



[www.irishlifepermanent.ie](http://www.irishlifepermanent.ie)

31<sup>st</sup> December 2010

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## Executive summary

The Capital Requirements Directive (CRD) as amended which is applicable to all EU countries gives effect to the requirements of the Basel II accord plus revisions which is the revised regulatory capital framework for financial institutions.

This document which is the group's disclosure under Pillar III of the CRD outlines the group's approach to risk and capital management as at 31<sup>st</sup> December 2010 for Irish Life & Permanent plc (the then group holding company & licensed Bank), including detailed information on the capital adequacy process.

As is outlined in greater detail later in the document, in early 2010 following shareholder & court approval, the group was restructured and Irish Life & Permanent Group Holdings plc became the new parent and holding company for the group. The new structure has the same capital structure, board and management team as the former Irish Life & Permanent plc and the business ethos and business activities remain the same.

In December 2010, the Bank for International Settlements published finalised proposals for changes to both the regulatory capital (Basel III) and the liquidity management framework for financial institutions. The regulatory capital framework changes will be phased into effect on a transition basis from January 2013 to December 2018. As the key elements of the Basel III requirements do not commence until January 2014 and the rollout will occur on a phased basis until 2018, they have not been reflected in the disclosures in this document

In quarter 1, 2011 the group participated in the Prudential Capital Assessment Review (PCAR 2011) and the Prudential Liquidity Assessment Review (PLAR 2011) exercises as part of the Financial Measures Programme Report (FMPR) required by the Central Bank of Ireland. On 31<sup>st</sup> March, 2011, the Central Bank published the results of these exercises. These identified a Total Gross Capital Requirement of €4.0 billion was required for the Group's banking business in order to: (i) achieve a Core Tier 1 Capital Ratio of 6 per cent. (plus an additional buffer) in a stressed scenario by 31 December 2013; and (ii) cover losses associated with the requirement to deleverage the Bank's balance sheet in order to achieve a loan to deposit ratio of circa 122.5 per cent. by 31 December 2013. As these requirements do not impact the year 2010 disclosures, they have not been reflected in this document. Some further background to the PCAR/PLAR exercises is set out in section 9 (Capital Adequacy Review) of this document and on the group's website at [www.irishlifepermanent.ie/investor-relations](http://www.irishlifepermanent.ie/investor-relations).

In respect of Pillar I regulatory capital requirements for the year 2010, Irish Life & Permanent plc has approval to avail of the more sophisticated approaches available under the CRD for measuring & calculating regulatory capital in respect of the majority of its credit exposures. The group received approval from the Financial Regulator in December 2007 to move to the foundation internal ratings based approach (FIRBA) for its retail, corporate & sovereign portfolios and has completed its agreed binding rollout of IRB portfolios as at 31<sup>st</sup> December 2009.

Circa 99% of the group's portfolios are now on this FIRBA regulatory capital approach. For the remaining immaterial portfolios & non credit obligation assets, the standardised approach is used.

For both market & operational risk the group uses the standardised approach.

The second pillar in the CRD is the Supervisory Review Process, which should ensure that an institution's Internal Capital Adequacy Assessment Process (ICAAP) clearly identifies material risk and that adequate capital is allocated for this. Pillar II also includes provision for the evaluation of capital adequacy to be made by the Financial Supervisory Authorities. The group has put in place a comprehensive ICAAP process as detailed in section 8 of this document.

The third pillar in the CRD refers to the public disclosure for risk and capital management; including how and when an institution will disclose information on this. This information for Irish Life & Permanent plc is provided in this Pillar III disclosure, which is published annually on the group's website.

The group's total risk weighted assets as of end December 2010 amounted to €15.8bn (2009 - €16.4bn) excluding the interim capital requirement (ICR) of the Central Bank. Inclusive of the ICR, the risk weighted

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assets equivalent increase to €19.4bn (2009 - €20.2bn).

Of the €15.8bn in risk weighted assets, credit risk including off-balance sheet exposure accounts for approximately 95%, operational risk 4.8% and market risk 0.2%. Out of the total capital requirements for credit risk, (excluding non credit obligation assets), 98% has been calculated under the FIRB approach and circa 2% under the standardised approach.

At the end of December 2010, Irish Life & Permanent maintained a capital base in excess of minimum requirements. As at 31 December 2010 Irish Life & Permanent's total core tier 1 risk asset ratio was 10.6% [2008 -11.3%] (before application of ICR) as compared with a regulatory requirement of 8%.

The internal capital models of the group (economic capital) include all material risks for the group, rather than just credit risk, market risk and operational risk as required under Pillar I (see section 3 for further details). Irish Life & Permanent maintain economic capital levels sufficient to meet internal targets specific to the group's risk appetite. It is group policy that the group's economic capital base should at all times exceed its economic capital requirements.

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# 1 Introduction

This chapter sets out an overview of the current regulatory capital regime and its key requirements.

The Capital Requirements Directive (CRD) was brought into force with effect from January 2007 as a common approach for implementing the Basel II framework in the EU.

Basel II is an international accord whose aim is to implement a more risk sensitive framework to measure & assess risk for use in the calculation of regulatory capital, i.e. to arrive at the minimum capital that an institution is required to hold. The intention of the accord is to align the actual assessment of risk within an institution with the required regulatory capital through the use of internal models and an institution's own data/ estimates. The CRD contains a detailed set of minimum requirements which must be met to insure the conceptual soundness and integrity of this internal assessment. The level of capital required under the CRD has a backstop via the use of transitional rules. These specify the maximum possible reduction in regulatory capital permitted under the CRD for an institution by reference to its requirement under the former Basel I accord. While the transition requirements as per the Basel II accord/ CRD were originally to be in place until 31<sup>st</sup> December 2009, the capital floor has been extended until the 31<sup>st</sup> December 2011 via legislative changes to the original CRD.

In December 2010, the Bank for International Settlements published finalised proposals for changes to both the regulatory capital and the liquidity management framework for financial institutions.

It is expected that these proposals will ultimately be brought into European, and as a consequence Irish, law via changes to the capital requirements directive(s).

The regulatory capital framework changes are to be phased into effect on a transition basis from January 2013 to December 2018.

These proposals amongst other measures will require an increase in the minimum capital ratio required plus changes in the types of capital that can support that solvency ratio i.e. a focus on common equity. In summary there are 3 key changes which are:

- To raise the quality & quantum of regulatory capital required,
- Underpin this with a leverage ratio to act as a backstop,
- Introduction of a number of macroprudential elements into the framework to help contain systematic risks arising from procyclicality and the interconnectedness of financial institutions.

The BIS views a strong liquidity base supported by robust supervisory standards as being of equal importance to strong capital requirements. The enhanced liquidity proposals i.e. a new Liquidity Coverage Ratio (LCR) will be specified in 2015, together with a new Net Stable Funding Ratio (NSFR) in 2018.

- The LCR is intended to promote resilience to potential liquidity disruptions over a 30 day time horizon by ensuring that Banks have sufficient unencumbered high quality liquid assets to offset net cash outflows under an acute short term stress scenario.
- The NSFR requires a minimum amount of stable sources of funding at a bank relative to the liquidity profiles of the assets, as well as the potential for contingent liquidity needs arising from off-balance sheet commitments, over a one-year horizon. The NSFR aims to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items.

As the key elements of the Basel III requirements do not commence until January 2014 and the rollout will occur on a phased basis until 2018, they have not been reflected in the disclosures in this document.

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In quarter 1, 2011 the group participated in the Prudential Capital Assessment Review (PCAR 2011) and the Prudential Liquidity Assessment Review (PLAR 2011) exercises as part of the Financial Measures Programme Report (FMPR). The FMPR was one of the conditions of the Programme of Support. The aim of the FMPR was to place the Irish banking system in a position where it could fund itself and generate capital without undue further reliance on Irish or European public sources.

On 31st March, 2011, the Central Bank published the results of these exercises. These identified a Total Gross Capital Requirement of €4.0 billion was required for the Group's banking business in order to: (i) achieve a Core Tier 1 Capital Ratio of 6 per cent. (plus an additional buffer) in a stressed scenario by 31 December 2013; and (ii) cover losses associated with the requirement to de-leverage the Bank's balance sheet in order to achieve a loan to deposit ratio of circa 122.5 per cent by 31 December 2013.

As these requirements do not impact the year 2010 disclosures, they have not been reflected in this document. Some further background to the PCAR/PLAR exercises is set out in section 9 (Capital Adequacy Review) of this document.

The CRD regime is built on three pillars:

- Pillar I – specifies the minimum capital requirement for banks' exposures to credit risk (substantially revised and enhanced from those set out under Basel I), market risk (broadly unchanged from a 1996 amendment to the Basel I accord with some revised trading book requirements) and operational risk which is a new requirement as compared to Basel I. The original CRD has been amended to reflect capital changes for re-securitisations, changes to the definition of hybrid capital instruments and revisions to the large exposure regime.
- Pillar II – sets the rules for the Supervisory Review Process (SRP), including the Internal Capital Adequacy Assessment Process (ICAAP). Pillar II permits regulators to set target capital requirements in excess of the minimum amounts set out in Pillar I. These target capital requirements must be based on a thorough assessment of the supervised institution's firm wide risk management which is linked to its own assessment of capital adequacy. Supervisors are empowered to intervene if risk and or capital management processes are deemed unsatisfactory or if capital levels are deemed insufficient.
- Pillar III – Market disclosure requirements relating to the disclosure of risk and capital management, including capital adequacy information. This was introduced to bring market discipline and greater transparency to the world of risk and capital management in an institution.

### ***1.1 Pillar I***

The CRD has not changed the minimum required capital ratio of 8% as per the previous Basel I requirement. The key changes relate to the definition and calculation of risk weighted assets (RWA), which is the methodology used to measure the risk exposure of the institution. Hence, the regulatory capital requirements are still calculated using the following formula:

|   |
|---|
| $\text{Minimum capital requirements} = \text{Capital Base} / \text{RWA, such that the result} \geq 8\%$ |
|---|

Under Pillar I of the CRD, RWAs need to be computed for credit, market and operational risk. RWAs can be calculated using more sophisticated and risk sensitive methods than previously set out in the Basel I accord. Credit risk and market risk were included in the former Basel I accord, while operational risk is introduced as a new risk type in the CRD. Table 1 identifies the main approaches available for calculating RWA in each risk type as set out in the CRD:

Table 1 – Primary Approaches available under the CRD

| Approaches for reporting capital requirements        |                              |                                   |
|--|------------------------------|-----------------------------------|
| Credit Risk  | Market Risk                  | Operational Risk                  |
| (1) Standardised Approach                            | (1) Standardised Approach    | (1) Basic Indicator Approach      |
| (2) Foundation Internal Rating Based Approach (FIRB) | (2) Internal Models Approach | (2) Standardised Approach         |
| (3) Advanced Internal Rating Based Approach (AIRB)   |                              | (3) Advanced Measurement Approach |

### **Credit Risk**

In respect of Credit Risk, Irish Life & Permanent plc is in the main using the Foundation Internal Rating Based approach (FIRB) to calculate regulatory capital requirements. Credit risk computed according to FIRB is based on the group's own estimates of Probability of Default (PD) for each facility/ counterparty. In respect of its CRD Corporate, Sovereign & Institution asset classes fixed estimates of Loss Given Default (LGD) and Credit Conversion Factors (CCF) are utilised. In respect of the Retail asset classes, the group uses own estimates of LGD & CCF in accordance with the CRD requirements.

The standardised approach is being used only for a small proportion of its exposures (less than 1%) which are in run off & for which no new business is being written. The standardised approach for calculating credit risk is similar to the previous Basel I accord, except for a greater range of risk weights and the ability to use an external rating for the counterparties.

### **Market Risk**

For market risk regulatory capital requirements, Irish Life & Permanent plc is using the standardised approach for regulatory capital requirements.

### **Operational Risk**

Irish Life & Permanent plc is using the standardised approach for operational risk to compute its regulatory capital requirements.

### **Capital Floors**

In respect of overall minimum capital requirements, the CRD contains transitions rules (also known as capital floors) for all institutions implementing the new CRD capital adequacy requirements. These transitional rules, which were in force for the years 2007 to 2009, set the minimum capital requirements which will be permitted and they are directly related to the capital requirements of an institution as calculated under the Basel I accord. The capital floors have been extended until December 2011 and the required ratio is set under the legislation at 80% of the former Basel I required capital. As part of the group's accreditation for the use of the FIRBA, the capital requirements were set by the Financial Regulator so as to be not less

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than 95% of the minimum capital requirements calculated under Basel I regulations (note the CRD requirement was 80%). This requirement has continued for 2010 and the Central Bank of Ireland remains super-equivalent to the amended CRD.

## **1.2 Pillar II**

Pillar II, or the Supervisory Review Process (SRP), comprises two processes:

- the Internal Capital Adequacy Assessment Process (ICAAP) and
- the Supervisory Review and Evaluation Process (SREP).

The SRP is designed to ensure that institutions identify their material risks and allocate adequate capital, and employ sufficient management processes, to support such risk. The SRP also encourages institutions to develop and use better risk management techniques in monitoring and measuring risk in addition to the credit, market and operational risk in the CRD. The ICAAP allows banks to review their risk management policies and capital positions relative to the risk they undertake. Irish Life & Permanent plc has built its ICAAP around an Economic Capital framework to ensure that the group has sufficient available capital to meet regulatory and internal capital requirements, even during periods of economic or financial stress. The ICAAP includes all components of Irish Life & Permanent plc's risk management, from daily risk management of material risk to the more strategic capital management of the entire group and its legal entities.

Examples of other risk types included in Pillar II, which are not covered by the minimum capital requirements according to Pillar I, are liquidity risk, business risk, interest rate risk in the non-trading book, pension risk and concentration risk. These are covered either by capital or risk management and mitigation processes under Pillar II.

The SREP is the supervisor's review of Irish Life & Permanent plc's capital management and an assessment of Irish Life & Permanent plc's internal controls and governance.

## **1.3 Pillar III**

The CRD also requires institutions to disclose capital and risk management information.

In this document, Irish Life & Permanent plc sets out an overview of the different risk types in its balance sheet as well as off-balance sheet risk and the management of the risk and capital in accordance with the Pillar III disclosure requirements. This outline follows the structure below:

- Description of the group structure and overall risk management,
- Regulatory capital requirements,
- Credit risk, including exposure, RWA calculations, and loan losses,
- Market risk,
- Operational risk,
- Off-balance, including risk in derivatives and securitisation
- Internal capital, including other risk types ,
- Capital adequacy overview.

Further details and disclosure of risk, liquidity and capital management are presented in the annual report in accordance with the international financial reporting standards, IFRS.

The Pillar III disclosure is made for Irish Life & Permanent plc ("The Group") and is set out on the group's website "[www.IrishLifePermanent.ie](http://www.IrishLifePermanent.ie)". Pillar III disclosures are made on an annual basis.

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These Pillar III disclosures have been internally reviewed consistent with reviews undertaken for unaudited information published in the group's annual Financial Statements. They have not been reviewed by the group's external auditors. Disclosures are subject to external audit only to the extent that the information is required to be audited under an accounting or listing requirement.

## 2 Risk Management in Irish Life & Permanent plc

This chapter sets out the composition of Irish Life & Permanent group and the scope of its Pillar III disclosures. The section also outlines the group's approach to/ principles for management and control of risk.

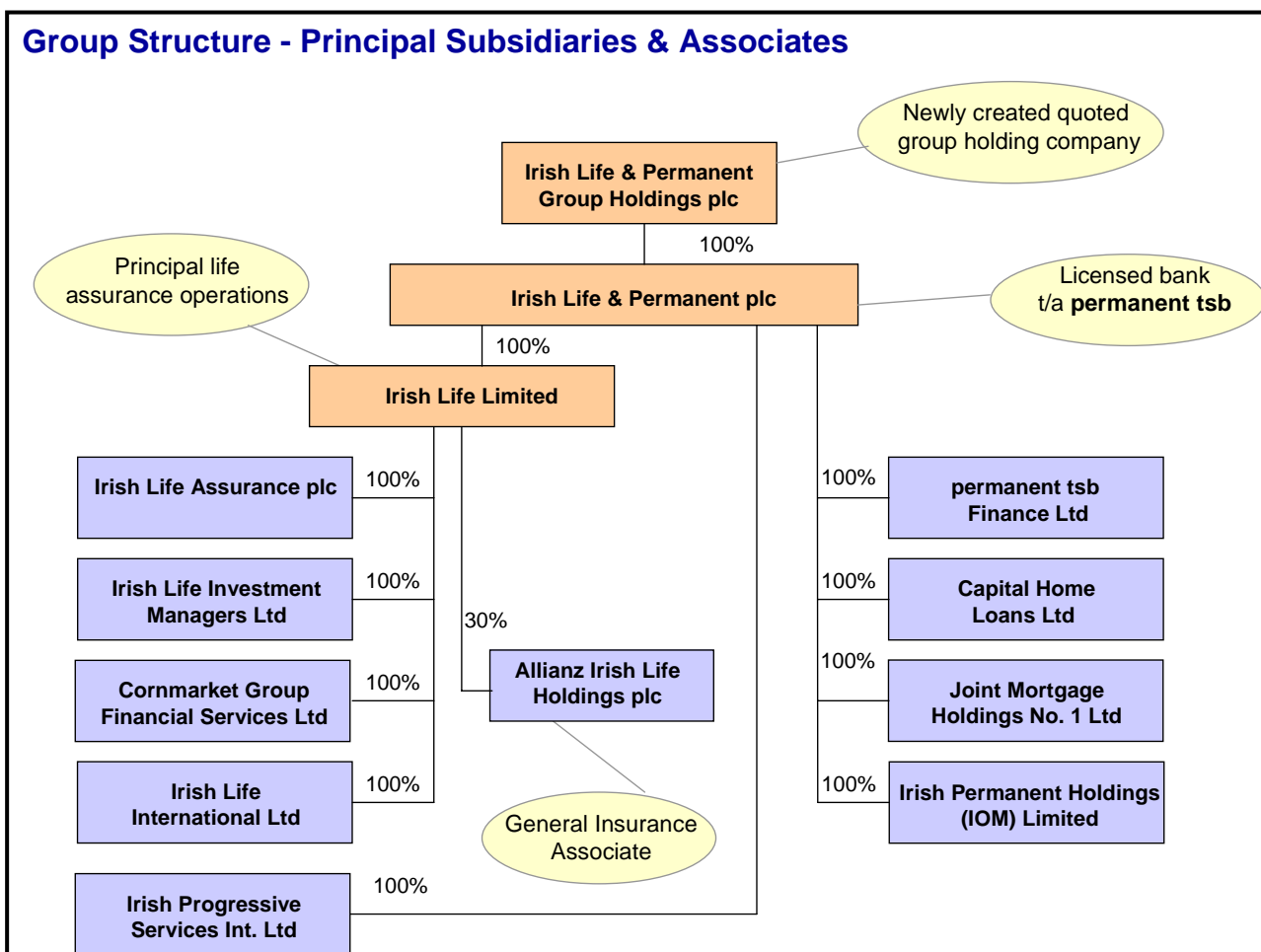
### 2.1 Overview of Group Legal Structure

As at 31<sup>st</sup> December 2009, Irish Life & Permanent plc was a publicly listed company on the Dublin and London stock exchanges. The Irish Life & Permanent group was formed from the merger of Irish Life and Irish Permanent in 1999. It was further strengthened with the addition of TSB Bank in 2001.

In early 2010 following shareholder & court approval, the group was restructured and Irish Life & Permanent Group Holdings plc became the new parent and holding company for the group. The new structure has the same capital structure, board and management team as Irish Life & Permanent plc and the business ethos and business activities remain the same.

As can be seen from the diagram below, the activities of the group can be categorised into three principal business lines of Banking, Life Assurance and Investment Management.

The new structure as set out below gives the group greater flexibility to respond to the challenges and changes taking place in the Irish financial services sector.



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## **2.2 Scope of application of CRD Disclosures**

The disclosures under Pillar III are on the basis of the consolidated financial view of Irish Life & Permanent plc. The Pillar III disclosures are on a consolidated basis in respect of the banking activities of the group inclusive of the relevant banking subsidiaries listed on the previous page and exclude insurance & investment operations. The group does not consider the banking subsidiaries shown therein to be sufficiently significant to require separate Pillar III disclosures and hence Pillar III disclosures are set out on the basis of consolidated banking operations.

Further details on the banking subsidiaries are set out in the group's financial statements.

In relation to the consolidated subsidiaries, the group is of the view that no material practical or legal impediment exists to the repayment of capital to the parent and that no material practical or legal impediment exists to the repayment of funds when due to the parent in respect of the subsidiaries given the group's 100% ownership of these subsidiaries and the contractual terms of the advances from the parent to the subsidiaries.

Insurance and investment operations are included within the group Financial Statements but, for CRD regulatory capital computations, the net investment in these operations is deducted from own funds as detailed in section 9.

## **2.3 Risk Management**

In the context of group risk management, risk is defined as unexpected future events leading to variability in performance and damage to earnings capacity, capital positioning, business reputation or cash flows; or any unexpected future event damaging the group's ability to achieve its strategic, financial, or overall business objectives.

Risk taking is fundamental to a financial institution's business profile and hence prudent risk management, limitation and mitigation forms an integral part of the group's governance structure. The group operates a proactive Enterprise Risk Management ("ERM") approach in the identification, assessment and management of risk. This framework underpins profitable and prudent risk taking throughout the group.

The group ERM is designed to ensure that all material risks are identified and managed and that business strategy across the group is implemented in full recognition of these risks.

In 2009, the board commissioned international risk management and strategy consultants Oliver Wyman to review the group's Corporate Governance framework and to advise on any changes necessary to ensure the group was operating in line with emerging international best practice. The board accepted and implemented the recommendations made by Oliver Wyman in this regard.

In addition, the board established a new board committee, the Board Risk and Compliance Committee, to provide oversight and advice to the board on risk governance, and to support the board in carrying out its responsibilities for ensuring that risks are properly identified, reported, assessed and controlled, and that the group's strategy is consistent with the group's risk appetite.

### **2.3.1 Risk Appetite & Strategy**

The board sets overall policy in relation to the type and level of risk that the group is permitted to assume. To achieve this, the board has established a formal risk appetite statement. The risk parameters identified in the risk appetite statement are applied in practice throughout the business. These risk parameters are closely aligned with the group's strategic and business objectives.

Risk parameters established in the risk appetite statement address core group values, such as solvency stability, earnings stability, prudent liquidity management, prudent credit risk management and operational risk management. Risk parameters have been established based on relevant internal and external data.

The group risk appetite statement has been developed through an iterative process involving all the key functions of the group. The board holds the final responsibility for approval of the risk appetite statement.

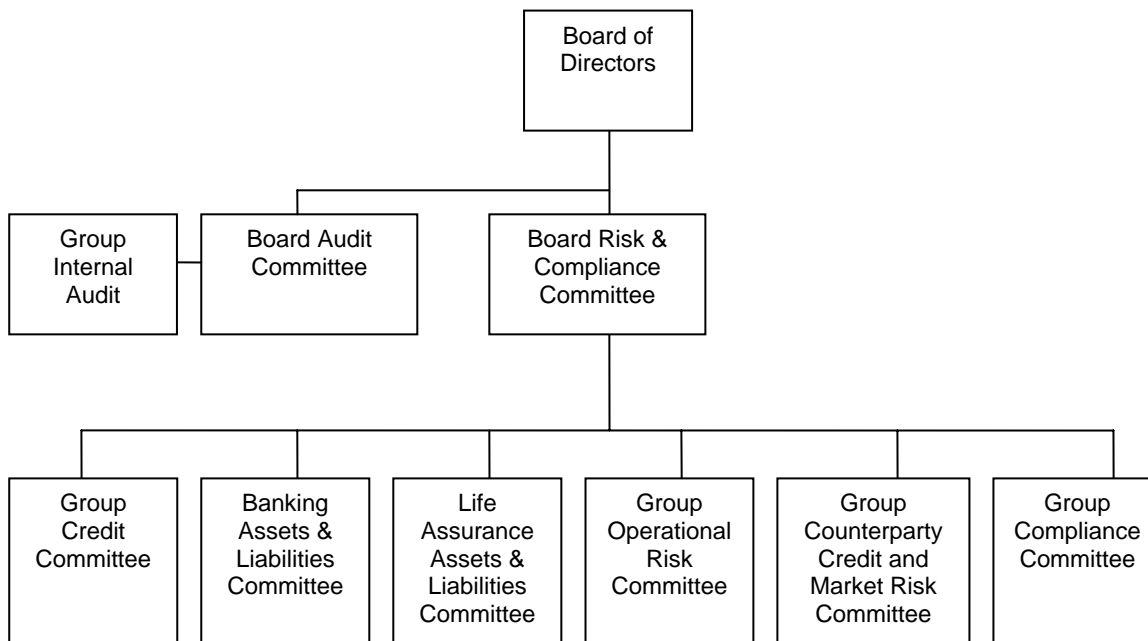
### 2.3.2 Risk Governance

The board is ultimately responsible for the governance of risk throughout the group and establishing mechanisms and structures to control and manage risk. In addition, the board approves overall policy in relation to the types and level of risk that the group is permitted to assume in the implementation of strategic and business plans.

The group’s risk governance framework was established by:

- Reviewing the risks applicable to the group and selecting the methodology and reporting structures best placed to identify, capture and monitor these risks,
- Developing relevant risk policies with appropriate terms of reference, mandates and committee composition,
- Benchmarking the group’s structures against industry guidelines for risk governance.

The risk governance structure, which is subject to ongoing review and amendment by the Board of Directors, is set out below:



The risk governance structure facilitates reporting and escalation of risk issues from the bottom up, and communication and guidance of group risk policy and risk decisions from the top down.

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## **Board Risk and Compliance Committee**

The Board Risk and Compliance Committee has responsibility for oversight and advice to the board on risk governance, the current risk exposures of the group and future risk strategy, including strategy for capital and liquidity management, the setting of compliance policies and principles and the embedding and maintenance throughout the group of a supportive culture in relation to the management of risk and compliance. The Board Risk and Compliance Committee supports the board in carrying out its responsibilities for ensuring that risks are properly identified, reported, assessed and controlled, and that the group's strategy is consistent with the group's risk appetite.

The Board Risk and Compliance Committee is responsible for monitoring adherence to the group risk appetite statement. Where exposures exceed levels established in the appetite statement, the Board Risk and Compliance Committee is responsible for developing appropriate responses. This is facilitated by the periodic review of a key risk indicators report calibrated to the risk appetite statement.

The Board Risk and Compliance Committee, in turn, delegates responsibility for the monitoring and management of specific risks to committees accountable to it. These committees are the Group Credit Committee, the Banking Assets & Liabilities Committee, the Life Assurance Assets & Liabilities Committee, the Group Operational Risk Committee, the Group Counterparty Credit and Market Risk Committee, and the Group Compliance Committee. The terms of reference for each committee, whose members include members of group senior management, are reviewed regularly by the Board Risk and Compliance Committee.

## **Group Internal Audit**

Group Internal Audit's mission, as per its Board approved charter, is to add value to, and improve the group's operations through the risk-based, independent assessment of the adequacy, effectiveness and sustainability of the group's governance, risk management and control processes. Group Internal Audit's primary responsibility is to the group's Board of Directors through the Audit Committee. All activities undertaken within, and on behalf of, the group are within the scope of Group Internal Audit; this includes the activities of subsidiaries and the work of risk and control functions established by the Group. To fulfil its mission, Group Internal Audit:

- Undertakes regular group-wide assessments of current and emerging risks to determine audit needs;
- Evaluates the adequacy, effectiveness and sustainability of the group's governance, risk management and control processes regarding the:
  - reliability and integrity of operational and financial information
  - effectiveness and efficiency of operations
  - safeguarding of assets
  - compliance with laws, regulations and contracts;
- Assesses the implementation of major change initiatives;
- Supports the continuous improvement of the group's operations through the sharing of best practice;
- Delivers a Board-approved audit plan to a high professional standard; and,
- Regularly reports significant governance, risk management and control issues to the Audit Committee and management's progress in addressing them.

The Head of Group Internal Audit reports directly to the Board of Directors through the Audit Committee for audit assurance purposes and to the Group Chief Executive Officer for administrative purposes. The Audit Committee reviews the scope and nature of the work of Group Internal Audit on an ongoing basis to confirm its independence and undertakes an independent external review of Group Internal Audit on a regular basis. The most recent review was undertaken in 2010.

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In the performance of their third line of defence role (Group Risk and Compliance constitutes the second line of defence and business management constitutes the first line of defence), Group Internal Audit has unrestricted access at any time to all records, personnel, properties and information of the group, its subsidiaries and its affiliates.

### **Group Credit Committee**

The Group Credit Committee is chaired by the Group Finance Director and includes members of group senior management. It is responsible for developing and implementing credit policy within the group. The policy addresses all material aspects of credit risk management, including credit risk assessment processes, collateral requirements and the risk grading of individual credit exposures. The credit risk management systems operate through a hierarchy of lending authorities which are related to internal loan ratings, which are in turn linked to the probability of credit default. All credit approvals are subject to a system of tiered individual authorities. Above a certain level, approvals require sign off by the Group Credit Committee. The Group Credit Committee also monitors credit and credit risk exposure and its evolution against the risk appetite set by the board, and oversees the development, implementation and performance of credit risk measurement tools. The committee oversees the application of the Internal Rating Based (“IRB”) regulatory capital regime across portfolios, reviews the results of forecasting and stress testing, and monitors regulatory and economic capital consumption against limits set within the risk appetite framework.

### **Assets and Liabilities Committees (“ALCOs”)**

The group has separate ALCOs for its banking and life assurance businesses. The Banking ALCO is chaired by the Group Finance Director and includes members of group senior management. The Banking ALCO reviews and is responsible for all activities relating to Treasury counterparty credit exposures, funding and liquidity management and strategy, and structural asset and liability management. The Banking ALCO is also responsible for the management of market risk. The Life Assurance ALCO is chaired by the Group Chief Executive and includes members of group senior management. The Life Assurance ALCO is responsible for the management of risks arising from the life assurance business assets and liabilities.

### **Group Operational Risk Committee**

The Group Operational Risk Committee is chaired by the Group Head of Risk and Compliance and includes core business unit heads from across the group. The Group Operational Risk Committee provides oversight and management of operational risk within the group. This oversight includes reputation-impacting events and risks. The committee identifies the group’s top operational risks and ensures appropriate actions are taken by the business to mitigate and manage these risks.

### **Group Counterparty Credit and Market Risk Committee**

The Group Counterparty Credit and Market Risk Committee is chaired by the Group Head of Risk and Compliance and includes management representatives from Treasury and Irish Life Investment Managers. The Group Counterparty Credit and Market Risk Committee is responsible for cascading risk appetite limits to business unit level, setting exposure limits for financial counterparties, and monitoring aggregated counterparty credit risk exposures against limits. The Group Counterparty Credit and Market Risk Committee proposes changes to credit risk limits, policy, guidelines and methodology to the Board Risk and Compliance Committee and recommends appropriate strategies.

### **Group Compliance Committee**

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The Group Compliance Committee is chaired by the Group Head of Risk and Compliance and includes core business unit heads from across the group. The Group Compliance Committee provides oversight and management of compliance within the group, including setting out the compliance and ethical standards to be observed by staff across the group in relation to legal, regulatory and market conduct responsibilities. The emphasis is on conducting business following a best practice approach and with a strong customer focus.

### **Group Actuarial Function**

Led by the group's Chief Actuary, this function is responsible for monitoring and regulating the capital and solvency of the life assurance companies and reports to the boards of life assurance companies, Life Assurance ALCO and the Board Risk and Compliance Committee on a regular basis. Summary risk reports are prepared for the consideration of the Life Assurance ALCO on a regular basis. Reports, which include asset/liability matching reports, are prepared covering shareholder exposure to market risk. Reports are also prepared reviewing credit risk.

### **Group Head of Risk and Compliance**

The Group Head of Risk and Compliance provides independent oversight of the group's risk governance and risk management processes. The Group Head of Risk and Compliance reports on an operational level to the Group Chief Executive, has direct access to the Risk and Compliance Committee and reports regularly to the Risk and Compliance Committee. The Group Head of Risk and Compliance is tasked with:

- Developing and maintaining the group's Enterprise Risk Management ("ERM") structure;
- Developing and maintaining the group's Internal Capital Adequacy Assessment Process ("ICAAP");
- Providing independent risk advice to senior management throughout the group;
- Identifying material risks for the group and developing appropriate responses to such risks; and
- Policing group-wide adherence to risk policies and the group's risk appetite statement.

The Group Head of Risk and Compliance is a member of the executive management team and of all risk committees within the group and directly manages the risk teams and compliance teams throughout the group.

### **2.3.3 Risk Identification and Assessment**

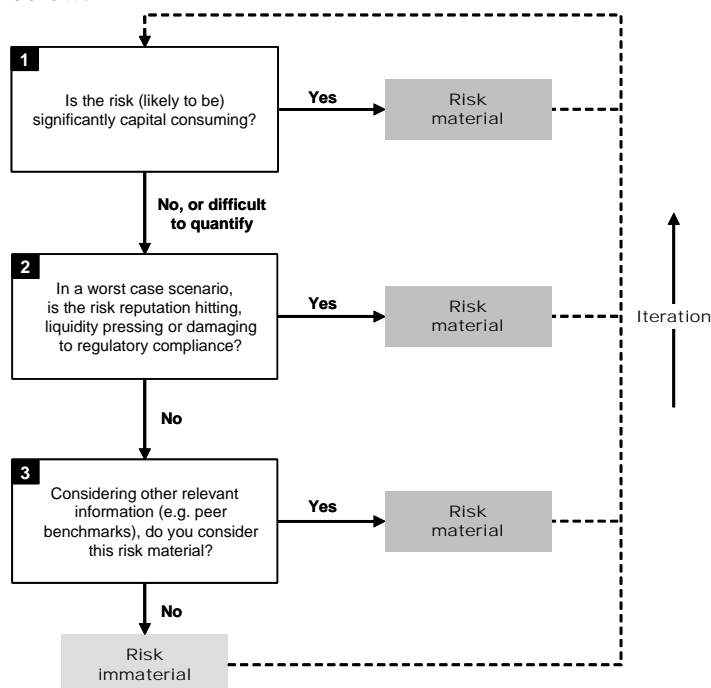
The risk identification and assessment process is overseen by the Group Head of Risk and Compliance, and supported by the group risk department. Significant input is also provided by relevant senior management and the specific risk committees.

The risk identification and assessment process operates within a clearly defined structure following four distinct steps.

1. ***Risk investigation*** – Through a consultative process involving relevant members of group senior management and business unit leaders, risks facing the group are monitored on an ongoing basis and formally reviewed on an annual basis. The risk identification process utilises a top down approach to identifying significant risks for the group supported by a bottom up risk identification exercise carried out at business unit level.

2. **Determination of materiality** – The group has a clearly defined definition of materiality in relation to risk assessment. This definition, which is approved by the board, is applied to all identified risks to determine which risks are material for the group. The materiality assessment is ratified with group senior management and relevant business leaders.

The determination of a risk's materiality follows an iterative approach as represented in the chart below.



3. **Risk treatment** – For each identified risk the group's approach to management of the risk is established. Risk management techniques include (but are not limited to) limitation, monitoring, mitigation and capitalisation.
4. **Documentation and recording** – The risk assessment and treatment of all material risks is documented in full. Documentation is ratified by the relevant risk committees.

### Stress Testing & Scenario Analysis

The group carries out scenario and stress testing for both the banking business and the insurance and investment business as well as at a combined group level. Stress tests consider various combinations of economic parameters reflecting different stress scenarios. From this, the group's capital adequacy is determined at a confidence level linked to the group's desired credit rating over a three-year time horizon. Stress testing is also performed in the context of credit losses, funding issues and market shocks to help inform business policy.

Stress scenarios are based on extreme, but plausible, negative events. The associated economic environment relevant to each scenario is established through a consultative process involving group senior management and external experts. The appropriateness of all stress tests and scenarios and assumptions underpinning them are agreed by the Board Risk and Compliance Committee and approved by the Board. Determination of certain macroeconomic drivers for each scenario allows the group's models to determine expected asset returns and forecast the risk profile of the group given the stressed environment.

Stressed capital adequacy projections under each scenario provide senior management with information incorporated in the strategic planning process.

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## Economic Capital

The group has elected to use Economic Capital as its core unit of risk currency. Internal economic capital models allow the group to allocate economic capital by business activity.

The group will continue to develop its economic capital methodologies to support risk measurement and risk-based decision making at all levels of the business.

### 2.3.4 Material Group Risks

Material risks for the Irish Life & Permanent group are defined in the table below. In the context of Basel II they can be categorised between Pillar I and Pillar II risks as shown. Note that the Basel II framework is specific to banking operations. However, for comparability, any insurance risks derived from the group's insurance operations are defined below as they might compare with Basel II.

See the foot of the table for colour-coding regarding allocation of risk capital.

| Risk category | Risk   | Definition  |
|---------------|--|---|
| Credit risk   | Credit risk  | The current or prospective risk to earnings and capital arising from an obligor's failure to meet the terms of any contract with the group or its failure to perform as agreed.<br><br>Credit risk in the group mainly arises from the various forms of lending undertaken by the group, from wholesale credit exposures and from insurance counterparty exposures. Thus for Irish Life & Permanent this risk category can be sub-divided into the following risks.                                     |
|               | Default Risk                                       | The current or prospective risk to earnings and capital arising from an obligor's failure to meet the terms of any contract with the group or its failure to perform as agreed.<br><br>Credit default risk arises mainly on retail and corporate lending activities, fixed interest investment counterparty exposures and non-traded / over the counter derivatives exposures (since the group is exposed to the risk of the counterparty defaulting prior to the maturity of "in-the-money" products). |
|               | Reinsurance & Other Mitigating Counterparties Risk | The current or prospective risk to earnings and capital associated with the failure of a reinsurance, or other risk mitigation, counterparty to honour a contract in place.   |
|               | Settlement Risk                                    | The risk that the group delivers a sold asset or cash to a counterparty and then does not receive the purchased asset or cash as expected.  |
|               | Country Risk                                       | The current or prospective risk to earnings and capital associated with events in a particular country of operation, which may be under the control of the government but not under the control of a private enterprise or individual.  |
| Market Risks  | Equity Risk  | The current or prospective risk to earnings and capital associated with changes in the level or volatility of the market prices of equity assets.   |

| Risk category          | Risk               | Definition  |
|------------------------|--------------------|---|
|                        | Property Risk      | The current or prospective risk to earnings and capital associated with changes in the level or volatility of the market prices of property assets.   |
|                        | Interest rate Risk | The current or prospective risk to earnings and capital associated with changes in the level or volatility of interest rates. Interest rate risk exists for all assets and liabilities for which the net asset value is sensitive to changes in the term structure of interest rates or interest rate volatility.<br><br>Asset and liability mismatch risk in the banking book results from structural mismatches. This is also commonly known as the interest rate risk in the banking book (or “IRRBB” risk).<br><br>Structural mismatches arise mainly on assets on the balance sheet due to fixed rate lending. |
|                        | Inflation Risk     | The current or prospective risk to earnings and capital associated with changes in the level or volatility of rates of inflation.   |
|                        | FX Risk            | The current or prospective risk to earnings and capital associated with changes in the level or volatility of currency exchange rates.  |
|                        | Spread Risk        | The risk resulting from the sensitivity of the value of assets and liabilities to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure.<br><br>This is the spread / default risk on fixed interest assets.   |
| <b>Insurance Risks</b> | Mortality Risk     | The current or prospective risk to earnings and capital associated with the variability in liability cash flows caused by fluctuations in life assurance policyholder mortality rates. Mortality risk is the risk of a higher than expected mortality rate.<br><br>Life assurance contracts involve a benefit paid on death or serious illness of a policyholder and hence are exposed to increased mortality rates.  |
|                        | Longevity Risk     | The current or prospective risk to earnings and capital associated with the variability in liability cash flows caused by fluctuations in life assurance policyholder mortality rates. Longevity risk is the risk of a lower than expected mortality rate.<br><br>Annuity contracts involve the purchase of an annual income stream for the remainder of the policyholder’s life through a single payment and are therefore exposed to decreasing mortality rates.  |
|                        | Morbidity Risk     | The current or prospective risk to earnings and capital associated with the variability in liability cash flows caused by changes in the level, trend or volatility of disability and morbidity, inception and recovery rates.<br><br>The risk arises on both life insurance products and SLT (Similar to Life Techniques) health insurance (Specified Illness and Income Protection) products.   |
|                        | Catastrophe Risk   | The current or prospective risk to earnings and capital associated with the incidence of one-off insurance events in a given year, such as epidemic diseases or earthquakes, which lead to an increase in insured risk experience.<br><br>The risk arises on both life insurance products and SLT (Similar to Life Techniques) health insurance (Specified Illness and Income Protection) products.   |
|                        | Lapse Risk         | The current or prospective risk to earnings and capital associated with a change in the level or volatility of policyholder lapse rates (also known as persistency risk).   |

| Risk category         | Risk                                | Definition   |
|-----------------------|-------------------------------------|--|
|                       | Expense Risk                        | <p>The current or prospective risk to earnings and capital associated with unexpected changes in expenses.</p> <p>Losses can arise due to a change in expense levels (expense inflation) or from a change in business volumes, which support the expense base.</p>   |
| Liquidity Risk        | Liquidity Risk                      | <p>The risk that the group may be unable to meet its on and off-balance sheet obligations in a timely manner as they fall due, without incurring excessive cost, while continuing to fund its assets and growth therein. It includes the risk of unexpected increases in the cost of funding the portfolio at appropriate maturities or rates.</p> <p>Liquidity risk management of the group considers both short term liquidity risks and long term structural liquidity risks. The group manages liquidity risk using an array of management tools including, but not limited to, funding limits and targets, maturity mismatch analyses, contingency funding planning and stress testing / scenario analysis.</p>   |
| Other financial Risks | Securitisation Risk                 | The current or prospective risk to earnings and capital associated with buying or selling asset-backed securities.   |
|                       | Concentration Risk                  | The risk inherent in exposures that may arise within or across different risk categories throughout the group with the potential to produce losses large enough to threaten the group's health or ability to maintain its core business.   |
|                       | Pension fund Risk                   | <p>The current or prospective risk to earnings and capital associated with the uncertainty surrounding required contributions to defined benefit pension schemes.</p> <p>The risk may arise because the value of asset portfolios and returns from them may be less than expected or because changes in interest rates or other financial parameters may give rise to increases in the estimated value of the schemes' liabilities.</p> <p>Professional consulting actuaries are regularly appointed by the pension fund trustees to assess and review the funding status and the underlying risk profile of each of the group's pension schemes. The results of such reviews are used to drive strategic decision making to reduce risk.</p> <p>Following a full review of each pension scheme in 2006 and wide consultation with staff and pension fund members, the group's defined benefit pension schemes were closed to new members and the asset mix of the funds was altered in order to reduce ALM risk. Furthermore it was communicated to existing members that pension benefits were not guaranteed, and it was specifically pointed out that if the combination of contributions and investment returns are not sufficient to provide for the specified benefits, then either more money would need to be added, by way of increased contributions from either or both pension scheme members and the group, or else the benefits promised will have to be reduced.</p> |
|                       | Corporate Finance Underwriting Risk | The current or prospective risk to earnings and capital associated with underwriting issuance of equity or debt securities.  |
| Operational Risk      | Operational Risk                    | <p>The current or prospective risk to earnings and capital associated with inadequate or failed internal processes, people and systems or from external events. This risk includes IT, information security, project, outsourcing, tax, legal, fraud and compliance risks.</p> <p>Thus for IL&amp;P this risk category can be sub-divided into more specific risk categories which include but are not limited to the following risks.</p>   |

| Risk category                    | Risk                   | Definition   |
|----------------------------------|------------------------|--|
|                                  | Regulatory change Risk | The current or prospective risk to earnings and capital associated with unforeseen changes in regulation.  |
|                                  | Legal Risk             | The current or prospective risk to earnings and capital associated with unenforceable contracts, lawsuits, adverse judgments or non-conformance with laws.   |
|                                  | Compliance Risk        | The risk of failure to meet regulations applicable to the group.   |
|                                  | Customer Advice Risk   | The current or prospective risk to earnings and capital associated with inadequate or failed customer advice process and procedures.   |
|                                  | Model & Residual Risk  | The risk arising from the uncertainty of model outputs, including the risk that parameters change over time and the risk that recognised measurement and mitigation techniques used by the group prove less effective than expected.   |
| <b>Other Non-Financial Risks</b> | Strategic Risk         | The current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment.   |
|                                  | Business Risk          | The current or prospective risk to earnings and capital in the short run (less than 1 year) due to unforeseen changes in the competitive environment.<br><br>Volatility in revenues is an inherent function of the markets in which the group operates. Business risk can never be completely eliminated but it is managed by the group to acceptable levels through management information systems reporting and active management. |
|                                  | Reputation Risk        | The current or prospective risk to earnings and capital associated with a deterioration of the group's reputation or standing due to a negative perception of the group's image among customers, counterparties, shareholders and / or supervisory authorities.  |

There are three broad ways in which risks facing the group can be treated. Irish Life & Permanent utilise different combinations of these treatments as deemed most applicable for specific risks:

**Capitalise** - The group accepts the risk as consistent with its risk appetite but holds capital to ensure solvency in the event of a severe occurrence of the risk.

**Manage** - The group works to control the causes of the risk and to reduce the level of the risk faced to an acceptable amount.

**Mitigate** - The group fundamentally transfers the risk away (e.g. by way of insurance or securitisation).

**Risk** The risk is capitalised as part of the group's Pillar I capital requirements.

**Risk** The risk is capitalised as part of the group's Pillar II economic capital framework. Pillar I capital-consuming risks are also included within the group's economic capital framework, albeit adjusted to reflect economic capital risk appetite.

**Risk** The risk is appropriately managed and / or mitigated such that it is unnecessary / inappropriate to allocate capital to the risk.

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### **2.3.5 Monitoring & Reporting**

Irish Life & Permanent has an established control environment that assists the directors in discharging their statutory duties in relation to risk management and controls. Throughout this control environment, risk monitoring and reporting plays a fundamental role with numerous risk reports being prepared and reviewed on a periodic basis dependent on the materiality of the risk for the group.

Specific risk reports are prepared for review by the relevant sub-committees of the Board Risk & Compliance Committee, the Board Risk & Compliance Committee itself and the Board of Directors. The risk committees meet regularly to review relevant risk reports with significant risk items being escalated in the reports to the Board Risk & Compliance Committee and subsequently the Board of Directors.

Risk reports include specific metrics on all material risks including credit risk, market risk, operational risk, insurance risks and liquidity risk. Within these reports, the results from numerous management monitoring techniques for each risk are highlighted to senior management. Examples of items included in the risk reports include, portfolio credit risk analyses, operational near miss and loss events, reinsurance status reports, asset / liability mismatch reports, liquidity stress test results and daily trading Value-at-Risk (VaR); etc.

### 3 Regulatory Capital Requirements – Pillar I

This chapter sets out the Pillar I regulatory capital requirement broken down under the key risk headings i.e. credit, market and operational risk in the CRD for Irish Life & Permanent plc as at 31<sup>st</sup> December 2010, with comparisons to 2009. In table 2 below, an overview of those capital requirements with equivalent Risk Weighted Assets (RWA) is shown. Credit risk accounts for 95% of the Pillar I regulatory capital requirements in Irish Life & Permanent plc, with operational risk making up 4% and market risk comprising the remaining 1%.

The table also notes the approach used for calculation of the capital requirements. Out of the total capital requirements for credit risk, 94% (2009 - 91%) has been calculated from utilisation of the foundation IRB approach with the remaining 6% (2009 - 10%) arising from use of the standardised approach.

Table 2: Capital requirements and RWA as at 31<sup>st</sup> December 2010

| <b>Pillar I Risk/ Approach</b>         | <b>2010</b>                       |                                  | <b>2009</b>                       |                                  |
|--|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|  | <b>Capital Requirement<br/>€m</b> | <b>CRD RWA Equivalent<br/>€m</b> | <b>Capital Requirement<br/>€m</b> | <b>CRD RWA Equivalent<br/>€m</b> |
| <b><u>Credit Risk</u></b>              |                                   |                                  |                                   |                                  |
| <b><i>IRB Foundation</i></b>           |                                   |                                  |                                   |                                  |
| Sovereigns                             | 85                                | 1062                             | 67                                | 834                              |
| Institutions                           | 78                                | 978                              | 87                                | 1,088                            |
| Corporate                              | 266                               | 3,328                            | 275                               | 3,441                            |
| Retail Mortgages                       | 615                               | 7,688                            | 591                               | 7,392                            |
| Retail Other                           | 68                                | 847                              | 91                                | 1,132                            |
| Qualified Revolving                    | 20                                | 244                              | 12                                | 145                              |
| Securitisation Positions               | 5                                 | 56                               | 4                                 | 56                               |
| <b><i>Standardised</i></b>             |                                   |                                  |                                   |                                  |
| Retail                                 | 22                                | 278                              | 51                                | 640                              |
| Institution                            | 0                                 | 0                                | 1                                 | 1                                |
| Corporate                              | 1                                 | 16                               | 2                                 | 27                               |
| Non Credit Obligation Assets           | 42                                | 519                              | 58                                | 729                              |
| <b><u>Market Risk</u></b>              |                                   |                                  |                                   |                                  |
| Traded Debt Instruments (Standardised) | 0.5                               | 6                                | 6                                 | 75                               |
| FX (Standardised)                      | 1.5                               | 19                               | 3                                 | 38                               |
| <b><u>Operational Risk</u></b>         |                                   |                                  |                                   |                                  |
| Standardised                           | 61                                | 767                              | 65                                | 813                              |
| <b>Total</b>                           | <b>1,265</b>                      | <b>15,809</b>                    | <b>1,313</b>                      | <b>16,411</b>                    |

As shown in the above table, the group's regulatory capital requirements are broadly similar in 2010 at €1.3bn as compared to 2009. Whilst the the group completed its IRB rollout programme on schedule and as agreed with the Central Bank, given the immaterial nature of the portfolios, their transfer to the IRBA approach lead to a negligible impact on the overall capital requirements.

#### 3.1 Capital Requirements for Credit Risk

In December 2007, Irish Life & Permanent received approval from the Financial Regulator to use the FIRB approach. At the end of December 2010, this methodology covered circa 99% of its loan portfolio exposures, inclusive of Group Treasury exposures. On the 1<sup>st</sup> January, 2010 the group completed its IRB

rollout with in excess of 99% of its exposures then on an IRB approach. The remaining circa 1% of the group's exposures are on the standardised approach under the CRD. These include a small immaterial portfolio (exposure value €20m) for which a permanent exemption has been granted under article 89 of the CRD and the group's Springboard Mortgages portfolio (circa €470m). These portfolios are not open to new business and are in run off. The group does not plan to move these portfolios to an IRB approach given their status i.e. in run off & coupled with their small or immaterial size. The standardised approach will continue to be used for the portfolios noted above and also for the non credit obligation assets on its balance sheet.

### 3.1.1 Capital Requirements by Asset Class/ Approach

The group's capital requirement for credit risk is set out in table 3 overleaf for the year ended 31<sup>st</sup> December 2010 based on asset class under both the IRB & standardised approaches which is in accordance with the group's reporting requirement for regulatory purposes. Circa 97% (2009 - 96%) of the group's exposures (inclusive of non credit obligation assets) for credit risk are maintained on the IRB approach for which the group received approval in December 2007 from the Financial Regulator. Comparative values for 2009 are set out in table 3A.

The group follows the exposure classes set out in the CRD and has an embedded algorithm within its IT systems to consistently allocate exposures to the appropriate CRD asset class.

Under both the IRB & standardised approaches, regulatory capital requirement is computed as risk weighted assets \* 8% where RWA is equal to the risk weight \* exposure. It is the computation of the risk weight that is significantly different under the IRB approach in the CRD.

The CRD provides a mathematical function to compute risk weights under the IRB approach whereas in the standardised approaches, risk weights are given or can be derived from a lookup table where ECAI ratings are used.

Details of the computation of risk weights is set out in section 4 of this document.

It should be noted that the exposure values shown in tables 3 & 3 A for regulatory capital are inclusive of any undrawn amounts multiplied by the relevant conversion factor to arrive at an Exposure for regulatory capital requirements.

*Table 3: Capital Requirements for credit risk as at 31<sup>st</sup> December 2010*

| <b>IRB Exposure Class</b> | <b>Balances</b> | <b>Exposure for Regulatory Capital (EAD)</b> | <b>Average Risk Weight</b> | <b>RWA</b>    | <b>Capital Requirement</b> |
|---------------------------|-----------------|--|----------------------------|---------------|----------------------------|
|                           | <b>€m</b>       | <b>€m</b>                                    |                            | <b>€m</b>     | <b>€m</b>                  |
| Sovereigns                | 5,748           | 5,748  | 18%                        | 1,062         | 85                         |
| Institutions              | 2,433           | 2,433  | 40%                        | 978           | 78                         |
| Corporate                 | 2,445           | 2,480  | 134%                       | 3,328         | 266                        |
| Retail                    | 32,613          | 33,624                                       | 26%                        | 8,779         | 702                        |
| -Retail Mortgages         | 31,377          | 31,683                                       | 24%                        | 7,688         | 615                        |
| -Retail Other             | 1,019           | 1,021  | 83%                        | 847           | 68                         |
| -Qualifying Revolving     | 217             | 920  | 27%                        | 244           | 20                         |
| Securitisation Positions  | 689             | 689  | 8%                         | 56            | 5                          |
| <b>Total IRB Approach</b> | <b>43,928</b>   | <b>44,974</b>                                | <b>32%</b>                 | <b>14,203</b> | <b>1,136</b>               |

| Standardised Exposure Class        | Balances<br>€m | Exposure for Regulatory Capital (EAD)<br>€m | Average Risk Weight | RWA<br>€m     | Capital Requirement<br>€m |
|------------------------------------|----------------|---|---------------------|---------------|---------------------------|
| Retail                             | 472            | 441   | 63%                 | 282           | 23                        |
| Institution                        | 4              | 4   | 23%                 | 1             | -                         |
| Corporate                          | 22             | 22  | 86%                 | 19            | 2                         |
| Central Governments                | -              | -   | -                   | -             | -                         |
| Non Credit Obligation Assets       | 953            | 953   | 54%                 | 514           | 41                        |
| <b>Total Standardised Approach</b> | <b>1,451</b>   | <b>1,420</b>                                | <b>57%</b>          | <b>816</b>    | <b>65</b>                 |
| <b>Overall Totals</b>              | <b>45,379</b>  | <b>46,394</b>                               | <b>32%</b>          | <b>15,019</b> | <b>1,201</b>              |

Table 3A: Capital Requirements for credit risk as at 31<sup>st</sup> December 2009

| IRB Exposure Class                 | Balances<br>€m | Exposure for Regulatory Capital (EAD)<br>€m | Average Risk Weight | RWA<br>€m     | Capital Requirement<br>€m |
|------------------------------------|----------------|---|---------------------|---------------|---------------------------|
| Sovereigns                         | 7,419          | 7,419                                       | 11%                 | 834           | 67                        |
| Institutions                       | 5,896          | 5,896                                       | 18%                 | 1,088         | 87                        |
| Corporate                          | 2,738          | 2,766                                       | 124%                | 3,441         | 275                       |
| Retail                             | 33,243         | 34,178                                      | 25%                 | 8,669         | 694                       |
| -Retail Mortgages                  | 31,811         | 32,185                                      | 23%                 | 7,392         | 591                       |
| -Retail Other                      | 1,336          | 1,429                                       | 79%                 | 1,132         | 91                        |
| -Qualifying Revolving              | 96             | 564   | 26%                 | 145           | 12                        |
| Securitisation Positions           | 736            | 736   | 8%                  | 56            | 4                         |
| <b>Total IRB Approach</b>          | <b>50,032</b>  | <b>50,995</b>                               | <b>28%</b>          | <b>14,088</b> | <b>1,127</b>              |
| Retail                             | 924            | 1,045                                       | 61%                 | 640           | 51                        |
| Institution                        | 4              | 4   | 20%                 | 1             | 1                         |
| Corporate                          | 23             | 27  | 100%                | 27            | 2                         |
| Central Governments                | -              | -   | -                   | -             | -                         |
| Non Credit Obligation Assets       | 880            | 880   | 100%                | 729           | 58                        |
| <b>Total Standardised Approach</b> | <b>1,831</b>   | <b>1,956</b>                                | <b>76%</b>          | <b>1,397</b>  | <b>112</b>                |
| <b>Overall Totals</b>              | <b>51,863</b>  | <b>52,951</b>                               | <b>30%</b>          | <b>15,485</b> | <b>1,239</b>              |

Whilst the required regulatory capital is similar at end 2010 as compared to end 2009, there has been a reduction in exposures particularly in respect of the Group Treasury portfolio as the group unwound its additional liquidity buffer which had been built up in light of the expected end of the government guarantee in September 2010.

The decrease in the exposures was offset by the downgrade of certain counterparties within the Group Treasury portfolio leading to higher PDs and hence increased capital requirements as at 31<sup>st</sup> December 2010.

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### 3.2 *Capital Requirements for Market Risk*

All treasury activities within the group's banking operations are centralised within the Treasury division which is subject to strict internal control and reporting procedures which are monitored by the Banking Assets and Liabilities Committee. This Committee, which operates under terms of reference which have been approved by the board, is chaired by the Group Finance Director and comprises members of senior management, including the Group Chief Executive and the Chief Executive, permanent tsb. All of Treasury's activities are subject to limits on the size and the nature of exposures which may be undertaken. These limits are outlined in the Treasury policy document which is regularly reviewed by the board.

Group Treasury has two primary roles:

- ◆ Management of liquidity within the group with a principal objective of ensuring that the group has sufficient funding available, at an optimal cost, to meet the operational needs of the group and to adhere to regulatory and prudential requirements.
- ◆ To plan and manage the balance sheet of the group's banking operations in accordance with best Asset Liability Management practice. It is also responsible for ensuring that the exposure to movements in interest and foreign currency exchange rates arising in the non-trading book of the group's banking operations is maintained within limits set by the board. In managing exposures arising in the non-trading book, the group uses duration based interest rate Gap Analysis and a Value at Risk (VaR) model.

Further detail in respect of the risk management for Group Treasury activities is set out in section 5 of this document.

In respect of Market Risk, the group utilises the Standardised approach for regulatory capital purposes. Under the standardised approach, two separate regulatory capital calculations are required:

1. Traded Debt Instruments
2. Foreign Exchange

Both of these calculations are very similar to the former Basel I approach. In respect of traded debt instruments, the capital charge is a combination of one for general market movement risk & also for the specific risk associated with each instrument. The charges are computed by allocating the securities to categories by reference to a maturity ladder/ instrument type & the long/ short position of the institution. A capital charge is then applied to the relevant categories according to the CRD. In respect of foreign exchange, the institution converts its open long or short positions to the reporting currency. The higher of the net short or long position is multiplied by 8% to determine the regulatory capital charge.

The capital requirements and equivalent risk weighted assets for 2010 are set out in table 4 below with comparisons for 2009.

**Table 4: Capital Requirements for Market Risk**

| <i>Pillar I Risk/ Approach</i>         | <u>2010</u>                      |                                 | <u>2009</u>                      |                                 |
|--|----------------------------------|---------------------------------|----------------------------------|---------------------------------|
|  | <i>Capital Requirement</i><br>€m | <i>CRD RWA Equivalent</i><br>€m | <i>Capital Requirement</i><br>€m | <i>CRD RWA Equivalent</i><br>€m |
| <b><u>Market Risk</u></b>              |                                  |                                 |                                  |                                 |
| Traded Debt Instruments (Standardised) | 0.5                              | 6                               | 6                                | 75                              |
| FX (Standardised)                      | 1.5                              | 19                              | 3                                | 38                              |
| <b><u>Total for Market Risk</u></b>    | <b>2</b>                         | <b>25</b>                       | <b>9</b>                         | <b>113</b>                      |

The differential between 2009 & 2010 is driven by the composition of the Group's holdings as at 31<sup>st</sup> December 2010.

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### 3.3 Capital Requirements for Operational Risk

The capital requirement for operational risk is calculated according to the Basel II standardised approach, in which all of the institution's activities are divided into eight standardised business lines: corporate finance, trading and sales, retail brokerage, commercial banking, retail banking, payment and settlement, agency services and asset management.

Total Pillar I capital requirements for operational risk are derived from the three year average "risk-weighted relevant indicator" (based on gross income) for each business line multiplied by a fixed beta coefficient. Beta coefficients are established under Basel II for specific business lines and are calibrated to attribute higher capital requirements to business lines with perceived greater operational risk. Beta coefficients across business lines range from 12% to 18%.

Irish Life & Permanent divides its gross income into the specific business lines as specified under Basel II and applies the relevant co-efficient as shown below:

| <b>Basel II Business line</b> | <b>Basel II Beta Co-efficient</b> |
|-------------------------------|-----------------------------------|
| Corporate finance             | 18%                               |
| Trading and sales             | 18%                               |
| Retail brokerage              | 12%                               |
| Commercial banking            | 15%                               |
| Retail banking                | 12%                               |
| Payment and settlement        | 18%                               |
| Agency services               | 15%                               |
| Asset management              | 12%                               |

The regulatory capital requirement for operational risk amounts to €1m as at 31<sup>st</sup> December 2010 (€5m – December 2009). Movements in the required capital for operational risk are driven by the Bank's underlying income in the relevant business lines averaged over the last three years.

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## 4 Credit Risk (Pillar I)

In this chapter, credit risk and its key components are described in more detail with regard to

- The exposure classes used for the calculations of RWA and a reconciliation of these to the financial reporting figures in the annual accounts.
- Exposure information is broken down by various categories, CRD asset class, loan types, geographical segment & remaining maturity where relevant.
- The approaches and methods used in the RWA calculations are outlined including information about credit risk mitigation and the group's internal rating system.
- Information about impaired loans and loan losses is also disclosed.

### 4.1 Exposure Classes

Irish Life & Permanent has a diversified credit portfolio, which is divided into the relevant exposure or asset classes as defined by the CRD. The group is approved by the Central Bank to use the FIRB approach for the vast majority of its exposures (circa 99%) as detailed below with the remaining 1% on the standardised approach. This standardised approach as at December 2010 is applied to small/ immaterial portfolios that have either been granted a permanent exemption by the Central Bank or for which a permanent exemption is being sought given the nature of the business.

The group completed the transfer of those portfolios with temporary exemptions to IRB status as per its original IRBA application to the regulator by the 1<sup>st</sup> January 2010 with a further €572m of exposures moving from the standardised approach. That left less than 1% of its loan portfolios on the standardised approach as outlined above. These exposures which total less than €500m and include Springboard Mortgages & a former Guinness & Mahon portfolio which has a permanent exemption.

#### 4.1.1 FIRB Exposure classes

As outlined earlier and as set out previously in table 3, the vast majority of the Bank's exposures are on the FIRB approach. Within this approach, nearly 70% is represented by exposures secured on residential real estate. The principal exposures within each asset class are summarised below:

**Sovereign** exposures include the group's gilt & prudential deposits with the Financial Regulator.

**Institution** exposures include the majority of the group's Treasury exposures (money market, floating rate notes, derivative assets etc).

**Corporate** exposures include the group's larger exposures to commercial & larger residential investment properties.

**Retail** exposures as outlined above are primarily retail customer facilities secured on residential property. The retail other & qualified revolving sub asset classes include the group's consumer lending.

#### 4.1.2 Standardised Exposure classes

As previously outlined the group's standardised exposures represent a very small part of its loan book. As outlined above, less than €500m is now treated under the standardised approach. The key elements of the exposures on the standardised book as at 31<sup>st</sup> December 2010 are as follows:

**Corporate** exposures which include a small UK commercial property portfolio of circa €16m.

**Institution** exposures includes small exposure of circa €4m to a financial institution.

**Retail** exposures are predominately residential mortgage exposures for the group's Springboard mortgage subsidiary.

## 4.2 Exposure Information

The credit risk exposure presented in this report differs in some areas from the credit risk exposure in Irish Life & Permanent's financial reporting in the annual report. In Pillar III reporting the exposures are reported by CRD asset class and also include amounts for undrawn & off balance sheet positions as applicable.

The main differences between the exposure value used for regulatory capital purposes and the on balance sheet values reported in the group's financial statements for 2010 are outlined below and in the main relate to off balance sheet values which relate to credit equivalent exposure amounts for derivative products, undrawn loan amounts and loan commitments which have not yet been drawn by the customer. These are reflected in the exposure value via a credit conversion factor calculated in accordance with the requirements of the CRD. In addition, there is some technical estimation in the credit conversion factor to adjust the exposure at default for interest only facilities to reflect the fact that these do not experience a reduction in principal and should they default that their outstanding balance will also include the missed interest repayments.

An illustration of the key movements is set out in table 5A & 5B below, differentiated between the group's loan & Treasury portfolios:

**Table 5A – Comparison between Balance Sheet & CRD Asset Class Exposures for Customers (Loans)**

|   | 2010          | 2009          |
|---|---------------|---------------|
| <b>Loans &amp; Receivables to customers as per Financial Accounts</b> | <b>36,581</b> | <b>38,592</b> |
| Adjustments to Gross Loan Exposures                                   |               |               |
| Deferred Fees, discounts & fair value adjustments                     | -318          | -430          |
| Provisions impairments  | 883           | 477           |
| Exposures to Irish Life Assurance                                     | 388           | 391           |
| Other Intergroup Adjustments  | -             | -             |
| Repossessions transferred to Other Assets                             | 38            | 46            |
| Exposures classed as Treasury under Pillar III                        | -             | -211          |
| <b>Gross Loan Exposures</b>   | <b>37,572</b> | <b>38,865</b> |
| Adjustments to reflect IRB Treatments                                 |               |               |
| Securitisation Exposures excluded from RWA                            | -2,208        | -2,422        |
| Undrawn/ Conversion Factor Adjustments                                | 1,018         | 1,047         |
| Application Pipeline Exposures  | 30            | 54            |
| <b>Regulatory Capital EAD</b>   | <b>36,412</b> | <b>37,544</b> |

Undrawn/ conversion factor adjustments have increased in light of the movement of the group's current account portfolio to the IRB Foundation approach in 2009.

*Table 5B – Comparison between Balance Sheet & CRD Asset Class Exposures for Group Treasury*

**Debt Securities, Loans & Receivables to banks, Derivative Assets as per Financial Accounts**

|  | <b>2010</b>   | <b>2009</b>   |
|--|---------------|---------------|
| <b><u>Debt Securities</u></b>                                  |               |               |
| Debt Securities per Consolidated Balance Sheet                 | 12,098        | 15,780        |
| Less Insurance & Investment Operations                         | <u>-7,425</u> | <u>-8,373</u> |
| Banking Operations   | 4,673         | 7,407         |
| <b><u>Loans &amp; Receivables to Banks</u></b>                 |               |               |
| Loans & receivables to Banks per Consolidated Balance Sheet    | 3,565         | 4,925         |
| Less Insurance & Investment Operations                         | <u>-2,594</u> | <u>-2,321</u> |
| Banking Operations   | 971           | 2,604         |
| <b><u>Derivative Assets</u></b>                                |               |               |
| Derivative Assets per Consolidated Balance Sheet               | 1,255         | 1,169         |
| Less Insurance & Investment Operations                         | <u>-895</u>   | <u>-899</u>   |
| Banking Operations   | 360           | 270           |
| <b>Total for Banking Operations</b>                            | <b>6,004</b>  | <b>10,281</b> |
| <b><u>Add Back</u></b>   |               |               |
| Exposures classed as Treasury under Pillar III                 | -             | 211           |
| Impairment Provisions  | 6             | 19            |
| Sale & Repurchase Agreement Exposures (Annex VIII treatment)   | 2,754         | 3,838         |
| Exposures prior to EAD Adjustment                              | <b>8,764</b>  | <b>14,349</b> |
| Annex III Adjustments to compute Credit Risk Equivalent Values | 265           | 178           |
| <b>Regulatory Capital EAD</b>                                  | <b>9,029</b>  | <b>14,527</b> |

#### 4.2.1 Analysis of Exposure Type by Exposure Class

Table 6 below details the breakdown between the CRD asset classes and the main exposure types of the group. As can be seen, the predominant exposures continue to be to customers with on balance sheet exposures for residential mortgages.

*Table 6 – CRD Exposure classes split by loan type – 31<sup>st</sup> December 2010*

| IRB Exposure Class                 | ROI Residential Mortgages<br>€m | UK Residential Mortgages<br>€m | Commercial<br>€m | Consumer Finance<br>€m | Other Consumer<br>€m | Group Treasury<br>€m |
|------------------------------------|---------------------------------|--------------------------------|------------------|------------------------|----------------------|----------------------|
| Sovereigns                         | -                               | -                              | -                | -                      | -                    | 5,748                |
| Institutions                       | -                               | -                              | -                | -                      | -                    | 2,433                |
| Corporate                          | 225                             | 112                            | 1,791            | 186                    | 8                    | 159                  |
| Retail                             | 24,506                          | 6,668                          | 552              | 724                    | 1,174                | -                    |
| - Retail Mortgages                 | 24,506                          | 6,668                          | 507              | -                      | 1                    | -                    |
| - Retail Other                     | -                               | -                              | 44               | 724                    | 253                  | -                    |
| - Qualified Revolving              | -                               | -                              | -                | -                      | 920                  | -                    |
| Securitisation Positions           | -                               | -                              | -                | -                      | -                    | 689                  |
| <b>Total IRB Approach</b>          | <b>24,731</b>                   | <b>6,780</b>                   | <b>2,343</b>     | <b>910</b>             | <b>1,182</b>         | <b>9,029</b>         |
| Retail                             | 441                             |                                |                  |                        |                      |                      |
| Institution                        |                                 |                                | 4                |                        |                      |                      |
| Corporate                          |                                 |                                | 22               |                        |                      |                      |
| Central Governments                |                                 |                                |                  |                        |                      |                      |
| <b>Total Standardised Approach</b> | <b>441</b>                      |                                | <b>26</b>        |                        |                      |                      |
| <b>Overall Totals</b>              | <b>25,172</b>                   | <b>6,780</b>                   | <b>2,369</b>     | <b>910</b>             | <b>1,182</b>         | <b>9,029</b>         |

*Table 6A – CRD Exposure classes split by loan type – 31<sup>st</sup> December 2009*

| IRB Exposure Class                 | ROI Residential Mortgages<br>€m | UK Residential Mortgages<br>€m | Commercial<br>€m | Consumer Finance<br>€m | Other Consumer<br>€m | Group Treasury<br>€m |
|------------------------------------|---------------------------------|--------------------------------|------------------|------------------------|----------------------|----------------------|
| Sovereigns                         | -                               | -                              | -                | -                      | -                    | 7,419                |
| Institutions                       | -                               | -                              | -                | -                      | -                    | 5,896                |
| Corporate                          | 228                             | 56                             | 1,763            | 238                    | 5                    | 476                  |
| Retail                             | 25,316                          | 6,302                          | 611              | 982                    | 967                  | -                    |
| - Retail Mortgages                 | 25,316                          | 6,302                          | 566              | -                      | -                    | -                    |
| - Retail Other                     | -                               | -                              | 45               | 982                    | 403                  | -                    |
| - Qualified Revolving              | -                               | -                              | -                | -                      | 564                  | -                    |
| Securitisation Positions           | -                               | -                              | -                | -                      | -                    | 736                  |
| <b>Total IRB Approach</b>          | <b>25,544</b>                   | <b>6,358</b>                   | <b>2,374</b>     | <b>1,220</b>           | <b>972</b>           | <b>14,527</b>        |
| Retail                             | 473                             | 328                            | -                | -                      | 244                  | -                    |
| Institution                        | -                               | -                              | 4                | -                      | -                    | -                    |
| Corporate                          | -                               | 7                              | 20               | -                      | -                    | -                    |
| Central Governments                | -                               | -                              | -                | -                      | -                    | -                    |
| <b>Total Standardised Approach</b> | <b>473</b>                      | <b>335</b>                     | <b>24</b>        | <b>-</b>               | <b>244</b>           | <b>-</b>             |
| <b>Overall Totals</b>              | <b>26,017</b>                   | <b>6,693</b>                   | <b>2,398</b>     | <b>1,220</b>           | <b>1,216</b>         | <b>14,527</b>        |

In general, portfolios exposure levels have been broadly similar between 2009 & 2010. An exception to this is the Group Treasury portfolio which has declined following the planned reduction in assets which were being held as additional liquidity. Other movements reflect either exchange rates or the natural amortisation of the loans as new business reduced given underlying economic circumstances.

## 4.2.2 Exposures by Geographical Segment

In table 7, the exposures are split by main geographical areas with the associated CRD asset classes. The main markets for the group are Ireland & the UK. Geographical exposures are set out on the basis of the location of the counterparty for Group Treasury exposures and loan issuance for the bank's loan books.

*Table 7 – Exposure Spilt by Geographic Areas & CRD Asset Class as at 31<sup>st</sup> December 2010*

| IRB Exposure Class                 | ROI Balances<br>€m | UK Balances<br>€m | Other EU<br>Balances<br>€m | Rest of World<br>€m |
|------------------------------------|--------------------|-------------------|----------------------------|---------------------|
| Sovereigns                         | 4,025              | -                 | 935                        | 788                 |
| Institutions                       | 598                | 321               | 492                        | 1,022               |
| Corporate                          | 2,320              | 145               | -                          | 16                  |
| Retail                             | 26,956             | 6,668             | -                          | -                   |
| - Retail Mortgages                 | 25,014             | 6,668             | -                          | -                   |
| - Retail Other                     | 1,021              | -                 | -                          | -                   |
| - Qualified Revolving              | 920                | -                 | -                          | -                   |
| Securitisation Positions           | 277                | 192               | 198                        | 22                  |
| <b>Total IRB Approach</b>          | <b>34,176</b>      | <b>7,326</b>      | <b>1,624</b>               | <b>1,848</b>        |
| Retail                             | 441                | -                 | -                          | -                   |
| Corporate                          | -                  | 22                | -                          | -                   |
| Institution                        | 4                  | -                 | -                          | -                   |
| Central Government                 | -                  | -                 | -                          | -                   |
| <b>Total Standardised Approach</b> | <b>445</b>         | <b>22</b>         | <b>-</b>                   | <b>-</b>            |
| <b>Overall Totals</b>              | <b>34,621</b>      | <b>7,348</b>      | <b>1,624</b>               | <b>1,848</b>        |

*Table 7A – Exposure Spilt by Geographic Areas & CRD Asset Class as at 31<sup>st</sup> December 2009*

| IRB Exposure Class                 | ROI Balances<br>€m | UK Balances<br>€m | Other EU<br>Balances<br>€m | Rest of World<br>€m |
|------------------------------------|--------------------|-------------------|----------------------------|---------------------|
| Sovereigns                         | 5,597              | -                 | 1,667                      | 155                 |
| Institutions                       | 4,049              | 599               | 668                        | 580                 |
| Corporate                          | 2,315              | 400               | 41                         | 10                  |
| Retail                             | 27,876             | 6,302             | -                          | -                   |
| - Retail Mortgages                 | 25,883             | 6,302             | -                          | -                   |
| - Retail Other                     | 1,429              | -                 | -                          | -                   |
| - Qualified Revolving              | 564                | -                 | -                          | -                   |
| Securitisation Positions           | 322                | 181               | 212                        | 21                  |
| <b>Total IRB Approach</b>          | <b>40,159</b>      | <b>7,482</b>      | <b>2,588</b>               | <b>766</b>          |
| Retail                             | 717                | 328               | -                          | -                   |
| Corporate                          | 20                 | 7                 | -                          | -                   |
| Institution                        | 4                  | -                 | -                          | -                   |
| Central Government                 | -                  | -                 | -                          | -                   |
| <b>Total Standardised Approach</b> | <b>741</b>         | <b>335</b>        | <b>-</b>                   | <b>-</b>            |
| <b>Overall Totals</b>              | <b>40,900</b>      | <b>7,817</b>      | <b>2,588</b>               | <b>766</b>          |

The decrease in ROI balances between 2009 & 2010 is predominately driven by the Group Treasury exposures as outlined earlier.

## 4.2.3 Commercial Exposures

The bank's loan book exposures are predominately to retail customers. In the table below the Bank's commercial loan book as set out by asset class (table 6) is broken down into the key commercial sectors with which it deals.

**Table 8 – Commercial Exposures Split by category**

| Category                                   | Exposures    | Exposures    |
|--|--------------|--------------|
|  | 2010<br>€m   | 2009<br>€m   |
| Residential Investment Property.           | 167          | 93           |
| Agriculture                                | 31           | 33           |
| Retail/ Office Unit Investment<br>Property | 1,434        | 1,583        |
| Manufacturing / Construction               | 42           | 43           |
| Professional & Service                     | 215          | 221          |
| Retail Unit                                | 307          | 331          |
| Tourism                                    | 47           | 45           |
| Warehousing / Development                  |              | -            |
| Personal Investment                        |              | 45           |
| Other                                      |              | 4            |
| <b>Total Commercial Exposures</b>          | <b>2,243</b> | <b>2,398</b> |

The group's commercial loan portfolio is effectively closed to new business and no new lending has taken place in 2010. The movements in the above table are as a result of reclassification of existing exposures between the relevant sectors/ categories.

#### 4.2.4 Profile of Exposures by Maturity

As required by the CRD to calculate regulatory capital for its sovereign, institution & corporate asset class exposures, the group has to calculate a value for the remaining or effective maturity of the facility/ deal. As required by the Financial Regulator the Bank uses the approaches set out under Annex VII, part 2, section 13 rather than the simple approach specified under section 12.

Table 9 below shows a breakdown of the effective maturity of the Bank's exposures as at 31<sup>st</sup> December 2010 for the relevant asset classes.

**Table 9 – Exposure split by maturity, 31<sup>st</sup> December 2010**

| Effective Maturity    | Sovereign<br>€m | Institutions<br>€m | Corporate<br>€m |
|-----------------------|-----------------|--------------------|-----------------|
| <= 1 Year             | 4,435           | 979                | 166             |
| >1 and <5 Years       | 916             | 1,053              | 495             |
| >= 5 years            | 397             | 401                | 1,820           |
| <b>Total Exposure</b> | <b>5,748</b>    | <b>2,433</b>       | <b>2,480</b>    |

**Table 9A – Exposure split by maturity, 31<sup>st</sup> December 2009**

| Effective Maturity    | Sovereign<br>€m | Institutions<br>€m | Corporate<br>€m |
|-----------------------|-----------------|--------------------|-----------------|
| <= 1 Year             | 5,555           | 4,647              | 410             |
| >1 and <5 Years       | 1,285           | 674                | 325             |
| >= 5 years            | 579             | 575                | 2,031           |
| <b>Total Exposure</b> | <b>7,419</b>    | <b>5,896</b>       | <b>2,766</b>    |

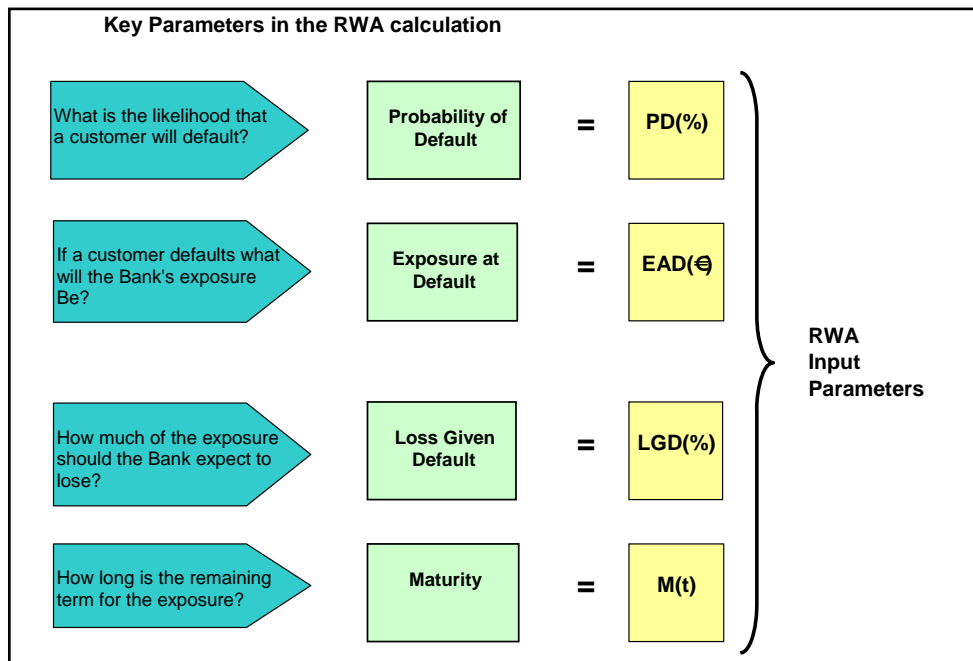
### 4.3 Calculation of Risk Weighted Assets

The RWA calculations in Irish Life & Permanent are in the main computed using an IRB approach. As the group has received Foundation IRB approval it calculates own estimates of the key credit risk parameters (PD, LGD & CCF) for all of its retail asset class portfolios (circa 66% of all of its exposures or 91% of its loan exposures excluding Group Treasury). The following sections describe the principles for calculating RWA with the FIRB and the standardised approach respectively.

#### 4.3.1 Calculation of RWAs under the FIRB Approach

The FIRB approach measures credit risk using a complex mathematical function which is driven by the Bank's own estimates of Probability of Defaults (PD), Loss Given Default (LGD) and Conversion Factors (EAD) for all of its retail CRD Asset Class exposures. In respect of Corporate Asset Class exposures the Bank's own estimates of PD & effective maturity (M) are used but the given CRD values are input for LGD & CF. The parameters are illustrated in figure 1

Figure 1: Key parameters in the RWA calculation



In the following sections the estimation of PD & LGD are described in more detail together with an outline of the group's rating system for credit risk. Note PD & internal rating are closely linked as is outlined later.

##### 4.3.1.1 Estimation of Key Credit Risk Parameters (PD, LGD & EAD)

This section of the document details in a summarised version the approach the group uses to estimate the key credit risk parameters required for regulatory capital computation.

#### Probability of Default (PD)

Internal ratings are assigned as part of the credit approval process. The consistency and transparency of the internal ratings are ensured by the use of rating models. A rating model is a set of specified and distinct rating criteria, which assigns a grade on the basis of a set of characteristics or attributes associated with an exposure. Credit scoring plays a central role in the ratings process.

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Credit scoring combined with appropriate portfolio risk segmentation is the method used to assign grades, and in turn PDs, to individual exposures. With regard to portfolio segmentation - the group's credit exposures have been segmented to appropriately reflect the characteristics, and risk profile, associated with different types of exposures.

Scorecards have been designed for each segment based on the drivers or characteristics of default associated with each segment. For instance, scorecards have been specifically developed for the bank's mortgage, unsecured and car finance business. Two broad types of scorecards are utilised by the group, application scorecards & behavioural scorecards. The scorecards have been constructed using regression analysis for all of the key portfolios. Typical scoring characteristics include financial details, bureau information, product behavioural and current account data. For segments where there is not enough data to develop statistical models, expert judgement based models are used.

Scorecard output is used as part of a calibration process to determine a PD percentage for each exposure. In doing so, exposures have been calibrated to one-year default rates that are applicable for each segment based on the Capital Requirement Directive's (CRD) definition of default i.e. >90 days etc. The one-year default rates used in this calibration process have been adjusted to ensure they cater for the 'long-run'.

With regard to the Group's Treasury exposures external ECAI grades are used in tandem with other relevant factors in the ratings assignment process.

All of the group's exposures are mapped to a risk rating scale (masterscale) which reflects the risk of default. The assignment of an exposure to a grade is based on the probability of an exposure defaulting in the next year – as per the CRD's definition of default. The rating scale consists of 25 specific 'ratings', including a default grade.

### **Loss Given Default (LGD)**

As a means of meeting the CRD requirements with regard to LGD – the group makes use of the “workout” approach to LGD estimation for all retail IRB portfolios. It is used for each of the group's key retail segments including mortgages, car finance, unsecured finance etc.

The process splits into two key areas: estimation of ‘realised’ LGD at pool level and the calibration of pools to meet the downturn requirements set out in the CRD. Therefore, as part of the estimation process, realised LGD is worked out based on the discounted realised recoveries and associated discounted costs for all observed defaults in the dataset. Having identified relevant drivers of loss, exposures are placed into 'pools' and realised LGD is estimated for each pool. The second step sees the calibration of each pool to appropriate downturn conditions.

In relation to non-retail portfolios, the given LGD values set out in the CRD in relation to FIRB firms are applied.

### **Credit Conversion Factor (CCF)**

The vast majority of retail exposures operating under the IRB approach do not have “undrawn” amounts. The retail portfolios for which IRB approval has been granted are mainly structured repayment facilities (mortgages, term loans and HP & Leasing facilities) and as outlined, proportionately not many facilities have undrawn amounts.

The group uses a two step approach to CCF modelling. In step one, realised CCFs are calculated based on historic defaults. Within this process, drivers of realised CCF are identified (e.g. limit utilisation). These drivers are then used to create pools. Average realised CCFs are then applied to each pool.

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In the second step, the pool CCFs from step one are adjusted for a downturn / long run scenario (as required)

In relation to the group's non-retail portfolios – the CCF provisions outlined in the CRD in relation to FIRB firms are applied.

#### **4.3.1.2 Validation of Estimates**

Irish Life & Permanent has established an internal validation process in accordance with CRD and regulatory requirements to ensure that the rating systems in place for PD, LGD and CCF remain robust and appropriate for the relevant IRB portfolios.

The Validation Unit has a direct reporting line to the Group Risk function independent of the Bank and the Head of the Validation Unit also has the ability to directly raise any matters of concern at the executive oversight group for the Bank's internal rating systems (Risk Parameter Committee).

The Validation Unit carries out two principal activities, namely annual reviews (periodic validation) & reviews of new enhancements (initial validation).

On an annual basis each of the Bank's internal rating systems is subjected to a periodic validation which involves a comprehensive review of the rating system including model performance, back testing, business use of the models and data quality. All enhancements or new developments are subjected to initial validation which ensures the suitability of the methodologies used to develop the rating systems, improvements in model performance where enhancements have been made and compliance with CRD requirements. No enhancement to the Bank's internal rating system is permitted to go live unless it receives a recommendation for approval from the group's Validation Unit and is approved in accordance with the group's IRBA governance process outlined earlier.

The validation process incorporates both quantitative and qualitative measures and provides an ongoing independent review of models, procedures and systems to ensure the accuracy of PD, LGD and CCF estimates. The tests employed in the validation process include statistical performance tests of the rating models discriminatory power, testing PD against the expected level of defaults, testing the realised losses for LGD through time and testing the predicted defaulted exposure amounts resulting from the CCF model against realised defaulted exposure amounts.

The results of both the annual rating system periodic validations and any initial validation reviews carried out as necessary in relation to enhancements are reported on a regular basis to the Risk Parameter Committee. The validations performed during 2010 show that the ratings systems within the group are meeting their overall requirements with any enhancements scheduled to be implemented.

The activities of the Validation Unit are subject to review on a yearly basis by Group Internal Audit.

#### **4.3.1.3 Summary view of the Group's exposure by Rating Grade**

In the table below the group's exposures have been detailed by CRD asset class distributed on a five point summarised internal rating scale.

As outlined above exposures are initially rated as part of a credit approval process. Exposures are then re-rated as a norm on a monthly basis via an automated behavioural scoring process or in respect of a small number of corporate portfolios on an annual basis at account review stage.

The group uses a twenty five point internal rating scale from 1 to 25 where one represents the best risk grade or lowest PD and 25 represents the defaulted exposures or PD = 100%. The internal rating scale or masterscale is not a rating tool but is based on probability of default and is used to aggregate borrowers for

comparison and reporting purposes after their rating by the underlying rating tool(s) (models) as outlined earlier. It should be noted that the rating tools (models) require recalibration at relevant intervals which can result in a change to the PD applicable to the rating grade and hence this can result in a change to the masterscale profile at a portfolio level.

This twenty five point rating scale has been summarised for presentation purposes into 5 blocks or segments as per the disclosures in the group's financial statements, namely

- ◆ Investment Grade – IRB ratings 1 to 7
- ◆ Excellent Risk profile – IRB ratings 8 to 16
- ◆ Satisfactory Risk profile - IRB ratings 17 to 21
- ◆ Fair Risk Profile - IRB ratings 22 to 24
- ◆ Defaulted Cases

Investment Grade categories represent strong exposures to corporates, sovereigns or institutional investors. Some retail exposures may be included where there is an extremely low probability of default.

Excellent risk profile grades would typically include performing residential mortgages.

The satisfactory risk profile grades include consumer finance exposures and larger mortgage exposures e.g. commercial investment property.

Fair risk profile contains the remainder of the group's exposures which have not defaulted and includes certain cases which have not yet defaulted but are exhibiting underlying symptoms of default e.g. missed payments or partial payments.

The defaulted category is self explanatory and contains those facilities which have defaulted, where default is defined as 90 days past due or where the Bank considers that the customer is unlikely to pay the outstanding liability in full.

The tables below set out by IRB asset class for 2010 the group's exposures by summary IRB grades, average exposure weighted risk weights & PDs with comparatives to 2008.

**Table 10 – Analysis of Group Treasury exposures as at 31<sup>st</sup> December 2010**

| IRB Exposure Class/ IRB Segments | Sovereigns   |             |             | Institutions |             |             | Securitisation Positions |             |             |
|----------------------------------|--------------|-------------|-------------|--------------|-------------|-------------|--------------------------|-------------|-------------|
|                                  | EAD          | Average RW% | Average PD% | EAD          | Average RW% | Average PD% | EAD                      | Average RW% | Average PD% |
| Investment Grade                 | 3,799        | 6%          | 0.02%       | 1,544        | 25%         | 0.07%       | 681                      | 8%          | 0.04%       |
| Excellent Risk Grade             | 1,948        | 43%         | 0.18%       | 827          | 51%         | 0.24%       | 8                        | 20%         | 0.12%       |
| Satisfactory Risk Grade          | -            | -           | -           | -            | -           | -           | -                        | -           | -           |
| Fair Risk Grade                  | -            | -           | -           | 61           | 280%        | 24.1%       | -                        | -           | -           |
| Defaulted                        | -            | -           | -           | -            | -           | -           | -                        | -           | -           |
| <b>Total IRB Exposures</b>       | <b>5,748</b> | <b>-</b>    | <b>-</b>    | <b>2,433</b> | <b>-</b>    | <b>-</b>    | <b>689</b>               | <b>-</b>    | <b>-</b>    |

**Table 10A – Analysis of Group Treasury exposures as at 31<sup>st</sup> December 2009**

| IRB Exposure Class/ IRB Segments | Sovereigns   |             |             | Institutions |             |             | Securitisation Positions |             |             |
|----------------------------------|--------------|-------------|-------------|--------------|-------------|-------------|--------------------------|-------------|-------------|
|                                  | EAD          | Average RW% | Average PD% | EAD          | Average RW% | Average PD% | EAD                      | Average RW% | Average PD% |
| Investment Grade                 | 7,342        | 11%         | 0.03%       | 5,351        | 15%         | 0.05%       | 729                      | 7%          | 0.03%       |
| Excellent Risk Grade             | 77           | 57%         | 0.13%       | 532          | 43%         | 0.18%       | 7                        | 21%         | 0.12%       |
| Satisfactory Risk Grade          | -            | -           | -           | -            | -           | -           | -                        | -           | -           |
| Fair Risk Grade                  | -            | -           | -           | 11           | 285%        | 24.05%      | -                        | -           | -           |
| Defaulted                        | -            | -           | -           | 2            | 0%          | 100%        | -                        | -           | -           |
| <b>Total IRB Exposures</b>       | <b>7,419</b> | <b>-</b>    | <b>-</b>    | <b>5,896</b> | <b>-</b>    | <b>-</b>    | <b>736</b>               | <b>-</b>    | <b>-</b>    |

**Table 11 – Analysis of CRD Corporate Asset class exposures as at 31<sup>st</sup> December 2010**

| IRB Exposure Class/ IRB Segments | Corporate    |             |             |
|----------------------------------|--------------|-------------|-------------|
|                                  | EAD          | Average RW% | Average PD% |
| Investment Risk Grade            |              |             |             |
| Excellent Risk Grade             | 386          | 94%         | 0.7%        |
| Satisfactory Risk Grade          | 1,234        | 160%        | 2.8%        |
| Fair Risk Grade                  | 417          | 238%        | 17.8%       |
| Defaulted                        | 442          | 0%          | 100.0%      |
| <b>Total IRB Exposures</b>       | <b>2,480</b> | <b>-</b>    | <b>-</b>    |

**Table 11A – Analysis of CRD Corporate Asset class exposures as at 31<sup>st</sup> December 2009**

| IRB Exposure Class/ IRB Segments | Corporate    |             |             |
|----------------------------------|--------------|-------------|-------------|
|                                  | EAD          | Average RW% | Average PD% |
| Investment Risk Grade            | 103          | 12%         | 0.04%       |
| Excellent Risk Grade             | 921          | 101%        | 0.22%       |
| Satisfactory Risk Grade          | 1,156        | 163%        | 2.6%        |
| Fair Risk Grade                  | 302          | 199%        | 8.63%       |
| Defaulted                        | 285          | 0%          | 100%        |
| <b>Total IRB Exposures</b>       | <b>2,767</b> | <b>-</b>    | <b>-</b>    |

**Table 12 – Analysis of CRD Retail Asset class exposures as at 31<sup>st</sup> December 2010**

| IRB Exposure Class/ IRB Segments | Retail        | Retail Mortgage |             |             | Retail Other |             |             | Qualified Revolving |             |             |
|----------------------------------|---------------|-----------------|-------------|-------------|--------------|-------------|-------------|---------------------|-------------|-------------|
|                                  | EAD €m        | EAD €m          | Average RW% | Average PD% | EAD €m       | Average RW% | Average PD% | EAD €m              | Average RW% | Average PD% |
| Excellent Risk Grade             | 22,135        | 21,139          | 11%         | 0.7%        | 335          | 52%         | 0.8%        | 661                 | 10%         | 0.3%        |
| Satisfactory Risk Grade          | 5,545         | 5,019           | 26%         | 2.2%        | 396          | 82%         | 2.5%        | 130                 | 49%         | 2.7%        |
| Fair Risk Grade                  | 3,356         | 3,089           | 53%         | 20.4%       | 186          | 116%        | 16.7%       | 81                  | 96%         | 12.5%       |
| Defaulted                        | 2,588         | 2,436           | 100%        | 100.0%      | 103          | 129%        | 100.0%      | 48                  | 77%         | 100.0%      |
| <b>Total IRB Exposures</b>       | <b>33,624</b> | <b>31,683</b>   | <b>-</b>    | <b>-</b>    | <b>1,021</b> | <b>-</b>    | <b>-</b>    | <b>920</b>          | <b>-</b>    | <b>-</b>    |

**Table 12A – Analysis of CRD Retail Asset class exposures as at 31<sup>st</sup> December 2009**

| IRB Exposure Class/ IRB Segments | Retail        | Retail Mortgage |             |             | Retail Other |             |             | Qualified Revolving |             |             |
|----------------------------------|---------------|-----------------|-------------|-------------|--------------|-------------|-------------|---------------------|-------------|-------------|
|                                  | EAD €m        | EAD €m          | Average RW% | Average PD% | EAD €m       | Average RW% | Average PD% | EAD €m              | Average RW% | Average PD% |
| Excellent Risk Grade             | 22,855        | 21,750          | 10%         | 0.5%        | 650          | 51%         | 0.72%       | 454                 | 9%          | 0.62%       |
| Satisfactory Risk Grade          | 5,933         | 5,399           | 27%         | 2.4%        | 466          | 77%         | 2.47%       | 69                  | 57%         | 2.45%       |
| Fair Risk Grade                  | 3,785         | 3,559           | 58%         | 20.3%       | 199          | 115%        | 16.19%      | 27                  | 119%        | 15.26%      |
| Defaulted                        | 1,605         | 1,477           | 118%        | 100%        | 114          | 190%        | 100%        | 14                  | 228%        | 100%        |
| <b>Total IRB Exposures</b>       | <b>34,178</b> | <b>32,185</b>   | <b>-</b>    | <b>-</b>    | <b>1,429</b> | <b>-</b>    | <b>-</b>    | <b>564</b>          | <b>-</b>    | <b>-</b>    |

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#### 4.3.1.4 Comparison of Expected Loss and Actual Net Loss

In table 13 the Expected Loss (EL) is compared to the actual profit & loss charge for the year ended 31<sup>st</sup> December 2010 with a comparative to 2009. The EL that is shown is that which is used for regulatory capital purposes and so is a conservative one year estimate of loss calibrated to an economic downturn.

However, as the economic cycle has declined the group's provision's charge has moved closer to the regulatory EL as more facilities have defaulted and provision rates have increased. As noted below, it is not expected for the reasons outlined that the provisions will reach the regulatory EL in any period given its conservative nature.

*Table 13: Net loss and Expected loss by customer segment*

| IRB Exposure Class        | EL                             | P&L        | EL                             | P&L        |
|---------------------------|--------------------------------|------------|--------------------------------|------------|
|                           | (€m)                           | (€m)       | (€m)                           | (€m)       |
|                           | 31 <sup>st</sup> December 2010 |            | 31 <sup>st</sup> December 2009 |            |
| Sovereigns                | 1.9                            | -          | 0.9                            | -          |
| Institutions              | 8.1                            | -          | 3.5                            | -          |
| Corporates                | 248.8                          | 105        | 190.8                          | 99         |
| Retail Mortgages          | 380.8                          | 270        | 234.0                          | 187        |
| Retail Other              | 102.8                          | 38         | 102.2                          | 78         |
| Qualified Revolving       | 47.4                           | 7          | 14.0                           | 12         |
| <b>Total IRB Approach</b> | <b>789.7</b>                   | <b>420</b> | <b>545.4</b>                   | <b>376</b> |

It should be noted that due to influences of pro-cyclicality (rising PDs in times of economic decline), that EL will vary over time with the business cycle. Expected loss as computed using CRD parameter outputs will be necessarily different to the group's provisions for its loan portfolios for the following reasons:

- As outlined above downturn LGD is used in the regulatory capital formulae, whereas current actual losses are much closer to the realised LGD rate. This effect or differential is significantly more pronounced where the given LGD of 45% is used in the corporate asset classes.
- Cyclicity of the scorecards and the effect of the economic cycle adjustment which move actual observed default rates to a long run rate. In computing the Probability of Default used, the Bank has adjusted observed default rates to take account of its positioning within the current economic cycle. So there is a required divergence between actual observed default rates and the conservative PD used for regulatory capital.
- Economic cycle to which the group has been exposed in recent years which has led in general to extremely low loss rates on the mortgage portfolios in proportion to their size.

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#### 4.3.1.5 Relationship Between Internal & External Ratings

The table 14 shows the mapping from the internal rating scale to the Moody's rating scale, using summarised blocks from the group's 25 point internal rating scale. As outlined earlier on the group's masterscale, 1 is the best risk category & 25 the worst or defaulted category.

*Table 14: Indicative mapping of the Groups rating segments to Moody's*

| <b>Illustrative Rating Comparison</b> |                           |
|---------------------------------------|---------------------------|
| <b>Internal Rating Category</b>       | <b>Moody's Equivalent</b> |
| Investment                            | AAA to A3                 |
| Excellent                             | Baa1 to Ba2               |
| Satisfactory                          | Ba2 to B1                 |
| Fair                                  | B2 to C                   |
| Defaulted                             | D                         |

The mapping of the internal ratings to the Moody's rating scale is shown for illustrative purposes and it is not intended to reflect that there is a fixed relationship between the group's internal rating grades and the Moody's rating grades since the rating approaches differ.

#### 4.3.2 Calculation of RWA under the standardised approach

The standardised approach measures credit risk by applying given fixed risk weights in the Basel II accord/CRD based on the exposure class to which the exposure is allocated and is, hence, less sophisticated than the IRB approach for regulatory capital calculations. As outlined earlier, the group applies this approach to less than 1% of its overall loan exposures and it also applies it to the group's non credit obligation assets. There is an option under the standardised approach to utilise an external rating from eligible rating agencies for certain exposure classes to derive an applicable risk weight. As the group's exposures under the standardised approach are immaterial, are not to the relevant exposure classes (e.g. sovereigns) and are hence to unrated counterparties given the nature of the exposure (consumer), the group does not utilise this approach but avails of the risk weights given in the CRD.

In respect of this 1%, the group uses the standardised approach for only four principle groupings of exposures namely retail, institution, commercial exposures & other non credit obligation assets.

##### **Retail exposures:**

The facilities classified as retail on the standardised approach are facilities secured on residential mortgages which are assigned a risk weight of 35% or 75% depending upon the LTV & loan purpose in accordance with the Financial Regulator's guidance.

##### **Institution**

These exposures of circa €4m relate to a facility to a credit institution and fall to be classified as institution exposures which receive a risk weight of 20%.

##### **Commercial**

A small number of mortgage loans secured on commercial property which have an assigned risk

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weight of 100%.

### **Other Non Credit Obligation Assets**

This represents the balance of the non credit assets on the group's balance sheet which are assigned the given risk weight of 100%.

## **4.4 Credit Risk Mitigation**

As the group's principal exposure to credit risk is in respect of residential real estate mortgages and regulatory capital is computed on an IRB approach, the value of the collateral held is reflected in its LGD estimation process.

A common way to view residential real estate collateral is to view it by loan to value (LTV). As at 31<sup>st</sup> December 2010, the indexed LTV on the group's ROI residential mortgage facilities was 69% (2009 - 63%). The corresponding indexed LTV on its UK residential mortgage portfolio was 83% (2009 - 85%).

### **4.4.1 Average weighted LGD**

The LGDs for the group's retail portfolios are based on internal models and are divided into pools driven by appropriate drivers of loss. As is required by the CRD there is currently a minimum value of 10% utilised where internal estimates are less than this value. As at 31<sup>st</sup> December 2010, the average exposure weighted LGD for the group's retail mortgage portfolios was as follows:

- |                                 |       |                |
|---------------------------------|-------|----------------|
| ◆ ROI Retail Mortgage Exposures | 11.2% | (2009 - 11.2%) |
| ◆ UK Retail Mortgage Exposures  | 12.5% | (2009 - 10.8%) |

In respect of the group's smaller consumer portfolios which make up the retail other asset class, the average exposure weighted LGD is 58.7% - (2009 - 57.4 %.).

### **4.4.2 Other Credit Risk Mitigation**

As is outlined later in this document, the group has a number of residential mortgage based securitisations in issue. Certain of these securitisations met the original requirements for exclusion of the underlying residential mortgage assets from regulatory capital requirements under the former Basel I capital accord.

In August 2009, the group received permission to exclude certain RBMS securitisations from its calculation of risk weighted assets as per article 95 of the CRD. The exposure value and equivalent risk weighted assets excluded from regulatory capital calculations are detailed below as at 31<sup>st</sup> December 2010.

| <u>Securitisation</u>      | <u>Exposure Value</u> | <u>Risk Weighted Asset</u> |
|----------------------------|-----------------------|----------------------------|
|                            | <u>€m</u>             | <u>€m</u>                  |
| ▪ Fastnet Securities 2 plc | 1,372                 | 290                        |
| ▪ Auburn Securities 3 plc  | 94                    | 19                         |
| ▪ Auburn Securities 4 plc  | 440                   | 119                        |
| ▪ Auburn Securities 5 plc  | 302                   | 63                         |

As the group's principal exposures are to facilities backed by residential mortgages which fall in the retail asset class, the group as a norm does not avail of further credit risk mitigation in its regulatory capital computations than outlined above.

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## 4.5 *Information About Impaired Loans & Loans Losses*

### 4.5.1 Approach to & Definition of Impaired loans

As per the group's 2010 financial statements, its policy in regard to impairment provisioning and the use of accounting estimates & judgement are set out below:

#### **Basis of Preparation & Significant Accounting Policies – Impairment Provisions**

The group assesses impairment of financial assets at each balance sheet date on a case by case basis for assets that are individually significant and collectively for assets that are not individually significant.

Assets are impaired only if there is objective evidence that the result of one of more events that have occurred after the initial recognition of the asset have had an impact on the estimated future cash flows of the assets. For individual assets this includes changes in the payment status of the counterparty. Collective assessment groups together assets that share similar risk characteristics and, applies a collective methodology based on existing risk conditions or events which have a strong correlation with a tendency to default.

Potential impairment is calculated by comparing the present value of the estimated future cash flows discounted at the effective interest rate applicable to the asset (after taking account of the security held) with the carrying value in the balance sheet. Where loans are impaired the written down value of the impaired loan is compounded back to the net realisable balance over time using the original effective interest rate. This is reported through interest receivable within the income statement and represents the unwinding of the discount. A write-off is made when all or part of a loan is deemed uncollectible or forgiven. Write-offs are charged against previously established provisions for impairment or directly to the income statement.

For individually assessed accounts, loans are treated as impaired as soon as there is objective evidence that an impairment loss has been incurred. The criteria used by the group to determine that there is such objective evidence include, known cash flow difficulties experienced by the borrower, overdue contractual payments of either principal or interest, or a breach of loan covenants or conditions.

Individually assessed impairment allowances are determined by evaluating the exposure to loss, case by case, on all individually significant accounts and all other accounts that do not qualify for the collective assessment approach outlined below. In determining allowances on individually assessed accounts, a number of factors are considered including:

- The group's aggregate exposure to the customer;
- The viability of the customer's business model to generate sufficient cash flow to service debt obligations;
- The ranking of the group's claim in relation to the customer's other obligations;
- The realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- The likely distribution available on liquidation or bankruptcy.

Impairment is assessed on a collective basis to cover losses which have been incurred but not yet identified on loans subject to individual assessment and to calculate impairment allowances where large numbers of loans are managed using a portfolio approach such as credit cards or motor vehicle financing.

The collective impairment allowance takes into account historical loss experience in portfolios of similar credit risk characteristics, current economic conditions and account behavioural trends.

## 4.5.2 Impaired Balances

Set out below as at 31<sup>st</sup> December 2010 (with comparatives to December 2009) is an overview of the group's loan portfolios by key products, detailing their composition in terms of impairment:

|  | 2010          |                                       |                                      |                  |                           |             |
|--|---------------|---------------------------------------|--------------------------------------|------------------|---------------------------|-------------|
|  | Total<br>€m   | ROI<br>Residential<br>mortgages<br>€m | UK<br>Residential<br>mortgages<br>€m | Commercial<br>€m | Consumer<br>Finance<br>€m | Other<br>€m |
| Neither past due nor impaired <sup>#</sup> | 31,909        | 22,342                                | 7,195                                | 1,261            | 1,111                     | -           |
| Past due but not impaired                  | 3,699         | 3,006                                 | 221                                  | 363              | 109                       | -           |
| Impaired                                   | 1,538         | 992                                   | 111                                  | 280              | 155                       | -           |
| <b>Total</b>                               | <b>37,146</b> | <b>26,340</b>                         | <b>7,527</b>                         | <b>1,904</b>     | <b>1,375</b>              | <b>-</b>    |

|  | 2009          |                                       |                                      |                  |                           |             |
|--|---------------|---------------------------------------|--------------------------------------|------------------|---------------------------|-------------|
|  | Total<br>€m   | ROI<br>Residential<br>mortgages<br>€m | UK<br>Residential<br>mortgages<br>€m | Commercial<br>€m | Consumer<br>Finance<br>€m | Other<br>€m |
| Neither past due nor impaired <sup>#</sup> | 34,603        | 24,306                                | 7,158                                | 1,495            | 1,433                     | 211         |
| Past due but not impaired                  | 3,208         | 2,535                                 | 251                                  | 273              | 149                       | -           |
| Impaired                                   | 828           | 415                                   | 75                                   | 171              | 167                       | -           |
| <b>Total</b>                               | <b>38,639</b> | <b>27,256</b>                         | <b>7,484</b>                         | <b>1,939</b>     | <b>1,749</b>              | <b>211</b>  |

## 4.5.3 Provision for impairment on loans and receivables to customers

Set out in table below is a summary of the movement in the group's provisions in the year broken down between collective and specific provisions as 31<sup>st</sup> December 2010 with comparatives to 2009.

### a) Loans and receivables

|                                     | 2010           |                  |             | 2009           |                  |             |
|-------------------------------------|----------------|------------------|-------------|----------------|------------------|-------------|
|                                     | Specific<br>€m | Collective<br>€m | Total<br>€m | Specific<br>€m | Collective<br>€m | Total<br>€m |
| As at 1 January                     | 241            | 236              | 477         | 37             | 102              | 139         |
| Charge to profit or loss            |                |                  |             |                |                  |             |
| Impairment losses                   | 312            | 131              | 443         | 213            | 163              | 376         |
| Amounts recovered during the year   | -              | (8)              | (8)         | -              | -                | -           |
| Amounts written off during the year | (7)            | (22)             | (29)        | (10)           | (30)             | (40)        |
| Exchange movements                  | -              | -                | -           | 1              | 1                | 2           |
| <b>As at 31 December</b>            | <b>546</b>     | <b>337</b>       | <b>883</b>  | <b>241</b>     | <b>236</b>       | <b>477</b>  |

<sup>#</sup> These are loans and receivables where contractual interest or principal payments are past due but the company believes that impairment is not appropriate on the basis of the level of security/ collateral available and/ or the stage of collections of amounts owed to the company.

Set out below is an analysis by the group's significant loan portfolios of the provisions in place as at 31<sup>st</sup> December 2010 with comparatives to December 2009.

#### Analysis of provisions as at 31 December

|                         | 2010           |                  |             | 2009           |                  |             |
|-------------------------|----------------|------------------|-------------|----------------|------------------|-------------|
|                         | Specific<br>€m | Collective<br>€m | Total<br>€m | Specific<br>€m | Collective<br>€m | Total<br>€m |
| ROI residential lending | 322            | 124              | 446         | 125            | 69               | 194         |
| Commercial lending      | 163            | 60               | 223         | 78             | 35               | 113         |
| UK lending              | 47             | 16               | 63          | 28             | 14               | 42          |
| Consumer finance        | 14             | 137              | 151         | 10             | 118              | 128         |
|                         | <b>546</b>     | <b>337</b>       | <b>883</b>  | <b>241</b>     | <b>236</b>       | <b>477</b>  |

#### 4.5.4 Provision for impairment on Debt Securities

In 2009, the group had no profit & loss charge for impairment provisions in the debt securities portfolio (2008 - €122m). It maintains a collective provision of €19m against this portfolio.

#### 4.5.5 Analysis of profit or loss charge

Set out below is an analysis of the group's profit and loss charge for provisions in respect of loans to consumers & on debt securities for the year ended 31<sup>st</sup> December 2010 with comparatives to 2009.

|                         | 2010           |                  |             | 2009           |                  |             |
|-------------------------|----------------|------------------|-------------|----------------|------------------|-------------|
|                         | Specific<br>€m | Collective<br>€m | Total<br>€m | Specific<br>€m | Collective<br>€m | Total<br>€m |
| ROI residential lending | 187            | 56               | 243         | 107            | 47               | 154         |
| Commercial lending      | 80             | 25               | 105         | 69             | 30               | 99          |
| UK lending              | 25             | 2                | 27          | 27             | 6                | 33          |
| Consumer finance        | 5              | 40               | 45          | 10             | 80               | 90          |
|                         | <b>297</b>     | <b>123</b>       | <b>420</b>  | <b>213</b>     | <b>163</b>       | <b>376</b>  |

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## 5 Market Risk (Pillar I)

Market risk is the risk of change in fair value of a financial instrument due to changes in equity prices, property prices, interest rates or foreign currency exchange rates. All market risks within the group are subject to strict internal controls and reporting procedures and are monitored by the group's Assets and Liabilities Committee. All market risks are subject to limits on the magnitude and nature of exposures which may be undertaken. These limits are outlined in policy documents which are regularly reviewed by the board.

Market risk in the group's banking operations arises from open positions in interest rate or currency products. The market risk exposure is managed by Group Treasury. Group Treasury use a number of tools to identify market risk; including Value at Risk, Interest Rate Duration Gap, Stress-Testing, Mark to market / stop loss reports. Market risk is reported on an overall basis and is also separated into trading and non-trading portfolios. Proprietary trading has ceased since 1 July 2009, though there remains a residual trading book which for IFRS accounting reasons has not been transferred to other portfolios as yet. This will be wound up as soon as feasible.

In managing market exposures, the group uses a Value at Risk ("VaR") model. VaR is a statistically based estimate of potential loss on a portfolio from adverse market movements, which summarises the predicted maximum loss over a target time horizon and a given confidence level. Group Treasury adopts JP Morgan's Risk Metrics methodology which is a variance-co-variance approach. The VaR model assumes a holding period of 10 days, and a 99% confidence level is applied. Volatilities and correlations are exponentially weighted (the most recent event carries a greater weighting), and are calculated based on price movements over the past 150 days. The volatilities and correlations are imported daily from Risk Metrics.

VaR limits are approved by the board and established for the overall banking book and residual trading portfolio. VaR reports are produced and quantified by Treasury Risk Management and reported to senior management daily and to the Group Assets and Liabilities Committee on a monthly basis.

The prices of similar financial instruments do not move in exact step with each other and, as a result, the total risk contained in a portfolio of different financial instruments cannot be calculated by taking the sum total of the individual risks. The VaR methodology employed by the group calculates the risk in each instrument held in the portfolio and measures the impact of diversification of the risk of the portfolio using an industry standard methodology (the variance-co-variance approach).

As with any market risk measurement system, the VaR methodology utilised by the group has recognised limitations. VaR does not measure "event" (e.g. crash) risk or incorporate assumptions about the range of likely changes in future market conditions, including behavioural assumptions about the various types of assets and liabilities (particularly those arising from retail transactions). Accordingly, the group supplements its VaR methodology with other risk measurement techniques including interest rate duration gap, stress testing and mark to market / stop loss reports.

Stress testing techniques are also used as a means to assess potential exposure to pre-defined moves in individual risk factors.

The non-trading book comprises the bank's retail and corporate deposit books and its loan book combined with the inter-bank book, wholesale funding instruments and the liquid asset investment portfolio, is managed by Treasury.

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**Value at risk - non trading**

|                | 2010 | 2009 |
|----------------|------|------|
|                | €m   | €m   |
| At 31 December | 5.5  | 4.2  |
| Average        | 5.4  | 5.0  |
| Minimum        | 3.0  | 3.4  |
| Maximum        | 8.9  | 7.5  |

As outlined in section 3, the group utilises the Standardised approach for regulatory capital purposes for market risk. Under the standardised approach, two separate regulatory capital calculations are required:

1. Traded Debt Instruments or position risk
2. Foreign Exchange Risk

Both of these calculations are very similar to the former Basel I approach as set out in section 3.

**Position risk** requires regulatory capital for an institution having a position in debt securities in the trading book. Debt securities include all fixed rate & floating rate debt securities and similar instruments. In addition, debt derivatives and off balance sheet instruments which react to changes in interest rates are also included. Under the standardised approach, two charges arise, one for the risk of general market movements & one for specific risk of the movement in the price of an individual security. In respect of general risk, the instruments are slotted into a maturity ladder and general risk weights applied to the long & short positions. The net positions are then subjected to various capital charges ranging from 10% to 150%. The capital requirement for specific risk involves categorisation of the security type e.g. government or non government. Certain categories of debt security have no specific risk capital requirement. The specific risk capital requirement is calculated by categorising the applicable debt securities positions (both long & short) into the required categories determined by credit quality steps & security issuer. A capital charge of 0% to 12% is then calculated depending on the category into which the relevant debt security has been assigned.

**Foreign exchange risk** on the standardised basis provides capital for open long or short currency positions. To compute the required capital, the open positions either long or short are converted into the reporting currency (Euro). The higher of the net short or long position is determined and this forms the basis of the regulatory capital charge, which is the highest net position multiplied by 8%.

The capital requirements and equivalent risk weighted assets are set out in table 15 below.

*Table 15: Capital Requirements for Market Risk*

| <i>Pillar I Risk/ Approach</i>         | <u>2010</u>                      |                                 | <u>2009</u>                      |                                 |
|--|----------------------------------|---------------------------------|----------------------------------|---------------------------------|
|  | <i>Capital Requirement</i><br>€m | <i>CRD RWA Equivalent</i><br>€m | <i>Capital Requirement</i><br>€m | <i>CRD RWA Equivalent</i><br>€m |
| <b><u>Market Risk</u></b>              |                                  |                                 |                                  |                                 |
| Traded Debt Instruments (Standardised) | 0.5                              | 6                               | 6                                | 75                              |
| FX (Standardised)                      | 1.5                              | 19                              | 3                                | 38                              |
| <b><u>Total for Market Risk</u></b>    | <b>2</b>                         | <b>25</b>                       | <b>9</b>                         | <b>113</b>                      |

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## 6 Operational Risk (Pillar I)

Operational risk is an inherent part of doing business and hence is present in all activities of the group. The management of operational risk depends on a robust control framework and sound monitoring and reporting of risk events and trends. Appropriate risk governance and control structures, qualified and competent staff and strong leadership provide key foundations for the control environment for operational risk across all entities of the group.

Irish Life & Permanent operates an industry best practice operational risk framework which includes the measurement and monitoring of both operational and regulatory risk. The aim of this framework is to help focus management attention on the subset of operational risks which are material at each level of the organisation (either in terms of financial impact, or more broadly because of reputational or regulatory impacts).

Central Group management, and each of the business units within the group, identify the material operational risks to which they are exposed. The identification process is based on a detailed review of business activities, supplemented by reference to external industry information. Each business unit has a designated operational risk manager who is responsible for coordinating operational risk management within that business unit. The local management team of each business unit is responsible for reviewing and authorising the register of main operational risks for each business unit on an annual basis. Each business unit also revisits each operational risk (and their associated controls) on a quarterly basis to ensure they are kept up-to-date throughout the year and also to identify emerging operational risks.

The group operational risk framework utilises business unit operational risk registers to identify the group's material operational risks. Materiality is determined by a quantitative and qualitative assessment of each risk by reference to its likelihood of incidence, potential financial impact and potential reputational impact. These material operational risks are regularly reported to the Group Operational Risk Committee and the Board Risk & Compliance Committee. The Group Operational Risk Committee is responsible for steering progress on the measurement and mitigation of these risks. Key risk indicators are used to carry out this monitoring process.

The group operates an industry best practice risk and event recording database. The database is coordinated by the Group Risk function with the business units recording all operational risk (including regulatory risk and reputational risk) events and near misses across the group. Risk events and their associated impact are analysed in accordance with the group's operational risk categories which comply with Basel II requirements. All loss events are recorded in the register.

The operational risk database generates risk reports for review at the Operational Risk Committee meetings. Each report details the number of operational risk loss events and near misses by business unit for the period.

Operational risk cannot be entirely eliminated from an entity's business operations without the cessation of business. Acknowledging this fact, the group has implemented risk mitigation techniques to reduce the level of this risk where possible.

The group maintains a comprehensive suite of insurance cover in order to mitigate against operational risk to the extent possible. Aligned closely to the operational risk event types established by Basel II, insurance cover includes:

- Theft and fraud (internal and external)
- Civil liability
- Employer's liability
- Business interruption

- 
- Directors' and Officers' liability
  - Natural catastrophe cover (Business Continuity Planning)

The framework of controls established across the group to manage operational risk is subject to periodic and independent assessment by Group Internal Audit.

As described in section 3.3, operational risk capital requirements for the group are calculated based on the Basel II standardised approach. Updated annually, the operational risk capital requirements are derived from the gross income of the group for the period. Refer to section 3.3 for further details on the calculation.

As outlined earlier, the group's regulatory capital requirement for operational risk as at 31<sup>st</sup> December 2010 is circa €61 million (2009 - €65m).

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## **7 Disclosure of off-balance sheet & securitisation (included in Pillar I)**

### **7.1 Introduction**

In this section the group sets out its disclosure information in respect of off balance sheet items, derivatives & securitisation.

### **7.2 General Off Balance Sheet Disclosures**

Off-balance sheet items include derivatives and securitisations.

### **7.3 Derivative Risk**

The key derivative contracts which the group utilises comprise interest rate swaps, cross currency swaps, future rate agreements, futures and options. Within the banking operations derivatives are used to reduce interest and foreign currency exchange rate exposures (fair value hedges) and to generate incremental income for the group (trading). The group enters into derivative contracts in the main to hedge its underlying balance sheet asset & liability positions. It does maintain a small trading book with open positions which is subject to strict limits. The group does not utilise or provide credit default derivatives. Derivatives give rise to both counterparty & market risk.

#### **7.3.1 Counterparty Risk**

Counterparty risk is that the counterparty to a derivative contract into which the group has entered defaults prior to the maturity of the contract.

To estimate exposure values for regulatory capital purposes for derivative contracts, the group uses the methodology outlined in Annex III of the CRD (mark to market plus add on). The credit risk on derivative products is a combination of the positive market replacement cost (obtained by 'marking to market') and a factor to account for potential future credit exposure.

Counterparty credit risk is approved and managed in line with a set of clearly defined policy statements, approved by the Board. The Group Assets and Liabilities Committee ("ALCO") is responsible for developing and implementing credit policy in relation to investment securities and exposures to wholesale banks. The credit policy covers parameters for exposure to counterparties, settlement risk exposure, country exposure & derivative credit exposure.

To meet CRD requirements, the group has established an internal ratings mechanism which is applied to each counterparty. Credit limits for counterparties are based on the final "notched" rating assigned to each counterparty as outlined below. These limits are maintained in the group's investment accounting system and specialist Risk Management and Compliance teams undertake regular independent monitoring of counterparty exposure against limits. All breaches of counterparty limits are notified to the Assets and Liabilities Committee ("ALCO").

For investment securities & wholesale bank applications (and ongoing assessment), the PD for a counterparty is determined using the group's IRB model. As a basis for the IRB credit rating for the counterparty, the group uses the lowest credit rating for the counterparty from three separate rating agencies. This credit rating is mapped to a statistical PD before application of the group's "notching" process. The

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“notching” process increases the counterparty credit rating (and hence PD) according to predefined notching parameters. “Notching” parameters revise the IRB credit rating for a counterparty upwards dependent on factors such as geographical location, presence of the counterparty on rating agency “watchlists” and economic market stability amongst others.

### **7.3.2 Market Risk**

The group deals with market risk for regulatory capital purposes on the standardised approach as outlined in section 3.2 & in section 5. For internal management purposes, the group utilises a VaR approach as outlined in section 5.

## **7.4 Securitisations**

Securitisation risk is the risk of loss associated with buying or selling asset-backed securities. Securitisation risk occurs when issuing mortgage backed securities as a risk transfer or funding device. Securitisation risk is minimised through the use of ‘standard’ (as opposed to exotic) securitisation structures, the use of only high quality counterparties to perform the structuring, oversight and governance provided by appropriately qualified experienced external and internal parties.

Irish Life & Permanent is primarily an originator of securitisations and at 31 December 2010, the group had advances secured on residential property subject to non-recourse funding. These loans, which have not been derecognised, are shown within loans and receivables to customers and the non-recourse funding is shown within debt securities in issue.

The Group also invests in purchased positions and these cover the RMBS asset class.

The securitisations originated by the Group involve selling pools of mortgages to special purpose entities which issue mortgage backed floating notes (‘notes’) to fund the purchase of these mortgage pools.

Under the terms of these securitisations, the rights of the providers of the related funds are limited to the mortgage loans in the securitised portfolios and any related income generated by the portfolios, without recourse to Irish Life and Permanent plc. Irish Life and Permanent plc is not obliged to support any losses in respect of the mortgages subject to the non-recourse funding.

The risk weighted exposure amounts for these loans are calculated using the IRB approach. The risk weighted amounts for the Group’s purchased positions are also calculated using the IRB approach. Where the group invests in RMBS securities, these are treated for regulatory capital purposes under the internal ratings based approach set out in annex IX of the CRD using the ratings based methodology.

Monitoring of securitisation risk within the group principally occurs through three processes:

1. a review of the mortgage pool to be used in the securitisation including checking the pool is appropriately homogeneous by reference to time in arrears and loan-to-value (LTV) amongst other parameters
2. a review of the internal securitisation process following the execution of a transaction allowing the process to be improved in terms of efficiency and risk reduction
3. monthly monitoring of the underlying mortgage pool performance following the transaction

The financial assets (see accounting policy Note 1 item (x) in the Annual Report and Financial Statements 2010) are held on the group statement of financial position and a liability recognised for the proceeds of the funding transaction. Purchased positions are included as loans and receivable within debt securities.

*Table 16: Total Amount of Exposures Securitised*

| <b>Exposure Type</b>  | <b>Outstanding amount of exposures<br/>€m</b> |
|-----------------------|---|
| Residential Mortgages | 2,208   |

*Table 17: Losses Recognised, Amount of Impaired and Past Due*

| <b>Exposure Type</b>  | <b>Past due exposures<br/>€m</b> | <b>Impaired exposures<br/>€m</b> | <b>Losses recognised<br/>€m</b> |
|-----------------------|----------------------------------|----------------------------------|---------------------------------|
| Residential Mortgages | 103                              | 39                               | -                               |

*Table 18: Positions Retained and Purchased*

The positions retained and purchased relate to residential mortgage exposures. The total exposure amount at 31 December 2010 is €689m (2009 - €736m).

| <b>Risk Weight Band</b> | <b>€m</b> | <b>€m</b> |
|-------------------------|-----------|-----------|
|                         | 2010      | 2009      |
| 6% - 10%                | 611       | 729       |
| 12% - 18%               | 70        |           |
| 20% - 35%               | 8         | 7         |
| Total                   | 689       | 736       |

There have been no new securitisations originated by the Bank which qualify for derecognition under Pillar 1 in the year to 31 December 2010.

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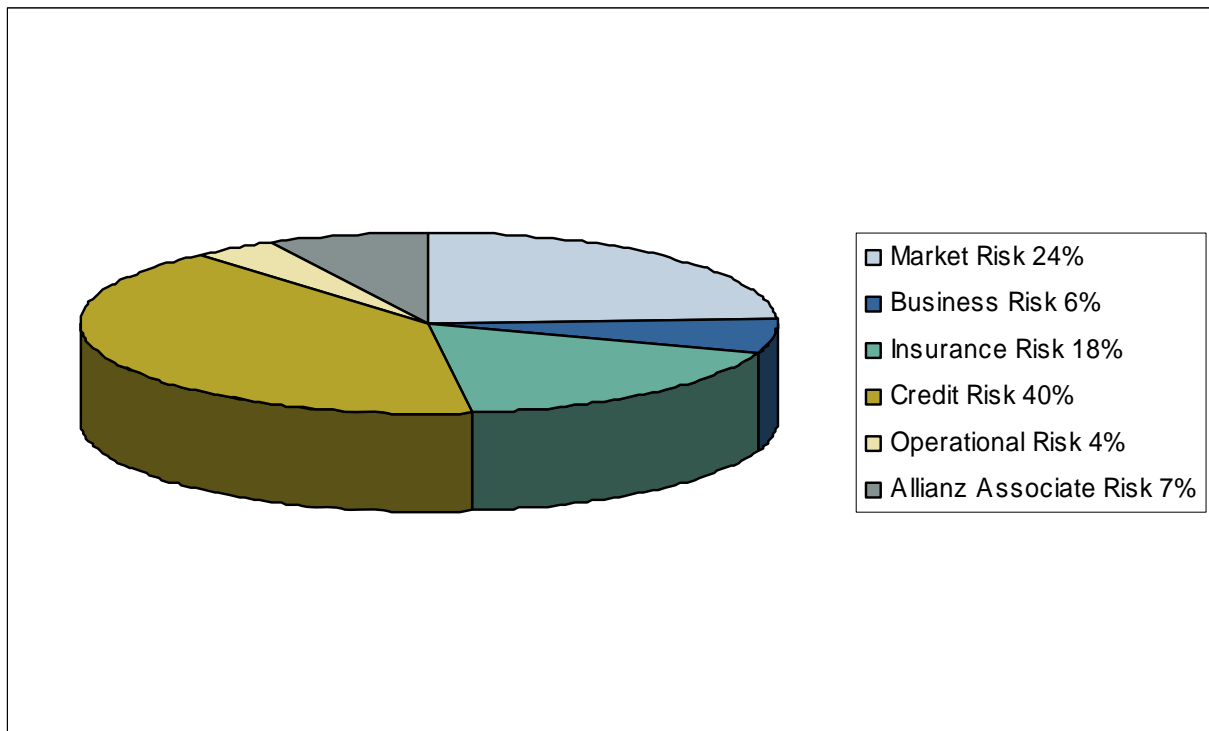
## 8 Internal Capital including other risk types

In addition to, and incorporating, Pillar I capital requirements for credit risk, market risk and operational risk; Irish Life & Permanent operates an internal capital adequacy assessment process (“ICAAP”). A core component of the ICAAP is the group’s economic capital framework which establishes internal capital requirements across the group. The ICAAP is described in more detail in section 9.3.

### 8.1 Economic Capital

The group has elected to use Economic Capital as its core unit of risk currency. The chart below shows the composition of diversified economic capital by risk category for the group as at the end of June 2010. Total economic capital requirements of the group, including all diversification benefits arising from imperfectly correlated risks, as at the end of June 2010 total €1,692m (June 2009: €1,394m). Economic capital is calibrated to the group’s internal target senior debt rating (as referenced to the Standard & Poors rating scale) of A-.

#### **Group Diversified Economic Capital distributed by risk category – 30 June 2010**



Irish Life & Permanent calculates economic capital requirements for the following risks:

| <b>Risk category</b> | <b>Sub-risk for which economic capital is derived</b>  |
|----------------------|--|
| Credit Risks         | Credit default risk *<br>Credit concentration risk *<br>Reinsurance & Other Mitigating Counterparties risk |
| Market Risks *       | Equity risk<br>Property risk<br>Interest rate risk<br>Spread risk<br>Allianz associate risk                |
| Operational Risk     | Operational risk *   |
| Insurance Risks      | Mortality risk<br>Longevity risk<br>Morbidity risk<br>Lapse risk<br>Expense risk                           |
| Other Risks          | Business risk  |

\* Pillar I capital is also determined for these risks where relevant.

Irish Life & Permanent uses industry standard Value-at-Risk (VaR) as its core methodology for measuring market risk. VaR measures are statistically converted into economic capital requirements.

The significant differences between Pillar I capital requirements and economic capital requirements are:

- Economic capital requirements include all risks arising from the life insurance operations of the group (these include credit default risk for insurance counterparties, reinsurance & other counterparties risk, insurance market risks - equity risk, property risk, interest rate risk and spread risk, mortality risk, longevity risk, morbidity risk, lapse risk, expense risk, insurance operational risk and insurance business risk). Pillar I excludes such risks (as pertain to the insurance business) since Basel II regulatory capital requirements extend only to banking operations. Minimum capital requirements for the insurance business are established separately based on regulator-dictated minimum solvency requirements.
- Economic capital requirements for the banking business include risks otherwise excluded from banking Pillar I capital requirements. These risks are bank business risk and the Allianz associate risk.
- Aggregate economic capital requirements are reduced by the effects of imperfect correlation between risks. The occurrence of one risk event does not necessarily trigger the occurrence of another risk event unless the two risks are perfectly correlated. This imperfect correlation between risks generates diversification benefits that reduce total economic capital requirements.
- Economic capital requirements are statistically derived for all risk types at a confidence level of 99.9% which is equivalent to a long term credit rating target of A- as per Standard & Poors. Pillar I capital requirements are also calibrated to a 99.9% confidence level but Pillar I models differ from economic models in a number of important areas, including:
  - Credit risk capital models under Pillar I use regulatory parameters with various conservatism adjustments included. Examples of such parameters would be the Pillar I

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use of Probability of Default (PD) metrics with in-built (non-“economic”) conservatism buffers, Pillar I use of downturn Loss Given Default (LGD) figures rather than long-run average LGD; and the use of CRD-specified asset correlations. Economic capital requirements for credit risk are derived using internal “economic” best estimates of risk parameters.

- The Pillar I calculation of market risk capital requirements follows the Basel II standardised approach. Economic capital models derive capital requirements for market risks using a VaR-based approach.

## 8.2 *Liquidity Risk*

Liquidity risk relates to the ability of the group to meet its on and off-balance sheet obligations in a timely manner as they fall due, without incurring excessive cost, while continuing to fund its assets and growth therein.

This risk has come sharply into focus in recent times with the commencement of the current financial crisis. Such was the focus placed on liquidity risk that on 30 September 2008, the Irish government announced a scheme to guarantee bank liabilities – retail, corporate and interbank deposits, senior unsecured debt, covered bonds and dated subordinated debt of Irish banks out to 29 September 2010. This announcement led to the implementation of the Credit Institutions (Financial Support) Scheme 2008 by the Irish Government and Irish Life & Permanent plc was confirmed as a covered institution under this legislation. The Government extended this scheme subsequently to guarantee issuance of up to five years maturity.

Liquidity management for banking operations within the group is carried out by the group’s treasury function. In carrying out this responsibility, treasury’s principal objective is to ensure that the banking operations have sufficient funding available, at an optimal cost, to meet the operational needs of the bank and to adhere to regulatory and prudential requirements. The liquidity management process includes:

- Day-to-day funding; managed by monitoring future cash flows to ensure that requirements can be met. This includes replacing funds that mature or are borrowed by customers;
- Balance sheet funding; managed by monitoring the funding profile against established target funding levels, with monitoring performed by the ALCO;
- Maintaining a portfolio of marketable assets that can be easily liquidated as protection against any unforeseen interruption to cash flow;
- Monitoring balance sheet liquidity ratios against internal and regulatory requirements; and
- Managing the concentration and profile of debt securities in issue.

Under the regulatory protocol under which the group operates, required liquidity holdings are based upon various cash flow stress tests. The key limits applied are that an institution must have sufficient available liquidity to cover 100% of outflows over the next eight days and 90% of outflows over the next month. It monitors liquidity ratios daily and reports them weekly to the Central Bank.

Irish Life & Permanent plc liquidity policies and protocols establish quantitative rules and targets in relation to measurement and monitoring of liquidity risk. The Banking ALCO plays a fundamental role in the monitoring of liquidity risk measures through the monthly review of liquidity reports. The Banking ALCO monitors sources of funding and reviews short term and long term borrowings and their respective maturity profiles. Additionally, liquidity reports to the Banking ALCO each month include the loans to deposits ratio for review and latterly, also include the stable funding ratio.

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In the latter part of 2008 and in the early part of 2009, the continuing dislocation in financial markets, the sharp downturn in economic conditions, the substantial deterioration in credit conditions and the severe liquidity constraints negatively impacted financial institutions around the world. In addition to these unprecedented trading conditions, Irish financial institutions experienced more severe and more rapidly deteriorating economic conditions in Ireland than elsewhere, due in large part to the severe deterioration of the Irish property market. The Irish economy entered recession in 2008 following which there was a large increase in the level of unemployment and a rapid fall in house prices leading to a significant increase in the level of impairment provisions over the last three years. This caused the Group to report losses in its banking business in 2009 and 2010.

In common with other Irish banks, and as a consequence of the Irish banks' and the Irish State's credit ratings downgrades, debt markets are currently closed to the Bank. The Bank participates in the ELG Scheme without which it would have been unable to raise debt in 2010 required to fund its operations. The Bank's participation in the ELG Scheme is necessary to maintain its retail and corporate deposits with balances above those guaranteed under the Deposit Guarantee Scheme, albeit at significantly higher costs than historically. The Bank has become increasingly reliant on funding from the ECB and the Central Bank.

The regulatory protocols under which the Bank operates require levels of liquidity to be maintained based on various cash flow stress tests. These protocols are designed to ensure that banks funding profiles have an appropriate spread of maturities. The key limits applied are that an institution must have sufficient available liquidity to cover 100 per cent of outflows over the next 8 days and 90 per cent of outflows over the subsequent 9 to 30 days. As a consequence of the industry-wide funding difficulties experienced from the last quarter of 2010, particularly the increased reliance on ECB funding which is short term in nature and rolls over frequently, the Bank has breached and is currently in breach of these limits. The Bank has reported and continues to report these breaches to the Regulatory Authorities.

Irish Life & Permanent uses a number of analytical tools to monitor and control liquidity risk including:

- Analysis of IL&P's performance against statutory requirements;
- Balance sheet composition;
- Measures to ensure that funding is not overly concentrated in particular products or taken from a concentrated set of lenders;
- Balance between long-term and short-term funding;
- Loan to Deposit Ratio, to evaluate the balance between Retail and wholesale funding;
- A Stable Funding Ratio, which is used to provide a measure of the core liquidity available;
- A liquidity gap schedule, which reviews the timing of expected asset and liability cash flows and illustrates the mismatch between them for various time buckets;
- Monitoring of cumulative cashflow mismatches over particular periods;
- Dependency reports, showing any dependency within particular product groups to specific counterparties.

In addition to the ongoing management of liquidity risk a contingency plan will be put into place to achieve the following:

- A strategy to minimise the impact in the event of a liquidity problem - diversification of funding, stock of liquid assets, development and protection of IL&P's relationships and reputation in the market; (Reliance limits)
- Indicator monitoring: Identification of key indicators that might be used to warn of a pending liquidity problem and also to gauge recovery following responsive action;
- Stress testing crisis scenarios. Estimating the impact from stressful situations on IL&P's ability to fund itself.

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### Scenario Analysis, Stress Testing and Assumptions:

The Banking ALCO will determine the appropriate level of detail for the selected scenarios and the resultant inflows/outflows. A liquidity problem can arise from ‘unexpected’ internal events (operational problems, mergers and acquisitions, ratings downgrades) and/or external events (credit problems, market events, systemic shock, recession). Procedures to this effect will be documented to include an implementation plan and any assumptions agreed. A timetable for the performance of stress testing and scenario analysis is to be prepared at the commencement of each financial year, with the outcome of these examinations to be reported to the board annually. For the purpose of contingency funding planning four scenarios are currently examined:

- Scenario 1: One notch downgrade to long term ratings and one notch downgrade to short-term rating
- Scenario 2: Two notch downgrade to long-term ratings and two notch downgrade to short-term rating
- Scenario 3: Run on the Retail Bank
- Scenario 4: Worst Case Scenario – all funding is withdrawn at contractual maturity

We may from time to time construct other ‘ad hoc’ scenarios.

The Committee of European Banking Supervisors published guidelines on liquidity buffers in December 2009. These guidelines, which built on CEBS’s Recommendations on Liquidity Risk Management, elaborated upon the appropriate size and composition of liquidity buffers to enable banks to withstand a liquidity stress for a period of at least one month without changing their business models.

Its guidance stated that institutions should apply three types of stress scenarios: idiosyncratic, market specific, and a combination of the two. The core of the idiosyncratic stress should assume no rollover of unsecured wholesale funding and some outflows of retail deposits. The market-wide stress should assume a decline in the liquidity value of some assets and deterioration in funding-market conditions. The results of these stress tests are supplied monthly to the Banking ALCO.

The group has a clearly defined contingency funding plan established. In the event of a crisis, the Banking ALCO or an appointed sub-committee serves as the Contingency Planning Committee and shall meet more frequently than monthly, as deemed necessary.

Pre-emptive planning is engaged in to ensure diversification of funding sources by product and counterparty. Market access opportunity is monitored continuously. A stock of highly liquid assets is required to be held along with the continued development of bilateral repo counterparties.

Contingency plans are informed by the results of stress testing and scenario analysis which consider the possible impact of adverse stress scenarios on the liquidity profile of the group. The analyses quantify potential funding and cost of funding shocks to the group.

The following strategies are a sample of those that would be used to ease funding pressure in a liquidity crisis:

- Asset reductions, such as bond sales, loan sales or asset securitisations, and utilisation of ECB Repo Facility. IL&P is cognisant of the time needed to organise a securitisation and that the ability to securitise may diminish in stressed market conditions.
- Asset discouragement, primarily in the form of limitations on credit extension or trading account assets. Stricter control of counterparty or collateral issues may also be employed.
- Borrowing from the ECB Marginal Lending Facility.
- Use of committed backstop facilities.

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Effective internal and external communications are of paramount importance in a liquidity crisis. An early cohesive response outlining management's strategy to deal with the problem can ameliorate fears of market participants.

### **8.3 Insurance Risk**

Irish Life & Permanent has in place a robust framework for the management of insurance risk to ensure that any risk accepted is in line with the group's risk appetite and that effective insurance risk measurement takes place.

The group manages its insurance risk through underwriting limits, approval procedures for new products and reinsurance where appropriate. Underwriting limits relating to writing insurance risk and retention limits for such risk are clearly recorded in formal policy documents.

The group's life operations cede insurance and investment risk to a number of reinsurance companies as a risk mitigation technique.

Insurance risk economic capital is held to protect the group against uncertainty in future mortality and morbidity rates. The economic value of the insurance business is dependent on the evolution of mortality and morbidity rates over time. Expected and worst case scenarios (at a target confidence level) for the insurance business economic value after one year can be calculated based on such scenarios. The difference amounts to economic capital requirements for insurance risk.

### **8.4 Other Risk Types**

#### **Reinsurance counterparty credit risk**

Arising in the life insurance business of the group, reinsurance counterparty risk is managed through the group's reinsurance strategy. The reinsurance strategy is established by the ALCO and approved by the Board of Directors. The group selects only high quality reinsurance counterparties and assets are held in charged accounts in respect of reinsurance treaties for annuity business to further mitigate against risk. Withdrawals from charged accounts have to be authorised by Irish Life Assurance plc. The group regularly reviews the financial security of its reinsurance counterparties.

Economic capital for reinsurance counterparty credit risk is derived from the unexpected losses inherent in exposures when calibrated to a 99.9% confidence level. Unexpected losses are themselves a function of Exposure at Default (EAD), Probability of Default (PD) and Loss Given Default (LGD). Irish Life & Permanent obtain the credit rating for the counterparty from three separate rating agencies. This credit rating is mapped to a statistical PD before the application of the group's "notching" process. The "notching" process increases the counterparty IRB credit rating (and hence PD) according to pre-defined "notching" parameters. "Notching" parameters revise the IRB credit rating for a counterparty upwards, i.e. less favourable, dependent on factors such as geographical location, presence of the counterparty on rating agency "watchlists" and economic market stability, amongst others. LGD for counterparties is similarly established as a conservative estimate applying group expert opinion. The 'middle' rating of the rating agencies' notched ratings is then applied.

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### ALM risk

Interest rate risk in the banking book from structural mismatches on the balance sheet for interest bearing assets and liabilities mainly arises from fixed rate lending assets. The group currently has no appetite to bear foreign exchange risk in the non-trading book, hence all observed foreign exchange asset and liability mismatches arising in the non-trading book are hedged as soon as is practicable through the use of derivatives.

The group uses VaR models to measure how the risk varies over time. Positions against established VaR limits are reported daily within Group Treasury and to Group Risk. The ALCO monitors ALM risk through VaR reports.

ALM risk economic capital is calculated based on the VaR for core individual portfolios. Appropriate VaR estimates are converted into economic capital via statistical adjustments for economic capital time horizons, the required economic capital confidence level and other internal adjustment metrics.

### Insurance market risk

The economic value of the insurance business is exposed to adverse fluctuations in investment value caused by changes in interest rates, equity market total returns, real estate total returns or foreign exchange rates. The insurance market risk management framework of Irish Life & Permanent specifically addresses ALM risk, asset guarantees and the market contagion risk to fee income.

The ALM risk for the insurance business arises in non-linked funds and unit-linked products (when liability units are established or cancelled for customers before corresponding asset transactions have been completed). Risk associated with asset guarantees arise where the group has guaranteed certain investment products. Management fees are at risk from market falls since elements of fee income are derived from the value of assets under management.

Irish Life & Permanent minimises ALM risk to the greatest extent possible by closely matching all assets and liabilities, subject to reasonable cost management. Asset and liability mismatches, along with other market risks, are closely monitored by relevant risk committees. The potential impact of these risks on the solvency of the company is also monitored through the annual financial condition report. This report shows the impact on the company's solvency capital under various scenarios, for example specified falls in equity markets or specific interest rate movements.

Economic capital for market risks in the insurance business is derived from the potential economic value at risk within the insurance business. Expected and worst case scenarios for the insurance business economic value are calculated with the worst case scenario reflecting appropriate shocks to market risks at a 99.9% confidence level. The difference between the expected and worst case economic values represents the economic capital requirements for insurance market risk.

### Property risk

The portfolio of owner-occupied buildings and investment properties held by the group changes infrequently. The risk exposure to these properties is measured by the group through its economic capital framework. Property risk economic capital is the economic value that may be lost in the event of a fall in property values. The severity of the fall is derived from statistically calibrated shocks to commercial property values specific to the group's geographical diversification of its property portfolio.

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## Business risk

Business risk arises over the short term from volatility in revenues and costs that is an inherent function of the markets in which the group operates. Strategic decisions determine the operating environment of the group and hence, ultimately, drive the level of business risk to which it is content to be exposed.

Business risk, and the knock on effects of strategic risks manifesting in revenue fluctuations are capitalised within the group's economic capital framework.

The calculation of business risk economic capital for the banking group follows a 'revenue volatility' approach, deriving capital requirements from the historical volatility of the bank and peer institutions' revenues and forecast costing assumptions. Business risk economic capital in the insurance group is derived from the economic value of the business at risk from volatility in new business levels, product persistency rates and expenses for the business. As with other risks, economic capital is based on a worst case economic value loss from the reference expected case after application of calibrated shocks to expected new business, persistency, and expense levels at the required confidence level.

## Allianz associate risk

Arising in the banking group, this represents a risk to earnings and capital associated with the single equity exposure in Allianz-Irish Life Holdings plc. Economic capital for this risk is derived from the estimated market value loss of the asset under a calibrated worst case fall in its equity value based on historical market moves and additionally considering value reductions to reflect liquidity constraints for private equity holdings.

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## 9 Capital Adequacy Overview

### 9.1 Capital Ratios for Banking Operations

From 1 January 2008 the minimum regulatory capital requirement of the group's banking operations has been calculated in accordance with the provisions of Basel II as implemented by the European Capital Adequacy Directive and the Central Bank of Ireland. The objective of Basel II is to align bank regulatory capital more closely with the economic capital required to support the risks being undertaken. The capital required to cover credit, operational and market risks are required to be explicitly measured under the Basel II methodology.

In implementing Basel II the group has adopted the Internal Ratings Based ("IRB") approach to credit risk and was awarded FIRB accreditation in late 2007. Under the IRB approach the bank uses internally generated risk models to compute the capital required to support credit risk by calculating the probability of default and the loss given default in all of its various portfolio exposures. The models and calculations are conservatively based. With regard to operational risk the group has adopted the standardised approach under which all of the institution's activities are divided into eight standardised business lines: corporate finance, trading and sales, retail brokerage, commercial banking, retail banking, payment and settlement, agency services and asset management, with individual operational risk capital weightings for each. Value at risk, an industry wide standard, is the methodology which the group has adopted in regard to the measurement of market risk internally. For regulatory capital purposes the group adopts the standardised approach as outlined earlier.

The following table summarises the composition of regulatory capital and the ratios of the group for the year ended 31 December 2010 with comparisons to 31<sup>st</sup> December 2009. They are calculated in accordance with Basel II (CRD) regulatory capital requirements.

|  | 2010                | 2009                |
|--|---------------------|---------------------|
|  | €m                  | €m                  |
| <b><u>Tier 1 capital</u></b>                           |                     |                     |
| Share capital  | 2,922               | 2,922               |
| Reserves   | 760                 | 951                 |
| Prudential filters                                     | <u>62</u>           | <u>65</u>           |
| <b>Total qualifying Tier 1 capital</b>                 | <b>3,744</b>        | <b>3,938</b>        |
| <b><u>Tier 2 capital</u></b>                           |                     |                     |
| Subordinated liabilities                               | 1,166               | 1,167               |
| Revaluation reserve                                    | 4                   | 8                   |
| Other  | <u>62</u>           | <u>25</u>           |
| <b>Total qualifying Tier 2 capital</b>                 | <b>1,232</b>        | <b>1,200</b>        |
| <b>Total qualifying Tier 1 and Tier 2 capital</b>      | <b>4,976</b>        | <b>5,138</b>        |
| <b>Deductions</b>                                      |                     |                     |
| Investment in life operations                          | (3,295)             | (3,187)             |
| Excess of Expected Loss over Provisions                | -                   | (93)                |
| <b>Total Deductions from regulatory capital</b>        | <b>(3,295)</b>      | <b>(3,280)</b>      |
| <i>Deducted from Tier 1 (2010 €2,063; 2009 €2,080)</i> |                     |                     |
| <i>Deducted from Tier 2 (2010 €1,232; 2009 €1,200)</i> |                     |                     |
| <b><u>Total own funds</u></b>                          | <b><u>1,681</u></b> | <b><u>1,858</u></b> |

Based on required regulatory capital for the various risks covered by Pillar I and taking account of the Financial Regulator’s interim capital requirement, as shown below the group has capital well in excess of the required minimum level of 8%.

The Pillar II capital requirement under Basel II has yet to be determined. In the meantime an interim capital requirement (“ICR”) is applied equal to 23% of Pillar I RWAs. Adding this ICR, reduces the risk asset ratio to 9.2%. The application of the ICR effectively prevents a release of capital. However, it is the group’s expectation that the Pillar II capital add-on will be less than the ICR and will give a risk asset ratio somewhere between the 11.3% and 9.2% indicated below.

|  | <b>2010</b>  | <b>2009</b>  |
|--|--------------|--------------|
|  | <b>€m</b>    | <b>€m</b>    |
| Total Capital Required for Pillar I              | 1,265        | 1,313        |
| <b>Excess own funds</b>                          | <b>416</b>   | <b>545</b>   |
| Total risk-weighted assets before ICR            | 15,809       | 16,411       |
| <b><u>Risk asset ratio (all Core Tier 1)</u></b> | <b>10.6%</b> | <b>11.3%</b> |

With regard to required capital ratios for the group’s banking operations, see section 9.4. below for further details on the Central Bank’s Prudential Capital Assessment Review undertaken by the group in 2011.

## **9.2 Capital Management**

The group is regulated by the Central Bank of Ireland which sets and monitors regulatory capital requirements in respect of the group’s operations. While there are a number of regulated entities within the group which have individual regulatory capital requirements, the two principal regulated entities are Irish Life & Permanent plc (“IL&P”), which was the group’s holding company as at 31<sup>st</sup> December 2009 and which is also the group’s banking operation (trading as permanent tsb), and Irish Life Assurance plc (“ILA”) the group’s principal life assurance operation.

As outlined earlier, in early 2010 following shareholder & court approval, the group was restructured and Irish Life & Permanent Group Holdings plc became the new parent and holding company for the group. The new structure has the same capital structure, board and management team as Irish Life & Permanent plc and the business ethos and business activities remain the same.

Regulatory capital is the level below which the group’s capital must not fall. The group’s policy is to manage the capital base so as to meet all regulatory requirements while maintaining investor, creditor and market confidence and ensuring that there is adequate capital to support future growth in the business. In addition, the relationship between the level and composition of regulatory capital and the shareholders’ return on capital is monitored to ensure that there is an appropriate balance between equity and debt capital within the overall regulatory capital held.

The group manages its capital base through its Internal Capital Adequacy Assessment Process (“ICAAP”). The Irish Life & Permanent ICAAP is designed to allow capital requirements to be risk-adjusted and to fully reflect the risk profile and appetite of the group. The ICAAP incorporates a detailed process to identify all material risks for the group and ascertain whether they are to be addressed through management or mitigation (or a combination of the two), and whether capital is required to be held against each risk.

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### 9.3 ICAAP

As specified in the CRD, Pillar II (the Supervisory Review Process) has two core components which are the Internal Capital Adequacy Assessment Process (“ICAAP”) and the Supervisory Review and Evaluation Process (“SREP”). The ICAAP represents an institution’s own assessment of the internal capital it should hold against the risks it assumes. The objectives of a robust ICAAP are:

- To identify and measure all material risks for the institution.
- To set internal capital adequacy targets that relate directly to these risks and the risk appetite of the institution, and to measure capital adequacy against such targets.
- To ensure the integrity of internal capital adequacy assessments.

The SREP is applicable for the relevant supervisory bodies of the institution and its objectives are:

- To assess the adequacy of the institution’s internal mechanisms to identify risks and attribute capital to those risks.
- To inform the supervisory bodies’ over-arching assessment of the minimum capital requirements (including Pillar I requirements) for the institution, sufficient to cover all material risks.

At the end of December 2010, Irish Life & Permanent maintained a capital base in excess of minimum requirements. As at 31 December 2010 Irish Life & Permanent’s total core tier 1 risk asset ratio was 10.6% as compared with a regulatory requirement of 8%.

The internal capital models of the group (economic capital) include all material risks for the group, rather than just credit risk, market risk and operational risk as required under Pillar I (see section 3 for further details). Irish Life & Permanent maintains economic capital levels sufficient to meet internal targets specific to the group’s risk appetite. It is group policy that the group’s economic capital base should at all times exceed its economic capital requirements.

The ICAAP also incorporates stress testing of capital adequacy for a suite of severe but plausible stress scenarios. These scenarios include a range of economic and risk-specific adverse events. The results of the most recent ICAAP stress tests are used as a management tool for the Board Risk & Compliance Committee and Board of Directors when group strategy is set and monitored. They also help to drive risk policy and adjust risk appetite where appropriate.

### 9.4 2011 PCAR/ PLAR

Whilst not directly impacting the group’s 2010 disclosures, the following is outlined to provide a fuller picture to the reader.

On 31 March 2011, the Central Bank of Ireland published the results of the Prudential Capital Assessment Review (**PCAR 2011**) and the Prudential Liquidity Assessment Review (**PLAR 2011**) as part of the Financial Measures Programme Report (**FMPR**). The FMPR was one of the conditions of the Programme of Support for Ireland. The aim of the FMPR was to place the Irish banking system in a position where it could fund itself and generate capital without undue further reliance on Irish or European public sources.

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The FMPR identified a Total Gross Capital Requirement of €4.0 billion for the Group's banking business in order to: (i) achieve a Core Tier 1 Capital Ratio of 6 per cent. (plus an additional buffer) in a stressed scenario by 31 December 2013; and (ii) cover losses associated with the requirement to deleverage the Bank's balance sheet in order to achieve a loan to deposit ratio of circa 122.5 per cent. by 31 December 2013.

The Central Bank of Ireland requires the Bank to achieve this Total Gross Capital Requirement of €4.0 billion. The Institutions and the Irish Government have agreed that the Total Gross Capital Requirement of €4.0 billion is subject to appropriate adjustment for any capital generated through asset disposals (including the possible disposal of the Irish Life Group) and the Liability Management Exercise. €2.9 billion of the Total Gross Capital Requirement is required by the Central Bank to be achieved by 31 July 2011 with the balance to follow by no later than the Final Investment Date.

Of this Total Gross Capital Requirement, €0.2 billion will be met from internal Group resources. The Directors have considered the possibility of raising capital from other sources. Given the ongoing systemic problems in the Irish banking system and the amount required compared to the market capitalisation of the Company in mid 2011, the Directors do not believe that other capital is currently available to the Group to meet the Remaining Capital Requirement. Moreover, the Directors do not believe, at the present time, that there is an alternative source to meet the Remaining Capital Requirement other than the Liability Management Exercise, the possible disposal of the Irish Life Group and the State Investment.

Further details are to be found on the group's website at [www.irishlifepermanent.ie/investor-relations](http://www.irishlifepermanent.ie/investor-relations)

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## 10 Glossary of Terms/ Acronyms

|          |   |
|----------|---|
| ALCO     | Asset and Liabilities Committee   |
| ALM      | Asset & Liability Mismatch  |
| Basel I  | Original capital accord promulgated by the Bank for International Settlement in 1988.   |
| Basel II | Revised capital accord promulgated by the Bank for International Settlement with significantly more sophisticated approaches to the calculation of an institution's minimum capital requirement based on three pillars.   |
| BIS      | Bank for International Settlements  |
| CRD      | EU's Capital Requirements Directive (implementation of Basel II accord in the EU)   |
| CCF      | Credit Conversion Factor – parameter for converting off balance sheet or undrawn amounts to likely drawings based on historical experience for use in regulatory capital computations.  |
| CEBS     | Committee of European Banking Supervisors   |
| EAD      | Exposure at Default – balance that will be present on a loan should it actually default   |
| EC       | European Community  |
| ECAI     | External Credit Assessment Institutions (Rating Agencies)   |
| ECB      | European Central Bank   |
| EL       | Expected Loss - is viewed as the average loss through time on a portfolio and is normally managed by an institution through a number of means including credit policy, pricing of credit exposures and provisioning.  |
| FIRB     | Foundation Internal Ratings Based Approach – An approach under the CRD for the computation of credit risk parameters where estimation of the LGD & EAD risk parameters are based on given factors for certain asset classes (Sovereign, Institution & Corporate).             |
| FMP      | Financial Measures Programme – represents the banking element of the agreement between Ireland and the EC-ECB-IMF   |
| FMPR     | Financial Measures Programme Report – The Financial Measures Programme implements the Central Bank of Ireland's obligations under the agreement between Ireland and the EC-ECB-IMF. The report describes in detail how the FMP has been executed & the results at March 2011. |
| ICAAP    | Internal Capital Adequacy Assessment Process  |
| ICR      | Interim capital requirement. An interim arrangement at the Financial Regulator's direction for the computation of Pillar II capital (based on Basel I overall capital levels) pending finalisation of an institution's Pillar II capital requirement by the Regulator.        |

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|      |  |
|------|--|
| IFRS | International Financial Reporting Standard   |
| IMF  | International Monetary Fund  |
| IRB  | Internal Ratings Based Approach – statistical approach to estimating credit risk parameters (PD, LGD & EAD) for use in regulatory capital computations based on an institution’s own data. |
| LCR  | Leverage Cover Ratio   |
| LGD  | Loss Given Default is an estimate of the loss that will accrue to an institution on a defaulted loan should it not cure i.e. eventually repay in full.                                     |
| LTV  | Loan to value – loan amount as a proportion of the underlying security value.  |
| M    | Effective Maturity or the remaining maturity on a loan agreement.  |
| NAMA | National Asset Management Agency   |
| NSFR | Net Stable Funding Ratio   |
| PCAR | Prudential Capital Assessment Review   |
| PD   | Probability of Default is the probability that a loan will be more than 90 days in default or considered unlikely to pay in the next year.   |
| PLAR | Prudential Liquidity Assessment Review   |
| RPC  | Risk Parameter Committee   |
| RW   | Risk Weight – proportion of the exposure amount to be used for regulatory capital computations, normally expressed as a percentage.  |
| RWA  | Risk Weighted Asset – Monetary amount of the exposure multiplied by the relevant or computed regulatory capital risk weight.   |
| SREP | Supervisory Review & Evaluation Process  |
| SRP  | Supervisory Review Process   |
| VaR  | Value at Risk  |