defined strategy (with well-defined objectives, responsibilities and milestones) for the Corporate Loan Book. Specifically, in the period before December 2010, little consideration was given to strategic options for the parts of the Corporate Loan Book that fell outside Co-op Bank's risk appetite. Co-op Bank's plan was simply to continue to hold these assets and formulate individual workout plans for each customer connection.
- 1.36. The first consideration of any broader strategy for the Corporate Loan Book appears to have occurred in December 2010 where, in a presentation on the Corporate Real Estate ("CRE") sector to one of the committees, it was stated that *"It is the Bank's intention to explore opportunities to sell down non-core business lending"*
- 1.37. However, by March 2011, a presentation on the CRE sector to the Board once again reiterated the original piecemeal plan to simply *"work through and exit the agreed non-core lending situations, (including subordinated, overseas & distressed assets) to reduce residential investment, and to reduce the size of the largest transactions"*.

- 1.38. The Board first gave proper consideration to the strategic options for the Corporate Loan Book in July 2011 at an annual strategy meeting. The Board considered the sale of £1.9bn of Corporate Banking “*problem exposures*” and estimated that this would result in material losses and a major reduction in capital. It therefore decided not to pursue this option.
- 1.39. In late-2011, Co-op Bank decided to follow the lead of a number of other financial institutions and split the reporting of its Corporate division in two sections: Core and Non-Core. The Core division would contain assets that were consistent with the Co-op Bank’s strategy and risk appetite; the Non-Core division would contain those that were not consistent with the Co-op Bank’s strategy or risk appetite. The Non-Core division included all loans acquired from Britannia as well as a smaller number of heritage Co-op Bank loans.
- 1.40. Initially, the separation of the Corporate Division into Core and Non-Core was a presentational change. This was intended to enable the Co-op Bank to demonstrate the attractiveness of its underlying Core business. However, in early 2012, Co-op Bank began to reorganise its Corporate Banking division to reflect the split. It also increased its engagement with its advisors to explore options to dispose of Non-Core assets. Options were further explored in 2012, but still no clear strategy was articulated or executed.
- 1.41. In November 2012, the Board first approved the disposal of some of the non-core assets. Co-op Bank’s three-year plan included the proposal to sell just over £300m of Non-core assets in June 2013. However, even after this resolution, the strategy remained unclear with little transparency as to what the objectives or milestones were for the Non-Core portfolio. While Co-op Bank had reached the view that the size of the portfolio should be reduced, it was not clear what the scale of the reduction should be, when this reduction should be achieved by or who was ultimately responsible for achieving these aims.

- 1.42. It was not until 2013 that Co-op Bank began to formulate, communicate and implement a clear and comprehensive strategy for the Non-Core Loan Book. At this point, the Firm decided on an active programme of disposals, with the result that in 2013, non-core customer assets were reduced from £14.6 billion to £12.5 billion, with £1.5 billion of this reduction taking place in the second half of 2013.

*Overrides of policies and procedures on Corporate Loan Book*

- 1.43. The establishment of appropriate policies and procedures governing the conduct of a firm's activities is an essential component in the exercise of appropriate organisation and control of a firm's business. Equally important is a firm's monitoring of compliance with these policies and procedures, including assessing the appropriateness of any exercise of any discretion permitted thereunder.
- 1.44. Co-op Bank was exposed to high levels of unknown credit risk due to the widespread prevalence of out-of-date collateral valuations on the Corporate Loan Book. Co-op Bank's policy required valuations on performing assets every two years and on Watchlist assets at least annually. This issue had been identified as early as April 2010 in a report by external consultants. As at May 2013, approximately £1.4 billion of the corporate portfolio (including both Watchlist and non-Watchlist cases) had a valuation date older than 2010. In one case, the property for a connection, which had not been valued since 2001, was finally revalued in April 2013 when its value was found to have fallen from £98 million to £45 million.
- 1.45. Co-op Bank's KCC for corporate loans were routinely overridden by staff in the first line. In the second quarter of 2012, the majority – over 80% - of the non-core CRE portfolio (at this point the Corporate Loan Book was split into Core and Non-Core, the Non-Core element of which was valued at £2 billion) had a LTV of 80% or higher, which was in breach of the Co-op Bank's KCC. The lack of up-to-date valuations meant that this percentage could have been even higher.

- 1.46. Relationship Managers often chose to manage problematic loans themselves, rather than putting them on the Watchlist at the earliest opportunity. In cases where it would have been most appropriate for a loan to be placed on the Watchlist, this did not consistently occur because the criteria for doing so were not sufficiently clearly articulated in the Firm's policies (see also paragraphs 2.7 to 2.9 below) and because patterns of referral by Relationship Managers were not adequately monitored. Once on the Watchlist, loans should have received more attention and support which would have improved the Firm's ability to ensure that the best possible outcome was achieved from each exposure.
- 1.47. Loans were sometimes moved from "Performing" status very quickly to "Default" status in circumstances which did not reflect the real timescale of the deterioration of the relevant asset. For example, in March 2013, a connection moved from Performing to Watchlist to Default in two days. The total loan value was £4.3 million, for which a £1.7 million provision then needed to be raised. These practices made it difficult to address problem exposures and to gauge the most appropriate treatments for individual customers in an effective and timely manner which, in turn, increased the risks of higher impairment charges and contributed to delays in loss recognition.

*Failure to escalate key issues to the Board*

- 1.48. Firms should ensure that key decisions, both on assuming new risks and managing existing ones, are taken at the appropriate level within the firm, including at the level of the Board where decisions are sufficiently important. Information on material risks to which a firm is, or may be, exposed should therefore be referred or reported to the board and senior management on a timely basis.
- 1.49. During the Relevant Period, a number of key issues were not escalated to or brought to the attention of the Board of Co-op Bank on a timely basis, or at all. This meant that the Board was not apprised of risks and was not able to respond to the issues on a timely basis.

- 1.50. The change of assumption in July 2009 as to when Leek Notes would be redeemed, as described in paragraphs 1.11 to 1.20 of this Annex, was not adequately communicated to the Board on a timely basis (the earliest document which referenced this was provided to the Board in November 2009) and the Board was not asked to approve this decision before it was made, despite its significant capital and market reputational implications.
- 1.51. Before the merger on 1 August 2009, the Board was not notified of a potential triggering of the Material Adverse Change (“MAC”) Clause only days before its expiry. The MAC Clause gave both Co-op Bank and Britannia the ability to withdraw from the merger in certain specified circumstances. One of these specified circumstances was if Britannia’s capital headroom, relative to its capital requirements, fell below £100 million prior to completion. The potential for this trigger to be met arose from Britannia buying back subordinated debt and redeeming Leek Notes, together with a continuing depreciation in the asset value and deterioration of the business plan. These matters were not escalated to the Board, despite their potential to trigger the MAC Clause and the implication that Co-op Bank would need to focus carefully on capital post-merger.
- 1.52. More particularly, in the Board meeting of 22 July 2009 at which the Britannia merger was discussed, the Board was not made aware of the potential for Britannia’s capital to decline to a level which would trigger the MAC Clause, even though the expiry date of the MAC Clause was only days later and the merger was imminent. At the time of the Board meeting, Britannia had not pointed out to Co-op Bank the possibility of the MAC Clause being triggered (although the issues which gave rise to it had been known within Co-op Bank for some time). Making the Board aware of these matters would have allowed the Board to consider the implications, including whether any option to withdraw from the merger in the event of the MAC Clause actually being triggered should be exercised, or other contingency planning put in place to relieve pressure on capital post-merger.

- 1.53. Shortly after this Board meeting, when further information had been received and Britannia had notified Co-op Bank that it had come close to triggering the MAC Clause, a decision was taken by the business that there was still no need to inform the Board. Whilst the MAC Clause was never triggered, the decision not to inform the Board that it had nearly been triggered meant that the Board did not have the opportunity to focus at that stage on the deteriorating capital position of Britannia and the serious implications which this might have had for capital management in the combined entity.

Second line of defence

- 1.54. Second line functions should support and challenge the management of risks firm-wide, by expressing views within a firm on the appropriateness of the level of risk being run. In order to achieve this, these functions should be independent of a firm's revenue-generating functions and should possess sufficient authority and resource to offer robust challenge to the business.
- 1.55. During the Relevant Period, the second line of defence in Co-op Bank was not structured so as to provide adequate independent oversight and challenge of the first line. In some cases the first and second line roles were blurred, in particular within the corporate, capital management and treasury functions, where the second line risk teams were actively involved in the day-to-day business management and decisions. For example, the second line risk team not only managed lending exceeding £0.5 million that was considered to be at risk, and hence on the Watchlist, but also played an instrumental role in making recommendations to the business on proposed level of impairments and collective provisions. This direct involvement in the process prevented the second line function from providing wholly-independent challenge to provisioning levels determined by the first line.

1.56. The FSA wrote to Co-op Bank in June 2012 highlighting this concern:

*"In our view, the function does not exhibit adequate independence or strength of purpose. We regard this as a serious weakness in the control framework and likely to result in significant risk to customer outcomes".*

It was only at around this time that the issue began to be addressed.

1.57. Until the fourth quarter of 2011, risk responsibility was split between the Risk Directorate and the Finance Directorate along technical risk (financial risk comprised of credit, capital, markets and treasury risk) and operational risk lines. This prevented the establishment of an effective centralised second line risk function.

1.58. The second line risk function did not have a sufficient number of suitably-skilled staff to be able to effectively carry out its risk management responsibilities. With Corporate Watchlist and Default exposures doubling between the fourth quarter of 2009 and the first quarter of 2013 and headcount remaining constant, resources became increasingly stretched. Examples of this manifesting itself were the second line not dealing with recovery cases in a timely manner (especially in 2012) and its inability to perform a timely case-by-case review of the Britannia Corporate Book for FVA calculation purposes.

1.59. Managers within the second line risk function repeatedly voiced their concerns about headcount to senior management. These concerns did not begin to be addressed until the first quarter of 2013.

1.60. The second line did not monitor the first line business' adherence to required policies and procedures (for example, Relationship Managers within Corporate Banking were not subject to qualitative checking until the second half of 2012). This issue was first raised in April 2011, when a high-level review of Corporate Banking recommended the need for additional assurance in terms of regular qualitative assessments of lending portfolios to be performed by the second line of defence.

- 1.61. In the case of the Treasury function, the second line risk function was inadequate throughout the Relevant Period. A red-rated Internal Audit report dated July 2013 entitled "Treasury Key Controls" noted the lack of an appropriate second line challenge required to highlight any weaknesses to the first line. This deficiency had been identified within the Firm as early as 2009 but not acted on to an appropriate extent.

*Inappropriate objectives of second line Risk team*

- 1.62. Members of the second line risk team had an annual impairment target included in their performance objectives. Given the independent challenge and oversight that the risk function was expected to provide over the impairment figures, this created a conflict of interest and increased the risk that the second line risk team, which played an instrumental part in the impairment decision making process, would artificially reduce impairment charges.

Third line of defence

- 1.63. Internal audit should provide independent assurance over firms' internal controls, risk management and governance.
- 1.64. Internal Audit's audit plans and scope did not sufficiently focus on the high-risk areas of Co-op Bank. For example, although certain aspects of Corporate Banking were audited during the Relevant Period, these did not focus on the significant issues and risks that were emerging from this area of Co-op Bank until late 2012. Internal Audit did not assess the due diligence and FVA exercises in relation to the Corporate Loan Book.
- 1.65. Internal Audit's reviews of problem areas did not pick up on the key issues which it should reasonably have been expected to identify. For example, it produced a green-rated report on "Corporate Exposure Management" on 22 March 2010, stating that "*the controls established over corporate exposures are suitably robust and materially address the key risks*". This report did not reflect the issues with procedures and controls around the Corporate Loan Book which existed at that time (as further detailed in this Notice).

- 1.66. Similarly, on 6 September 2012, Internal Audit produced a memorandum entitled "High Level Review of the Corporate Banking Control Framework". This followed the publication of the FSA's findings of systems and controls failings in relation to the HBOS's Corporate Banking division. The objective of this Internal Audit review was to assess whether any of the weaknesses highlighted in the FSA's findings in relation to HBOS represented a risk to Co-op Bank's Corporate Banking division. It concluded that *"the overall control environment is generally robust. Whilst it is acknowledged that there are some control gaps, there is no evidence to indicate that the control failings detailed in the FSA's public censure to BoS are present..."* These findings in 2010 and 2012 were in stark contrast to the findings that an improved Internal Audit function (see paragraph 1.69 below) made in its subsequent red-rated "Review of Corporate Exposures" report dated 22 March 2013.
- 1.67. Internal Audit also had a practice of taking into account proposed remedial action in the grading of its reports. This resulted in internal audit reports recording more lenient gradings than were justified by the audit findings.
- 1.68. The failures of Internal Audit to focus sufficiently on high-risk areas and in the quality of its findings were, in part, caused by the deficiencies in the experience and number of its personnel. The FSA referred to resourcing of the function in June 2012 in a letter to Co-op Bank:
- "We continue to question the adequacy of resourcing in this function and as a direct result, its ability to provide the Board with the reassurances required of a third line defence."*
- 1.69. However, despite the Firm having been made aware of issues concerning the effectiveness of its Internal Audit function, positive steps to remedy the problems only began to be taken at the end of 2012, following an external consultancy firm's review of Internal Audit presented in November 2012 which noted that:

*"... the profile, skills and performance of Co-operative Banking Group Internal Audit (CBG IA) requires significant improvements to bring it in line with industry good practice."*

- 1.70. There was also a fundamental structural issue which affected the independence and objectivity of Internal Audit. The Head of Internal Audit reported to the second line Director of Risk until late-2011. This was a conflict of interest and a threat to the independence and objectivity of Internal Audit in its role of providing independent challenge to the second line.
- 1.71. Additionally, Internal Audit did not have a sufficient profile within Co-op Bank, affecting its ability to influence and impact on other parts of the Firm. Where Internal Audit did identify serious issues, they were often not adequately escalated or appropriately prioritised by the relevant business areas, as evidenced by a high number of outstanding internal audit findings that were not addressed during the Relevant Period. For example, the minutes for the November 2011 Audit Committee meeting in November 2011 record that the percentage of overdue actions was 32% (and had been 33% in the previous quarter).
- 1.72. For the foregoing reasons, Co-op Bank's "three lines of defence" model was flawed both in design and operation. The Firm's failure to put in place an adequate control framework during the Relevant Period resulted in the Firm's failure to organise and control its affairs responsibly and effectively, with adequate risk management systems in breach of Principle 3.

### *Inappropriate culture*

- 1.73. Firms should have a culture that supports their prudent management and individuals, whatever their position in a firm, should take responsibility for acting in a manner consistent with its safety and soundness. This is not to say that there is a particular firm culture which is “right” for regulated firms. Culture should support a firm’s board and management in clearly understanding the circumstances in which the firm’s viability would be under question and act to protect the firm against such an eventuality. A culture in which accepted orthodoxies are challenged, action is taken to address risks on a timely basis and risk and control functions carry real weight is likely to support prudent management.
- 1.74. Given the significant shortcomings in Co-op Bank’s control framework, there was an even greater need for an appropriate culture within Co-op Bank. However, Co-op Bank had a culture that encouraged priority for the short-term financial position of the Firm at the cost of taking prudent and sustainable actions for the longer term.
- 1.75. In addition to the matters set out above, this culture led to the amendment of monthly financial data generally to improve the short-term profit or capital position. In particular, in relation to impairments, this involved smoothing, generally downwards, of monthly corporate impairments in order to match budgets. These decisions on impairments were not based on the factual circumstances of individual loans, but were instead based on a desire to achieve impairment targets. As a result of these issues, smoothed figures were frequently reported to the Board. This meant that, on occasions, the Board did not have an accurate understanding of impairments, profits and capital, which could have affected their ability to make appropriate and timely strategic decisions. Examples of this practice include:
- (1) In late 2012, Co-op Bank was determined to deliver the profit figure it had forecast to the Co-op Group in July 2012. It was recognised that one of the risks to achieving this was the amount that would need to be booked in impairments against the Corporate Loan Book in the final months of the year.

The Firm's determination only to report impairments that had been budgeted for in the July forecast led to Co-op Bank recognising either no impairment or comparatively small impairments for a number of cases, contrary to the views of second line staff.

Despite evidence that the further impairments would be required before the end of 2012, in October 2012 Co-op Bank reaffirmed to the Co-op Group that it would achieve the profit figure it had forecast in July. In preparing its forecast for the final three months of 2012 which was to be presented to the Board, the Firm decided to recognise a number of impairments in December 2012 rather than October 2012. This meant that certain provisions that had been raised through the formal governance process in October 2012 were reversed, with Co-op Bank planning to book these provisions in December 2012 instead.

- (2) Within the Corporate Loan Book, a risk grade was automatically allocated to each connection, based upon financial data and lending terms. Relationship Managers could apply for this risk grade to be overridden where a robust rationale was provided. It would appear that in at least one instance (affecting three loans) the risk grading applied to loans was manually overridden for a short period of time over the month end, with no adequate rationale being provided. The risk grade was then reversed to an inferior grading the next month. This had the effect of improving the Board's perceptions of the Firm's capital position at that particular month-end.

- 1.76. The culture at Co-op Bank which encouraged priority for the short-term financial position of the Firm at the cost of taking prudent and sustainable actions for the longer term did not support the prudent management of the Firm. For this reason, the PRA considers that the culture at Co-op Bank contributed to the Firm's failure to operate an adequate control framework and to organise and control its affairs responsibly and effectively, in breach of Principle 3.

## **2. Risk management policy and policies and procedures over corporate lending and capital management**

- 2.1. In addition to the failings in its control framework described above, Co-op Bank did not have an adequate risk management framework policy and did not have proper risk policies and procedures in relation to capital management and corporate lending.

### *Risk appetite not appropriately articulated for first line businesses*

- 2.2. As noted above, a firm's stated risk appetite should be integral to a firm's strategy and at the heart of its risk management framework. A firm's articulation of its risk appetite through its risk management framework should be capable of cascading down through the business, ensuring that all the firm's activities are considered in the context of that appetite. This helps to ensure that a firm's affairs are responsibly and effectively controlled.
- 2.3. Co-op Bank's risk appetite was defined at a high-level as "cautious", but this appetite was not articulated in appropriate detail, with appropriate metrics, for the first line businesses to apply meaningfully to their activities nor to monitor their performance. This view was articulated in the Internal Audit report, entitled "Review of Corporate Exposures", dated 22 March 2013, which stated:

*"Whilst guiding principles for risk appetite have been set at a strategic level, these have not been disaggregated into risk policies and tolerances, to support the effective management of high risk exposures. Consequently, inconsistencies or delays, together with a high level of individual judgement are evident in the work out strategies being adopted for high risk exposures, which is adversely impacting the bank's ability to consistently optimise returns on individual exposures."*

- 2.4. In addition to weaknesses in the overall risk management framework policies described above, there were additional policy and procedural failings in the Relevant Period which are detailed below.

*Inadequate policies and procedures for the setting of financial budgets*

- 2.5. The Firm did not have a formalised impairment budget-setting methodology in place. Impairment budgets were set by senior management. These were arbitrary in nature and did not reflect any sophisticated modelling techniques. This in turn led to a lack of transparency in the approach actually taken and, more specifically, to an inability to be able to provide a robust justification for decisions taken.
- 2.6. Budgets for Corporate Loan Book impairments were largely based on actual impairment figures or budgets for the prior year, rather than based on any forward-looking exercise. Budgets in 2011 and 2012 were optimistic and actual impairments exceeded them significantly. For example, for 2012 the budget for Corporate Loan Book impairment provisions was £66.4 million, but the actual impairment provisions recorded in the 2012 financial statements were £456 million. In 2011 the budget was £60.7 million, but the actual impairment provisions were £117.3 million.

*Inadequate policies and procedures for management of exposures*

- 2.7. There was unclear guidance provided to staff within the Corporate Division as to how to determine whether or not an exposure should be deemed high-risk and moved onto the Watchlist for intensive management. This Internal Audit report stated that there was:
- “an over reliance on individual judgement, therefore significantly increasing the risk of exposures not being treated consistently. Furthermore, the rationale for individual cases being moved onto the Watchlist is not always captured which could have a detrimental impact on the subsequent management of that exposure”.*
- 2.8. The Internal Audit “Review of Corporate Exposures” report dated 22 March 2013 also noted the following further failures in the management of exposures within the Corporate division:

*"We have graded this report Red as having identified significant weaknesses in three key areas of the control framework for managing Corporate Exposures: monitoring of exposures and the triggers for identifying high risk exposures; subsequent monitoring and management of high risk exposures; and the process for providing against these exposures."*

- 2.9. These policy and procedural failures increased the risk that exposures would be inappropriately managed, that impairment provisions would not be made adequately and that the Board and senior management would not be made aware of and be able resolve issues in relation to Corporate exposures on a timely basis.

*Inadequate policies and procedures for impairment provisioning*

- 2.10. There was a lack of clear governance in relation to impairment provisions. The Provisions Meeting was the primary forum for impairment provision decisions during the Relevant Period but its authority, responsibilities and reporting lines were not properly established until October 2012. Until this date, the Provisions Meeting did not have formal terms of reference in place and it was not minuted. This meant that the rationale for important impairment decisions discussed and approved at the Provisions Meeting was not documented, resulting in a lack of transparency and accountability around these decisions.
- 2.11. Provisions were routinely raised or overridden outside the formal governance process, for example, being frequently agreed outside the Provisions Meeting.
- 2.12. The Internal Audit "Review of Corporate Exposures" report dated 22 March 2013 also noted high-risk weaknesses in the Firm's provisioning policy and processes:

*"The existing provisioning process does not allow for timely or robust determination of provision levels. The provisioning policy lacks sufficient detail, governance around provisioning needs strengthening, and the timing and methods used to calculate provisions across different exposures was found to be inconsistent. Collectively these issues significantly increase the risk of provisions being incorrectly calculated and reported."*

- 2.13. It was not until October 2013 that Co-op Bank took steps to address this failing, when it introduced and began to implement its Impairment, Loss Recognition and Forbearance Control Standards. These Standards provided greater clarity for impairment provisioning, setting out in more detail a specific impairment methodology, practices to be followed for charge-off (or re-classification as non-performing) and write-off, a definition for forbearance and the criteria governing forbearance.

*Inadequate policies and procedures for capital management*

- 2.14. Firms should develop a framework for capital management which captures the full range of risks to which the firm is exposed and which enables the potential impact of these risks to be modelled in stress scenarios which the firm may find itself facing in the future.
- 2.15. There were a number of systemic failures in the capital management framework at Co-op Bank during the Relevant Period. Internal Audit issued a report on capital planning in December 2013, which identified weaknesses in, inter alia, the capital planning process, timetables, tracking of capital planning issues and the security over models and spreadsheets. These weaknesses potentially put Co-op Bank's financial soundness at risk as they increased the risk that capital would be planned for and managed inadequately and that capital issues would not be escalated to and considered by the Board on a timely basis.

- 2.16. As set out above, Co-op Bank's lack of adequate risk management framework policies and appropriate policies and procedures over corporate lending and capital management during the Relevant Period resulted in a further failure by the Firm to organise and control its affairs responsibly and effectively, with adequate risk management systems, in breach of Principle 3.

### **3. Inadequate management information**

- 3.1. A firm should have available the information needed to support its control framework. This information should be of an appropriate quality, integrity and completeness, to provide a reliable basis for making decisions and so to control the business within agreed tolerances, and it should be produced in a sufficiently timely manner.
- 3.2. The management information produced by Co-op Bank, including information for presentation to the Board, was inadequate. This meant that the Board was not adequately apprised of key issues and information, which hampered its ability to deal with them in a timely manner.

#### *Inadequate financial management information*

- 3.3. The financial management information did not adequately highlight the key issues. For example, the Finance reports that were provided to the Board were lengthy and did not sufficiently highlight key issues such as, in the second half of 2012, the large variance of actual impairment provisions to budget – by June 2012 this adverse variance was forecast to be approximately £55 million over budget for 2012 and by September 2012 this was forecast to be approximately £70 million over budget. In the Finance reports to the Board, this large variance was not highlighted in the Executive Summary - it was only listed within detailed tables approximately 20 pages inside the reports, with no corresponding narrative highlighting this issue.
- 3.4. The smoothing of impairment provisions within monthly management information also meant that the Board did not receive timely updates on the true state of loan impairments (see paragraphs 1.73 -1.76 of this Annex above).

Inadequate risk management information

- 3.5. An effective risk management function should ensure that material risk issues receive sufficient attention from a firm's senior management and board.
- 3.6. At Co-op Bank, the Board did not receive an overarching single risk report until November 2010. Even then, the risk reports did not provide sufficient detail or quantitative analysis and were not presented in an easily-understandable format. Risk reports did not adequately explain action plans to manage each risk until May 2012.
- 3.7. At the first and second line level, risk management information was insufficient. For example, the management information on the volume and value of KCC overrides was inadequate. Until February 2013, no data was collated by management to understand the pattern of overrides within the different credit categories. When reports were produced, in the first months they excluded overrides for which authority had been sought (which defeated the object of the report). In an internal report in May 2013, it was noted that this resulted in 99.1% of cases being considered compliant, even though this figure included loans which were outside the KCC but had been approved by a delegated authority.
- 3.8. The management information produced for the various credit, exposures and risk management committees also focused on recent backward-looking financial statistics and did not contain sufficient analysis on future forecasts, trends, risks and action plans.
- 3.9. The risk information provided to the Board on the Corporate Loan Book painted an overly-optimistic picture of the corporate portfolio. For instance, in 2011, a presentation by the Risk Directorate to the Board on the CRE loan portfolio noted that *"the CFS CRE portfolio has held up well compared to many UK lenders through a combination of the prudent relationship-managed approach adopted through our key credit criteria that have been largely maintained – and in certain areas strengthened – through the cycle to deter the higher risk deals."* Subsequently, the Board did not spend sufficient time discussing risk connected with, and the overall strategy for, the corporate portfolio.

- 3.10. Co-op Bank's inability to produce management information adequate to support decision-making and to control the business represented a further failure by the Firm to organise and control its affairs responsibly and effectively, with adequate risk management systems, in breach of Principle 3.

**Facts and matters relating to the Principle 11 breach**

- 3.11. In the period from April 2012 to May 2013 two separate discussions took place amongst certain senior individuals at Co-op Bank about the future position of two key individuals. These resulted in the Firm forming views about intended personnel changes in senior positions at the Firm. The FSA/PRA was not informed of either of these intended changes in a timely manner (and in one case not until after the position holder had left the Firm). Moreover, during one particular conversation with the Firm, the regulator asked questions in relation to one of the position holders and was provided with an incorrect assurance by Co-op Bank.
- 3.12. Where a firm forms a view in relation to the members, structure or effectiveness of its senior management, this is a matter of which the PRA would reasonably expect to be notified without delay as part of its day-to-day supervision of the firm. This is to enable the PRA properly to consider and assess the management at the firms which it regulates and the risks to safety and soundness which may arise from changes to the management team.

## Annex C

### PENALTY FRAMEWORK

- 1.1. The breaches of Principles 3 and 11 occurred from 22 July 2009 to 31 December 2013. The PRA took over prudential regulation of Co-op Bank on 1 April 2013. As the breaches continued after 1 April 2013, pursuant to article 11(6)(b) of the Transitional Provisions Order, the PRA must apply its penalty regime set out in the PRA's Penalty Policy.

#### **Penalty for breach of Principle 3 and Principle 11 which would otherwise have been imposed on Co-op Bank**

##### **Step 1: disgorgement**

- 1.2. There is no evidence to suggest that Co-op Bank derived financial benefit directly from the breaches. The PRA therefore has not disgorged any sum from Co-op Bank.
- 1.3. The Step 1 figure is therefore **£0**.

##### **Step 2: seriousness of the breach**

###### Relevant revenue

- 1.4. Paragraph 19(b) of the PRA Penalty Policy defines "relevant revenue" as: 'the firm's revenue during its last business year, that is, the financial year preceding the date when the breach ended'. The Firm's relevant revenue is therefore revenue during the financial year preceding 31 December 2013 (when the breaches ended). In determining Co-op Bank's relevant revenue, the PRA has reviewed the Firm's audited financial statements and has had regard to any relevant considerations.
- 1.5. The PRA considers that relevant revenue includes revenue from interest receivable and similar income, fees and commission and net trading income (but not that from other operating income) and that it would be proportionate to allow an adjustment for interest expense and similar charges and fee and commission expense. However, the PRA does not consider that it would be appropriate for relevant

revenue to be adjusted to reflect conduct and legal provisions connected with the Firm's breach of certain Consumer Credit Act and other legal and regulatory requirements (including the re-statement of the 2013 comparatives in 2014 connected with the presentation of such provisions).

- 1.6. Based on this information, the relevant revenue is **£609,300,000**.
- 1.7. To arrive at the penalty the PRA has adopted the approach set out in the PRA's Penalty Policy.
- 1.8. The PRA has taken the following factors into account to determine the Step 2 amount:
  - (1) the Firm's breaches had an effect on the advancement of the PRA's general objective. In particular, Co-op Bank's breaches of Principle 3 affected its safety and soundness;
  - (2) the Principle 3 breach revealed a serious and systemic weakness in the Firm's business model, financial strength, governance, risk and other management systems and internal controls relating to all of its business;
  - (3) the duration and frequency of the breaches, in that the Principle 3 breach occurred for a period of nearly five years and, in relation to Principle 11, the Firm failed to be open and cooperative with the PRA in respect of two individuals over a period of 13 months;
  - (4) the breaches were neither reckless nor deliberate;
  - (5) the Firm was directly responsible for the breaches, particularly in terms of its failure to organise and control its affairs responsibly and effectively with adequate risk management controls in breach of Principle 3 where Co-op Bank failed to take adequate action in relation to matters repeatedly brought to its attention by the regulators;

(6) the Firm, towards the end of the Relevant Period, took steps to remedy the Principle 3 breach, including a complete overhaul of the risk management framework, steps to enhance the Firm's risk and Internal Audit functions and the replacement of senior management. Following the appointment of this new senior management, the Firm has taken further steps in this regard.

1.9. On this basis, the PRA considers that a seriousness factor of 20% should be applied to "relevant revenue" and, therefore, the Step 2 figure is **£121,860,000**.

### **Step 3: mitigating and aggravating factors**

1.10. The PRA considers that the following mitigating and aggravating factors are relevant:

- (1) The nature, timeliness and adequacy of the Firm's response to a number of letters and supervisory interventions by both the FSA and the PRA throughout the Relevant Period were poor. These included concerns over the control framework which had been raised by the FSA as early as the 15 September 2009, post the merger with Britannia;
- (2) The Principle 3 breach took place during a period when the banking industry was under some considerable pressure which ultimately led to the collapse of a number of well-known financial institutions. The Firm should have had a greater focus on the need for a more robust approach to its control framework in this environment;

1.11. However, the PRA does not consider that, in the circumstances, these factors are sufficient to justify any adjustment to the Step 2 figure. Therefore, the Step 3 figure is **£121,860,000**.

#### **Step 4: adjustment for deterrence**

- 1.12. If the PRA considers the penalty determined following Steps 2 and 3 is insufficient effectively to deter the Firm that committed the breach and others who are subject to the PRA's regulatory requirements from committing similar or other breaches, it may increase the penalty at Step 4 by making an appropriate deterrence adjustment to it.
- 1.13. The PRA does not consider an adjustment for deterrence is appropriate in this instance. The Step 4 figure is, therefore, **£121,860,000**.

#### **Step 5: settlement discount**

- 1.14. Pursuant to paragraph 28 of the PRA's Penalty Policy, if the PRA and the firm on whom a penalty is to be imposed agree the amount of the financial penalty and other terms, paragraph 26 of the PRA's Settlement Policy provides that the amount of the financial penalty which might otherwise have been payable will be reduced to reflect the stage at which the PRA and the firm reached agreement (as set out at paragraph 28 of the PRA Settlement Policy).
- 1.15. Assuming that the PRA and Co-op Bank would have been able to reach agreement at Stage 1, a 30% discount would have applied to the Step 4 figure.
- 1.16. The Step 5 figure would, therefore, be **£85,302,000**.

## **Annex D**

### **PROCEDURAL MATTERS**

#### **Decision maker**

- 1.1. The settlement decision makers made the decision which gave rise to the obligation to give this Notice.
- 1.2. This Final Notice is given under and in accordance with section 390 of the Act. The following statutory rights and duties are important.

#### **Publicity**

- 1.3. Sections 391(4), 391(6A) and 391(7) of the Act apply to the publication of information about the matter to which this Notice relates. Under those provisions, the PRA must publish such information about the matter to which this notice relates as the PRA considers appropriate. The information may be published in such manner as the PRA considers appropriate. However, the PRA may not publish information if such publication would, in the opinion of the PRA, be unfair to the person with respect to whom the action was taken or prejudicial to the safety and soundness of PRA-authorized persons.

#### **PRA contacts**

- 1.4. For more information concerning this matter generally, contact Miles Bake at the PRA (direct line: 020 7601 4920 / fax: 020 7601 4771).

## **APPENDIX 1**

### **DEFINITIONS**

#### **The definitions below are used in this Final Notice:**

- 1.1. "the Act" means the Financial Services and Markets Act 2000;
- 1.2. "Britannia" means the Britannia Building Society;
- 1.3. "Common Equity Tier 1 capital" means the sum of: common shares that meet the criteria for classification as common shares for regulatory purposes and which meet the criteria for inclusion in CET1 capital, stock surplus (share premium), retained earnings, accumulated other comprehensive income and other disclosed reserves and regulatory adjustments applied in the calculation of CET1;
- 1.4. "CPB" means Capital Planning Buffer;
- 1.5. "CFS" means Co-operative Financial Services;
- 1.6. "CFSMS" means CFS Management Services Limited;
- 1.7. "Co-op Bank" means The Co-operative Bank PLC;
- 1.8. "Corporate Loan Book" means the corporate and commercial loan book overseen by the Corporate and Markets (CAM)/Corporate and Business Banking (CABB) directorates of Co-op Bank;
- 1.9. "CRE" means Corporate Real Estate;
- 1.10. "the FCA" means the body corporate known as the Financial Conduct Authority;
- 1.11. "the FSA" means the body corporate known until 1 April 2013 as the Financial Services Authority;

- 1.12. "FSA003 and FSA003+ Capital Adequacy Reports" mean the quarterly and monthly reports made by a firm to the regulator which contained financial information relevant to the solvency of the firm;
- 1.13. "FVA" means Fair Value Adjustment –a merger-related adjustment which brought the book value of an asset or liability in line with the notional price that market participants would pay or receive in an orderly transaction as at the merger date, or 1 August 2009 in this case;
- 1.14. "Handbook" means the PRA's Handbook of Rules and Guidance;
- 1.15. "ICAAP" means Internal Capital Adequacy Assessment Process – firms are required to go through this to identify how much current and future capital is necessary and to assess risks to capital and explain how these will be mitigated against;
- 1.16. "ICG" means Individual Capital Guidance;
- 1.17. "KCC" means Key Credit Criteria;
- 1.18. "LCO" mean Legal Cutover – being the date on which the FCA and PRA came into existence i.e. 1 April 2013;
- 1.19. "LME" means Liability Management Exercise;
- 1.20. "LTV" means Loan-To-Value;
- 1.21. "MAC Clause" means Material Adverse Change clause;
- 1.22. "Notice" means the PRA's Final notice;
- 1.23. "the PRA" means the body corporate known as the Prudential Regulation Authority;
- 1.24. "the PRA's Penalty Policy" means "The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure April 2013 – Appendix 2 – Statement of the PRA's policy on the imposition and amount of financial penalties under the Act";

- 1.25. "the PRA's Settlement Policy" means "The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure April 2013 – Appendix 4 - Statement of the PRA's settlement decision-making procedure and policy for the determination and amount of penalties and the period of suspensions or restrictions in settled cases";
- 1.26. "Principle" means a principle of the FSA's or PRA's Principles for Businesses;
- 1.27. "RAG" means the grading system used to rate the seriousness of issues raised by Co-op Bank Internal Audit – "R" meaning Red, "A" meaning Amber and "G" meaning Green – Red being at the most serious end of the scale;
- 1.28. "the Relevant Period" means the period between 22 July 2009 to 31 December 2013;
- 1.29. "the Transitional Provisions Order" means the Financial Services and Markets Act 2012 (Transitional Provisions) (Enforcement) Order 2013;
- 1.30. "the Tribunal" means the Upper Tribunal (Tax and Chancery Chamber);
- 1.31. "UEL" means useful economic life – a measurement of the life of an asset; and
- 1.32. "Verde" or "Project Verde" is the name used within Co-op Bank to describe the proposed acquisition of 632 branches of the Lloyds Banking Group.