BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

FINAL NOTICE

To: **Keith Brian Alderson**

Individual Reference Number: **KBA01005**

Date: **14 January 2016**

1. ACTION

1.1. For the reasons set out in this Notice, the PRA hereby:

(1) imposes on Keith Brian Alderson a financial penalty of £88,890, pursuant to section 66 of the Financial Services and Markets Act 2000 ("the Act"), on the grounds that during the period between 1 August 2009 and 13 May 2013 (the "Relevant Period"):

a) Mr Alderson failed to comply with Statement of Principle 6 of the Statements of Principle and Code of Practice for Approved Persons ("Statement of Principle 6")[1]; and

b) Mr Alderson was knowingly concerned in certain, but not all, aspects of a contravention by The Co-operative Bank plc ("Co-op Bank"/"the Firm") of Principle 3 of the Principles for Businesses ("Principle 3")[2].

(2) makes an order, pursuant to section 56 of the Act, prohibiting Mr Alderson from performing any significant influence function in relation

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[1] The FSA Statements of Principle and Code of Practice for Approved Persons applied to Mr Alderson from 1 August 2009 to 31 March 2013 and the PRA's Statements of Principle and Code of Practice for Approved Persons applied from 1 April 2013 to 13 May 2013.

[2] Although the Principles for Businesses have now been replaced with effect from June 2014 by the PRA Fundamental Rules, the FSA Principles for Businesses applied to Co-op Bank in the Relevant Period up to 31 March 2013 and the PRA's Principles for Businesses in the Relevant Period from 1 April 2013 to 13 May 2013.

to a regulated activity carried on by a PRA-authorised person or a person who is an exempt person in relation to a PRA-regulated activity carried on by the person on the grounds that he is not a fit and proper person to perform such functions. This order takes effect from 15 January 2016.

1.2. The prohibition above does not prohibit Mr Alderson from performing other roles at PRA-authorised persons, or from performing any roles at other authorised persons.

1.3. Mr Alderson agreed to settle at an early stage of the PRA's investigation. Mr Alderson therefore qualified for a 30% (stage 1) discount under the PRA's Settlement Policy. Were it not for this discount, the PRA would have imposed a financial penalty of £126,986 on Mr Alderson.

2. SUMMARY OF REASONS FOR THE ACTION

Background

2.1. The PRA has decided to take this action as a result of Mr Alderson's conduct as both a significant management controlled function holder (CF29) and director controlled function holder (CF1) at Co-op Bank during the Relevant Period. He held the significant management controlled function (CF29) from 1 November 2007 to 28 January 2011 and the director controlled function (CF1) from 21 March 2011 to 4 June 2013, although Mr Alderson was not a member of the Board of Co-op Bank at any time.

2.2. Mr Alderson was responsible for the day to day management of the Corporate Banking Division at Co-op Bank throughout the Relevant Period. At the start of the Relevant Period, Mr Alderson held the title of Business Leader or Director[3] of Corporate Banking and was approved to perform CF29 in respect of that role. On 1 October 2010, Mr Alderson became the Managing Director of the Corporate and Business Banking Division ("CABB Division") and joined the Executive Committee of Co-op Bank.

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[3] The titles 'Business Leader' and 'Director' were used interchangeably at Co-op Bank during the Relevant Period.

2.3. Co-op Bank is a UK bank which provides high street and internet banking, current accounts, mortgages, savings accounts, credit cards and loans to individuals and businesses. The Firm is regulated by the PRA for prudential purposes and by the FCA for conduct matters.

2.4. Co-op Bank had in place a "three lines of defence" model of risk management under which Mr Alderson had first line responsibilities for managing Co-op Bank's exposures to their corporate lending customers. The development of an effective risk management framework was not part of Mr Alderson's responsibilities.

2.5. Until 20 December 2013, Co-op Bank was a wholly owned subsidiary of the Co-operative Banking Group, which in turn was a wholly owned subsidiary of the Co-operative Group Limited ("Co-op Group"). The Co-op Group is one of the UK's largest mutual businesses, owned by millions of UK consumers. It is a Registered Society within England and Wales and has interests across food, funerals, insurance and legal services.

2.6. Co-op Bank merged with Britannia Building Society ("Britannia"), a much larger building society, on 1 August 2009. As a result, the Corporate Banking Division inherited the Britannia Corporate Loan Book. A significant proportion of these loans were secured on commercial real estate ("CRE"), and did not comply with Co-op Bank's own lending standards. The Britannia Corporate Loan Book had a much higher risk profile than the pre-merger Co-op Bank Corporate Loan Book. Mr Alderson played no part in the decision to acquire the Britannia Corporate Loan Book and was not involved in any of the due diligence performed by Co-op Bank on the Britannia Corporate Loan Book. Following the merger, Mr Alderson had oversight of the combined former Co-op Bank Corporate Loan Book and the Britannia Corporate Loan Book ("the Corporate Loan Book").

2.7. On 1 October 2010, Mr Alderson became the Managing Director of the CABB Division. Despite the change in Mr Alderson's title, his responsibilities in relation to the day to day management of the Corporate Loan Book did not change substantively.

2.8. Between 2011 and early 2013, Co-op Bank was involved in the consideration of, and negotiations and planning for, a proposed project to purchase 632 bank branches from the Lloyds Banking Group, known as Project Verde. Co-op Bank decided in April 2013 not to proceed with Project Verde. As a result, between

November 2011 and October 2012, Mr Alderson held the substantial role of Executive Director of Customer Service Operations, in addition to his responsibilities as Managing Director of CABB.

2.9. On 17 June 2013, Co-op Bank publically announced that the Firm required an additional £1.5 billion of Common Equity Tier 1 capital. Approximately one third of this was as a result of substantial impairments to the Britannia Corporate Loan Book in the CABB Division. Co-op Bank subsequently undertook a Liability Management Exercise to improve its capital position, which completed on 20 December 2013. As a consequence of this exercise, Co-op Bank ceased to be a wholly owned subsidiary of the Co-op Group, although the Co-op Group continues to hold more than 20% of voting rights in general meetings of Co-op Bank.

Breaches and failures

2.10. Co-op Bank breached Principle 3 between 22 July 2009 and 31 December 2013 as it failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.[4]

2.11. Mr Alderson breached Statement of Principle 6 which states that an approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function and was knowingly concerned in certain, but not all, aspects of Co-op Bank's breach of Principle 3:[5]

(1) in relation to the assessment and escalation of risks posed by the Britannia Corporate Loan Book:

a) between 1 August 2009 and 13 May 2013, by failing to take reasonable steps to ensure that Co-op Bank adequately assessed the risks arising from the Britannia Corporate Loan Book holistically; and

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[4] The PRA published a Final Notice explaining these failings in more detail on 11 August 2015. See further at Annex B of this Notice.

[5] The PRA wishes to make clear that it does not find that Mr Alderson was aware that Co-op Bank was in breach of its regulatory obligations. In addition, as set out in paragraph 1.2.13(6), Mr Alderson did not deliberately or recklessly breach regulatory provisions.

b) between 1 August 2009 and January 2011, by not escalating specific risks inherent in the Britannia Corporate Loan Book sufficiently clearly to Co-op Bank's formal risk management forums and the Executive. As a result, Co-op Bank's governance forums could not properly consider these risks or the appropriate actions to mitigate them.

(2) in relation to the strategy for the Corporate Loan Book between 1 August 2009 and 13 May 2013, by:

a) failing to adequately implement the "manage and hold" strategy for the Corporate Loan Book, by failing to properly identify sufficiently clear and specific objectives, timescales or metrics against which Co-op Bank could assess the strategy for managing the Corporate Loan Book as a whole (rather than on an individual basis); and

b) failing to act in a timely manner in exploring options for a different strategy for the non-core part of the Corporate Loan Book and failing to take reasonable steps to ensure that an appropriate governance framework was put in place to make decisions on the possible disposal of certain of these assets.

(3) between 1 August 2009 and 13 May 2013, by failing to take reasonable steps to ensure that the CABB Division, as the first line of defence, took an adequate approach to the management of risk, including in relation to the identification and management of distressed accounts and compliance with policies and procedures on collateral valuations and key credit criteria ("KCC");

(4) between 1 August 2009 and 13 May 2013, by failing to take reasonable steps to ensure that the available management information was sufficient to monitor compliance with systems and controls; and

(5) during the Relevant Period, Co-op Bank had a culture which encouraged prioritising the short-term financial position of the Firm at the cost of taking prudent and sustainable actions for the longer-term. This was not consistent with Co-op Bank's cautious risk appetite and prudent bank management generally. This resulted in an environment in which some staff felt under pressure to meet

impairment forecasts that had previously been set. In the CABB Division, this meant that optimistic decisions were made on impairment budgets, forecasts and provisions. Mr Alderson placed emphasis upon previous forecasts in the process of setting subsequent forecasts for impairments. He did not always ensure that impairment budgets and forecasts were set solely by reference to an assessment of the risks within the Corporate Loan Book. On certain occasions where impairment budgets or forecasts were at risk of being exceeded, Mr Alderson challenged figures that were proposed to him for impairment forecasts or provisions. The PRA accepts that Mr Alderson did not intentionally place any member of Co-op Bank's staff under pressure to modify impairment figures in a way which was improper. However, on some occasions where such challenges were made, a more optimistic view on the impairment position was ultimately taken than would have been the case absent the challenge.

2.12. Annexes A and B set out the full particulars of Mr Alderson's breaches and failures.

2.13. In making the above findings against Mr Alderson, the PRA accepts:

(1) a number of factors which gave rise to some of the issues Mr Alderson was seeking to address during the Relevant Period had their origins in the pre-merger Britannia business with which he had no involvement;

(2) as Business Leader or Director of Corporate Banking and Managing Director of Corporate and Business Banking, Mr Alderson was operating within established Co-op Bank corporate governance structures;

(3) Mr Alderson was subject to significant management stretch in view of his other substantial management roles at Co-op Bank in addition to his responsibility for CABB;

(4) the assessment of forecasts, business performance, and the appropriate level of impairment provisioning requires the exercise of management judgement;

(5) Mr Alderson did not have any responsibility for the second and third lines of defence; and

(6) Mr Alderson did not deliberately or recklessly breach regulatory provisions and no findings of dishonesty or lack of integrity are being made in relation to him.

2.14. Notwithstanding these matters, the PRA considers that Mr Alderson's conduct was not sufficient to discharge his regulatory obligations.

PRA Powers

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

2.16. Although the conduct to which this matter relates began prior to, and ended after, LCO, Part 2 of the Financial Services Act 2012 (Transitional Provisions) (Enforcement) Order 2013 ("the Transitional Provisions Order") permits the PRA and/or FCA to take action under section 66 of the Act in respect of misconduct occurring pre-LCO where: (a) the controlled function which the person was approved to perform is, on the LCO, a significant-influence function in relation to the carrying on of a regulated activity by a PRA-authorised person; and (b) the FSA had not, before the LCO, given a warning notice in accordance with section 67(1) of the Act in respect of the misconduct. The PRA therefore has the power to take action in relation to this matter.

2.17. Pursuant to section 69(8) of the Act, the PRA must have regard to any statement published at the time when the contravention occurred when considering whether to impose a financial penalty (and if so, in what amount). Since the Relevant Period commenced before 1 April 2013 but continued after that date, pursuant to article 3(4)(b) of the Transitional Provisions Order, the PRA's Penalty Policy is the relevant policy to which the PRA must have regard.

PRA's rationale for taking action against Mr Alderson

2.18. The PRA considers that a good risk management culture and a strong control framework are of fundamental importance in ensuring a bank's safety and soundness.

2.19. Mr Alderson's failure to comply with Statement of Principle 6 and his being knowingly concerned in certain, but not all, aspects of the Firm's breach of Principle 3 during the Relevant Period is serious. These failings had the clear potential to affect the safety and soundness of the Firm. Due in part to these failings themselves, it is not possible to determine whether the capital shortfall at Co-op Bank could have been avoided. However, had Mr Alderson ensured that the CABB Division, as the first line of defence, had an adequate focus on risk; assessed and more effectively escalated the risks arising across the Britannia Corporate Loan Book; put in place proper systems and controls in the CABB Division; implemented the strategy for the Corporate Loan Book; ensured that management information was sufficient to identify and monitor risks; and ensured that there was an appropriate culture within CABB, and that impairment decisions were consistent with Co-op Bank's cautious risk appetite, this may have increased the prospects of the Firm dealing with the issues that it faced more effectively and in a more timely manner.

Sanction

2.20. Taking into account the above facts and matters and the relevant factors set out in the PRA's Penalty Policy, the PRA considers that Mr Alderson's failure to comply with Statement of Principle 6 and his being knowingly concerned in Co-op Bank's breach of Principle 3 warrant the imposition of a financial penalty of £126,986 by the PRA. That penalty was reduced by a 30% discount to £88,890 for settlement with Mr Alderson at Stage 1.

2.21. In addition, the PRA has decided to make a prohibition order pursuant to section 56 of the Act.

2.22. The basis and computation for this penalty and prohibition are set out in Annex C.

3. FAILINGS

3.1 The regulatory provisions relevant to this Final Notice are referred to in Appendix 2.

4. PROCEDURAL MATTERS

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

Robert Dedman

Chief Counsel, Regulatory Action Division

for and on behalf of the PRA

Annex A

PARTICULARS OF BREACHES AND FAILINGS

Facts and matters relied on

1. Background

Co-op Bank

1.1. Co-op Bank is a UK bank which provides high street and internet banking current accounts, mortgages, savings accounts, credit cards and loan to individuals and businesses. The Firm is regulated by the PRA for prudential purposes and by the FCA for conduct matters.

1.2. Until 20 December 2013, Co-op Bank was a wholly owned subsidiary of Co-op Banking Group, which in turn was a wholly owned subsidiary of the Co-operative Group Limited. The Co-op Group is one of the UK's largest mutual businesses, owned by millions of UK consumers. It is a Registered Society within England and Wales and has interests across food, funerals, insurance and legal services.

1.3. As an entity ultimately owned by a mutual, Co-op Bank had limited options for raising capital, and a lack of access to the capital markets. It could retain profits or receive funds from the Co-op Group, but unlike publically listed banks, it could not issue equity shares to the public from which it could raise capital without diluting Co-op Banking Group's stake in the Firm.

1.4. Prior to August 2009, Co-op Bank had assets of around £15 billion. Mr Alderson had been responsible for managing Co-op Bank's Corporate Loan Book since 2003 and had experience of managing down significant and unusual corporate loan exposures through developing close relationships with Co-op Bank's customers.

1.5. In January 2009, Co-op Bank announced plans to merge with Britannia, a larger building society with assets of around £35 billion. From Co-op Bank's perspective, the key driver for the merger was to acquire Britannia's extensive branch network and savings and mortgage product strength.

1.6. As part of the merger, Co-op Bank acquired the Britannia Corporate Loan Book, which were loans originated by Britannia of around £3.7 billion. Mr Alderson was not involved in any of the negotiations that led to this merger, the due diligence that was carried out by Co-op Bank on the Britannia Corporate Loan Book, or in Co-op Bank's decision to acquire the Britannia Corporate Loan Book (in the knowledge that the book was high risk and fell outside the risk appetite of Co-op Bank).

1.7. The terms of the merger were agreed in January 2009 and on 1 August 2009, Co-op Bank merged with Britannia and acquired all the assets and liabilities previously held by Britannia.

1.8. Between 2011 and early 2013, Co-op Bank was involved in the consideration of, and negotiations and planning for, a proposed project to purchase 632 bank branches from the Lloyds Banking Group, known as Project Verde. Co-op Bank decided in April 2013 not to proceed with Project Verde.

1.9. On 17 June 2013, Co-op Bank publically announced that the Firm required an additional £1.5 billion of Common Equity Tier One capital. Approximately one third of this was as a result of substantial impairments to the Britannia Corporate Loan Book, and in particular, loans secured on CRE. Co-op Bank subsequently undertook a Liability Management Exercise to improve its capital position which completed on 20 December 2013. As a consequence of this exercise, Co-op Bank ceased to be a wholly owned subsidiary of the Co-op Group, although the Co-op Group continues to hold more than 20% of the voting rights in general meetings of Co-op Bank.

1.10. During the Relevant Period, Co-op Bank sought to employ a "three lines of defence" model. In theory, this meant that:

(1) the first line of defence had responsibility for the management of risks, the loans in the Corporate Loan Book, and in particular for managing the risk that the loans would not be repaid in full;

(2) the second line of defence, including Compliance and Risk functions, provided independent challenge and guidance to the first line; and

(3) the third line of defence, comprising internal audit, provided independent assurance that appropriate procedures were in place and being followed.

1.11. However, the design and operation of the three lines of defence model was flawed. On 11 August 2015, the PRA published a Final Notice in respect of Co-op Bank, censuring the Firm for failing to take reasonable care to organise and control its affairs responsibility and effectively with adequate risk management controls, in breach of Principle 3.

2. Mr Alderson's role

2.1. Following the merger of Co-op Bank and Britannia in August 2009, Co-op Bank consisted of two primary operating divisions: Retail Banking and Corporate and Markets.

2.2. One of the sub-divisions in CAM was Corporate Banking, which was later renamed CABB.[6] Mr Alderson held the role of Business Leader or Director of Corporate Banking from 1 August 2009, but was not a member of the Executive Committee.

2.3. Mr Alderson was promoted to the newly-created role of Managing Director of CABB in October 2010. While Mr Alderson took on some additional responsibilities, such as becoming a member of the broader Executive decision-making committee of Co-op Bank, his roles and responsibilities in relation to CABB, as well as the scope of the CABB Division, remained the same.

2.4. As Managing Director of CABB, Mr Alderson was responsible for:

(1) managing the existing Corporate Loan Book to maximise return and minimise risk in line with Co-op Bank's objectives;

(2) leading the development and implementation of the strategy for CABB to support Co-op Bank's objectives; and

(3) the overall profit and loss of the CABB division.

2.5. From 1 November 2007 to 28 January 2011, Mr Alderson held a CF29 (significant management) function at Co-op Bank. From 21 March 2011 to 4

[6] For the purposes of this Notice, the name "CABB" will be used to refer to this division throughout the Relevant Period.

June 2013, Mr Alderson held a CF1 (director) function at Co-op Bank, although he was at no time a member of the Board of Co-op Bank.

2.6. In addition to his significant responsibility as Managing Director of CABB, between November 2011 and October 2012, Mr Alderson was appointed as Executive Director of Customer Service Operations, which included responsibility for managing around 4,500 staff based in various locations across the UK. The PRA acknowledges that this appointment led to significant management stretch on Mr Alderson's part as he already had various other responsibilities outside CABB during the Relevant Period including:

(1) responsibility for the Optimum closed book of mortgages (which was part of the non-core asset base);

(2) acting as a senior sponsor for Project Unity (a Co-op Group project aimed at cutting costs and unifying Co-op Bank within the Co-op Group structure);

(3) acting as the Co-op Bank representative on the UK Reclaim Fund Board and Risk Committee (a body set up by Co-op Bank at the request of the Government to collect, manage and distribute the dormant balances across the UK banking and building society sector); and

(4) responsibility for the Loss Recoveries Unit (a London based team whose remit was to pursue fraudulent and negligent valuers and solicitors).

3. Co-op Bank's risk management framework and risk appetite

3.1. The CABB Division was in the first line of defence and therefore owned and managed the risks and controls for the CABB Division. The second line of defence comprised risk and compliance oversight of the business. The third line of defence was Internal Audit. The development of an effective risk management framework was not part of Mr Alderson's responsibilities.

3.2. CABB was required to operate in accordance with the risk appetite set by Co-op Bank's Board. The risk appetite was stated to be cautious.

3.3. Firms should have robust frameworks for risk management and financial and operational control, commensurate with the nature, scale and complexity of their business, and consistent with their safety and soundness. A firm's stated risk appetite is an important factor in determining whether a firm's risk and control framework is commensurate with the nature of its business, and should be both integral to a firm's strategy and at the heart of its risk management framework. All the activities of the firm should be conducted within the context of that risk appetite.

3.4. Whilst Co-op Bank was a public limited company, it was wholly owned by a mutual business, the Co-op Group, which was wholly owned by its individual members. The nature of the Co-op Group structure meant that Co-op Bank had limited options for raising capital. The impact of a capital shortfall would, therefore, be more difficult to manage.

3.5. Mr Alderson was aware of Co-op Bank's cautious risk appetite. Furthermore, from various interactions with the FSA, external advisors and internal departments such as Internal Audit, Mr Alderson was aware of material weaknesses in the Firm's risk management framework. Accordingly, this should have led to an increased focus on risk within the CABB Division, as the first line of defence. Mr Alderson did take some steps to improve management of risk within the first line of defence, including setting up the Problem Exposures Review Group in 2010 which reviewed all loan portfolios that were in default or included on the watchlist on a monthly basis.

4. The merger with Britannia

4.1. The merger with Britannia, including acquisition of the Britannia Corporate Loan Book, took place on 1 August 2009. Mr Alderson was not responsible for any aspect of Co-op Bank's decision to acquire the Britannia Corporate Loan Book in the knowledge that the loans were high risk and were known by Co-op Bank to fall outside their cautious risk appetite at a time of deteriorating economic conditions and falling asset prices, particularly in the CRE sector.

4.2. Prior to the merger with Britannia, Co-op Bank's CABB Division operated a business model known as relationship banking. Essentially, CABB employed a substantial number of individuals known as Relationship Managers whose role was to know their customers and manage their business banking requirements from start to finish.

4.3. Britannia's corporate lending operation was very different. A significant proportion of Britannia's commercial lending had been sourced through brokers and intermediaries, rather than through Relationship Managers. Furthermore, all of Britannia's commercial lending was property-based: with £2.2 billion of loans backed by CRE, £0.8 billion of RSL loans and £0.7 billion of loans to landlords with buy-to-let or multiple occupation properties.

4.4. The Britannia Corporate Loan Book had a much higher risk profile than the pre-merger Co-op Bank Corporate Loan book. In particular:

(1) the Britannia Corporate Loan Book had a high degree of exposure to the CRE sector. A firm's exposure to a particular lending sector is known as its "sector risk";

(2) the Britannia Corporate Loan Book contained a number of large exposures to single borrowers. Over one third of Britannia's commercial loans had been made to just ten customers. This meant that, if one of these borrowers defaulted, this would have a significant impact on the performance of the loan book as a whole. This risk is known as "concentration risk";

(3) many of the loans made by Britannia had much higher loan-to-value ratios than those originated by Co-op Bank. The loan-to-value ratio compares the value of the loan to the value of the collateral it is secured against;

(4) many of the loans made by Britannia had much lower interest cover. Interest cover is a measure of a borrower's ability to make the interest payments on their outstanding debt. Co-op Bank had required its borrowers to demonstrate earnings of 1.5 times their interest payments whereas Britannia had only required earnings of 1.05 times the interest payments;

(5) a significant proportion of the Britannia Corporate Loan Book was due to be repaid in a single repayment on maturity of the loan, often meaning that a borrower would need to be able to refinance to make this payment. This is known as "refinancing risk";

(6) a significant proportion of the Britannia Corporate Loan Book was subordinated debt, where the debt owed to Britannia ranked below the debts of other creditors in the event of insolvency;

(7) the Britannia Corporate Loan Book contained holdings of a number of complex securities which were unfamiliar to Co-op Bank and outside of its expertise; and

(8) a significant proportion of the Britannia Corporate Loan Book had been originated between 2005 and 2007, at the height of the economic cycle and just before the onset of the financial crisis and the recession.

4.5. In order to manage the Britannia Corporate Loan Book effectively, Mr Alderson needed to:

(1) take reasonable steps to ensure that Co-op Bank adequately assessed the risks across the Britannia Corporate Loan Book holistically and ensure that these risks were sufficiently escalated to Co-op Bank's formal risk management committees and the Executive;

(2) implement the strategy for the Corporate Loan Book including defining objectives, timescales and metrics to assess the strategy for managing the Corporate Loan Book as a whole (rather than on a loan by loan basis);

(3) ensure that CABB, as the first line of defence, took an adequate approach to the management of risk;

(4) ensure that the impairment provisions on the Corporate Loan Book reflected Co-op Bank's cautious risk appetite; and

(5) ensure that management information was produced that was sufficient to monitor compliance with the Firm's systems and controls.

5. Failure to assess and escalate risks in the Britannia Corporate Loan Book

5.1. Between 1 August 2009 and 13 May 2013, Mr Alderson failed to take reasonable steps to ensure that Co-op Bank adequately assessed the risks across the Britannia Corporate Loan Book holistically. Rather, the focus of the

CABB Division was on assessing the risks arising from each loan, and each collection of loans to a single customer, on an individual basis.

5.2. In addition, between 1 August 2009 and January 2011, Mr Alderson failed to sufficiently escalate risks inherent in the Britannia Corporate Loan Book to Co-op Bank's formal risk management forums and the Executive. As a result, Co-op Bank's governance forums could not properly consider these risks or the appropriate actions to mitigate them. Mr Alderson became responsible for the Corporate Loan Book, including the Britannia Corporate Loan Book on 1 August 2009, and should have taken steps to ensure that the CABB Division assessed the profile and nature of the Britannia Corporate Loan Book holistically; the risks it posed and emerging issues; and that risks were mitigated and issues addressed in a timely manner. The nature of the Britannia Corporate Loan Book meant that the risk profile of the CABB Division changed significantly. It was of crucial importance for Mr Alderson to have a proper understanding of the risks in the Britannia Corporate Loan Book holistically. Moreover, given the higher risk nature of the Britannia Corporate Loan Book (as described at paragraph 4.4 above) Mr Alderson should have been aware of the importance of properly assessing the risks in this business. Although Mr Alderson was aware that, prior to the merger, external advisors had produced a due diligence report and the in house team reviewed a sample of Britannia loans, he did not request the due diligence report or a briefing from the in house team on what they had found.

5.3. In addition, as set out below, there were a number of exercises carried out during the Relevant Period by other areas of Co-op Bank which Mr Alderson and the CABB Division could have used to gain a better understanding of the profile of the Britannia Corporate Loan Book and the risks it posed, based on work undertaken by CABB, the Risk function and external advisors. These opportunities were not adequately taken. It was important to understand the risks in the Britannia Corporate Loan Book in the context of the newly merged Corporate Loan Book as a whole.

5.4. The work that was carried out by CABB and Mr Alderson generally focused on analysis of individual loans, and Mr Alderson did not request information or analysis of the overall Corporate Loan Book. It is acknowledged that a significant amount of work was undertaken in relation to individual loans, which identified issues. The FSA and reports commissioned by Co-op Bank also identified the high risk profile of the Britannia Corporate Loan Book which means that a commensurately robust risk management approach was required.

5.5. However, Mr Alderson considered that the issues raised would be remedied when Co-op Bank's policies and procedures were put in place. This was not the case and these issues continued to exist throughout the Relevant Period, as set out at section 7.

Due diligence on Britannia

5.6. In the months preceding the merger, the focus of the due diligence had been on other areas of Britannia's business, such as Britannia's residential mortgage portfolio, its securitisation vehicles and Platform, Britannia's intermediary business for mortgages and loans.

5.7. External advisors appointed by Co-op Bank to conduct due diligence on Britannia produced a report in early-2009 which noted that the Britannia Corporate Loan Book was heavily exposed to the commercial and residential property sector, but noted that the pure CRE and RSL portfolios had no arrears or provisions. The findings in the report were subject to an important caveat as the advisors only had limited access to Britannia's premises, audit files and management information.

5.8. In January 2009, a Co-op Bank in house team attended the premises of Britannia to conduct a review of a sample of commercial lending files. The review was limited in scope; it took place over two days and considered around 40-50 loan files in total. It identified a number of risks such as weak interest cover, high loan-to-value ratios and very long-dated loans.

5.9. Co-op Bank's advisors recommended that further due diligence be performed on the Britannia Corporate Loan Book between the signing of the merger agreement and the planned completion in August 2009. However, no further work was undertaken.

5.10. Accordingly, when the merger completed in August 2009, and Mr Alderson became responsible for CABB, Co-op Bank's understanding of the risks posed by the Britannia Corporate Loan Book was limited at best. Although Mr Alderson was aware that external advisors had produced a due diligence report and the in house team had reviewed a sample of Britannia loans, he did not request the due diligence report or a briefing from the in house team on what they had found and was unaware of the risks identified by this work.

5.11. Many of the risks inherent in the Britannia Corporate Loan Book, outlined in paragraph 4.4 above, were not properly appreciated by Co-op Bank until sometime after the merger had completed.

Post-merger assessment of the Britannia Corporate Loan Book

Co-op Bank analysis of the Britannia Corporate Loan Book

5.12. Following the completion of the merger in August 2009, Co-op Bank's Risk function began to undertake a series of exercises to gain a better understanding of the Britannia Corporate Loan Book. Mr Alderson was not directly involved in conducting this work, but he was aware of these exercises and had the opportunity to use the findings of this work to better understand the profile of and the risks posed by the Britannia Corporate Loan Book. He did not take this opportunity.

5.13. In addition, the issues that were identified were not adequately dealt with.

5.14. Co-op Bank identified that Britannia did not aggregate multiple loans to one borrower into a total figure for its exposure to a single counterparty. Having believed that Britannia's largest exposure to an individual counterparty was around £25 million, members of the Risk function discovered that in fact the Firm's exposure to a number of borrowers exceeded £100 million each. This was far greater than the average loan size of £15 million. This was subsequently escalated to Mr Alderson, who considered that it was "too high". Mr Alderson did not take additional steps, beyond the measures already in place to ensure closer monitoring or implement a specific strategy to manage these loans.

5.15. Review work undertaken by the Risk function and CABB identified an issue with out of date collateral valuations, which are of vital importance in managing a book of property loans. A collateral valuation is the valuation of the property the loan is secured against. If a borrower defaults, the collateral valuation should serve as a reliable estimate of the amount the bank should expect to recover. Collateral valuations are also required for a bank to be able to assess whether certain covenants are being complied with or not, for instance on loan-to-value ratios. It was therefore vital that the Firm's collateral valuations were accurate. To be accurate, collateral valuations needed to be updated on a regular basis.

5.16. During the first six months following the merger, it became apparent that a good proportion of the valuations of the properties that Britannia's smaller (lower than £1m) non-watchlist, non-default, loans were secured against were historic, with many collateral valuations having been performed five to ten years before. This was escalated to Mr Alderson in February 2010.

5.17. This raised the risk that the valuations of these properties were unreliable, potentially leaving Co-op Bank with a shortfall between the amount of exposure Co-op Bank had to a borrower and the value of the security. Mr Alderson was, or should have been, aware of this risk. Mr Alderson was aware that the valuations policy had been reviewed externally and was revised twice during the Relevant Period to address the concerns about the timeliness of obtaining valuations. As discussed in paragraph 7.16, if the loan exceeded the specific limits or the Relationship Manager wanted to waive the requirement for obtaining a new external valuation, the Risk function would determine whether this was permissible. However, Mr Alderson failed to take adequate steps to ensure that this issue was resolved, and it continued to exist throughout the Relevant Period.

Fair value adjustments

5.18. As a consequence of the merger, Co-op Bank was required to adjust the value of all of Britannia's assets and liabilities to reflect their "fair value". The fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The change in the value of the asset or liability for these purposes is known as a fair value adjustment.

5.19. For the Britannia Corporate Loan Book, adjustments were made to the value of a loan to reflect the expectation of not receiving full payment. For example, for a loan of £10 million, a firm may only expect to recover half of that amount in future and therefore would make a FVA of £5 million.

5.20. The exercise to establish the FVA for the Britannia Corporate Loan Book was undertaken by teams from Risk and Finance. CABB provided support for the exercise, and Mr Alderson received updates on the process and the proposed FVA. This was a further opportunity for Mr Alderson and CABB to request more detail on the analysis of the loans and to better understand the profile of and risks posed by the Britannia Corporate Loan Book. However, this work focused on calculating the FVA figure, and Mr Alderson did not take this opportunity to ensure that Co-op Bank developed a better understanding of the Britannia Corporate Loan Book at a portfolio level.

5.21. The review divided the Britannia Corporate Loan Book into two "pools" of loans: those that were performing, which was referred to as the "good book", and those which were in default or distress, which was referred to as the "distressed pool". Of the £3.7 billion Britannia Corporate Loan Book, £2.7 billion of loans were placed in the good book and £1 billion of loans were placed in the distressed pool.

5.22. The FVA taken against the good book amounted to £27 million. The FVA taken against the distressed pool amounted to £257 million.

Annual review process

5.23. Another opportunity for Co-op Bank and Mr Alderson to gain an understanding of the issues that were common across the Britannia Corporate Loan Book was the annual review process. This was a process that had been in place at Co-op Bank prior to the merger and was therefore being applied to the Britannia Corporate Loan Book acquired from Britannia for the first time in the year following the merger.

5.24. The annual review process involved every loan being reviewed by the first line Relationship Managers and the Risk function. Although this was a joint exercise between the CABB Division and the Risk function, the annual review process was ultimately owned by Mr Alderson.

5.25. All of the loans acquired from Britannia were reviewed by 1 August 2010. Again, despite undertaking a detailed loan-by-loan review of the entire Britannia Corporate Loan Book, inadequate efforts were made by CABB or the Risk function to identify widespread issues or patterns across the book. Mr Alderson was closely involved in the management of individual loans, particularly with those larger exposures, but he did not request aggregated information about the overall loan book, which he could have used to develop a more detailed understanding of the risks posed by the Britannia Corporate Loan Book. Although, as explained above, Mr Alderson was not a member of the Executive Committee, he nevertheless held responsibility for these matters in his capacity as a senior manager approved to carry out CF29.

FSA concerns and the independent review

5.26. Following the merger, the FSA expressed a number of concerns about the risks in the Britannia Corporate Loan Book during a meeting with Co-op Bank senior management, including Mr Alderson. These risks included exposure to subordinated debt, its dependency on certain tenants and issues around concentration and high loan-to-value ratios.

5.27. In February 2010, the FSA required Co-op Bank to conduct an independent review of the Corporate Loan Book, which was completed in April 2010. This highlighted credit risk, concentration risk and refinancing risk as key risks posed by the Britannia Corporate Loan Book. It also identified the following control weaknesses:

(1) out of date collateral valuations;

(2) a lack of clear documentation in some cases explaining why certain connections had been placed on the watchlist; and

(3) instances where there had been loan-to-value covenant breaches.

5.28. The majority of the issues were classified as "legacy issues" as they reflected the differing standards of Britannia pre-merger and would be resolved by applying Co-op Bank policies and procedures. However, the issue of out of date collateral valuations was identified in both the Britannia Corporate Loan Book and corporate loans originated by Co-op Bank.

5.29. The review also recommended that Co-op Bank monitor refinancing risk in the Britannia Corporate Loan Book on a systematic basis and formulate an action plan to address the risks.

5.30. Save in the case of loan-to-value covenant breaches, which were a result of the deteriorated state of the Britannia Corporate Loan Book, Mr Alderson considered that these issues would be remedied by the adoption of Co-op Bank policies and procedures and did not take any additional steps to ensure these issues were properly investigated, considered and rectified. As a result, they continued to exist throughout the Relevant Period.

Escalation of risks to Co-op Bank's various committees

5.31. In 2009 and 2010, despite the issues described above, Co-op Bank gradually gained a more detailed understanding of the risks posed by the Britannia Corporate Loan Book holistically. Mr Alderson discussed a number of these risks, including concentration risk and the level of exposure to subordinated debt, in a supervisory meeting with the FSA in January 2010 (five months after the merger was effective).

5.32. However, Mr Alderson did not take sufficient steps to ensure that these risks were made clear to the senior decision-making committees of Co-op Bank, and the Executive.

5.33. Between August 2009 and January 2011, Mr Alderson attended the following committees:

(1) the Portfolio Credit Committee, which was responsible for oversight of credit risk and ensuring that it remained within the agreed risk appetite;

(2) the Exposures Committee[7], which was responsible for considering individual loans; and

(3) the Executive Committee.

5.34. Mr Alderson also attended the Co-op Bank Board meetings by invitation.

5.35. Mr Alderson did not make sufficiently clear to these committees, or to the Executive, the severity of each of the risks Co-op Bank had assumed in taking on the Britannia Corporate Loan Book. This was principally due to the discussions focusing too heavily on the risks of individual loans or groups of loans with a single borrower, with insufficient focus on the risks that existed at a macro level across the Corporate Loan Book, following the merger.

[7] The Exposures Committee was a committee of non-executive directors that was responsible for reviewing and approving management actions on large corporate loans and considering the overall risk profile of the bank's counterparty exposures.

6. Failure in implementing the strategy for the Corporate Loan Book

6.1. At the time of the merger, it was agreed by Co-op Bank that a strategy of "manage and hold" would be adopted in relation to the Britannia Corporate Loan Book. This strategy involved continuing to hold the loans and seeking to manage down the exposure on each loan, where possible, without incurring disproportionate loss. Mr Alderson was responsible for the implementation of the manage and hold strategy for the Corporate Loan Book, which was approved by the Co-op Bank Board.

6.2. Between 1 August 2009 and 13 May 2013, Mr Alderson failed to properly identify sufficiently clear and specific objectives, timescales or metrics against which to assess the strategy for the Corporate Loan Book.

6.3. In addition, in 2012 and 2013 Mr Alderson failed to act in a timely manner in exploring options for the non-core part of the Corporate Loan Book and the possible impact on the Firm's capital position; and failed to take reasonable steps to ensure that an appropriate governance framework was put in place to make decisions on the possible disposal of certain assets in the Corporate Loan Book.

Background

6.4. The Britannia Corporate Loan Book was a closed book of assets when the merger completed in August 2009 as Britannia's commercial lending division had ceased writing new loans prior to the merger.

6.5. As such, the strategic issues for Mr Alderson and Co-op Bank related to the management of the Corporate Loan Book, comprised of the Britannia Corporate Loan Book and corporate loans originated by Co-op Bank.

6.6. As at January 2010, the Britannia Corporate Loan Book comprised of loans to approximately 240 borrowers to the value of £3.79 billion and the Co-op Bank Corporate Loan Book comprised of loans to approximately 3,200 relationship managed customers to the value of £6.35 billion.[8]

6.7. There were a number of options open to Co-op Bank for the Britannia Corporate Loan Book, each with varying consequences for the Firm's financial

[8] These balances represent committed exposure as at 31 January 2010.

position, particularly its profit and capital figures. This included sale of assets; a risk transfer mechanism to transfer the credit risk of the assets to a third party; and managing and holding the assets.

6.8. Whichever strategy or combination of strategies Co-op Bank opted for, given the high-risk nature of the Britannia Corporate Loan Book and the potential impact on Co-op Bank's capital position, it was vital that Mr Alderson was clear about:

(1) what it was seeking to achieve;

(2) when it sought to achieve this by;

(3) the likely impact of the strategy on the Firm's capital position;

(4) how it would measure the implementation and effectiveness of the strategy; and

(5) how decisions would be made about strategy.

Manage and hold

6.9. The initial strategy for the Britannia Corporate Loan Book was decided without any input from Mr Alderson. Prior to the merger completing, it was decided that the Firm would continue to hold the Britannia Corporate Loan Book and manage the loans down at an individual level. The objective was to manage down every individual loan in the Britannia Corporate Loan Book to zero whilst minimising losses on the loans. The only assets within the Britannia Corporate Loan Book that Co-op Bank initially planned to sell if the opportunity arose were subordinated and overseas loans and loans which exceeded £100 million ("tall trees").

6.10. As the Director of CABB, Mr Alderson was responsible for developing and implementing this strategy.

6.11. However, the manage and hold strategy was not sufficiently articulated in that Mr Alderson failed to properly identify sufficiently clear and specific objectives, timescales or metrics against which to assess the strategy for the Corporate Loan Book or to provide sufficient guidance to explain how the strategy should be implemented in practice on a loan by loan basis.

6.12. In July 2011, the Board first considered the strategic options for the Corporate Loan Book almost two years after completion of the merger. At an away day to consider the Firm's strategy, the Board was presented with five options for the future strategic direction of the Firm. One of these was the option to sell a £1.9 billion portfolio of the Corporate Loan Book, comprised mainly of the loans originated by Britannia that had been placed in the distressed pool as part of the FVA process.

6.13. The papers prepared for the Board noted that pursuing this strategy would give rise to a post-tax loss of £330 million and reduce the Firm's Tier 1 capital ratio by 0.5 per cent. The Board decided not to pursue this option but rather to continue with the manage and hold approach for the Corporate Loan Book, coupled with reducing exposure to the "tall trees".

6.14. Despite the Board's steer, following the strategy session in July 2011, Mr Alderson asked individuals from his CABB Division and the Risk and Finance functions to begin liaising with advisors to explore the options for what he referred to as the "non-core"[9] element of the Corporate Loan Book. Three possible options were identified, but no steps were taken to determine which of these was most suitable.

Core/non-core split

6.15. By the end of 2011, Mr Alderson's CABB Division and the Finance function had split CABB into core and non-core divisions, with virtually all of the Britannia Corporate Loan Book deemed to be non-core.

6.16. Initially, the split was purely for presentational purposes and no separate strategy was articulated for the non-core part of the Corporate Loan Book. When Mr Alderson presented the split to the Board in February 2012, the presentation merely noted that appropriate strategies for both the core and non-core divisions would be developed. While the previous manage and hold strategy had still not been properly articulated, Mr Alderson was now responsible for the development and implementation of these additional strategies for the core and non-core loans.

[9] "Non-core" was defined by Co-op Bank as assets which are not consistent with the Bank's strategy and risk appetite and are actively managed to achieve the most appropriate asset value on an individual loan basis or targeted for run down or exit.

6.17. During the period between the start of 2012 and April 2012, members of CABB and Finance continued to meet with various advisors to explore the options for the non-core part of the Corporate Loan Book. This included the need to develop a governance framework to make decisions on strategic options for non-core assets, for instance, whether to approve the sale of a loan.

6.18. However, Mr Alderson failed to act in a timely manner in exploring options for the non-core part of the Corporate Loan Book and failed to take reasonable steps to ensure that an appropriate governance framework was put in place to make decisions on the possible disposal of non-core assets.

6.19. Mr Alderson attended a meeting with other senior managers at Co-op Bank in April 2012 to discuss the strategic options for the non-core part of the Corporate Loan Book. The following month, Mr Alderson presented a similar paper to the Board of Co-op Bank.

6.20. While both presentations summarised the various options open to Co-op Bank for the non-core part of the Corporate Loan Book, neither contained any firm recommendations on the strategy to take for the non-core part of the Corporate Loan Book. The presentation to the Board also noted that a specialist team was being put in place by Mr Alderson to manage the non-core assets, including exploring the strategic options in relation to the non-core assets.

6.21. Significantly, the presentation to the Board noted that, of the £257 million of FVAs taken against the distressed pool loans in 2009, all but £36 million had already been utilised and this final £36 million was forecast to be consumed by the end of 2012. This meant that any further impairments to the distressed pool loans would be charged against the Firm's profit and loss account. In light of this, the presentation to the Board noted the need to act with pace in formulating a suitable strategy for the Corporate Loan Book.

6.22. Despite the recognised need for urgency, when the matter was revisited at the Board meeting in September 2012, once again no overarching strategy for the core and non-core parts of the Corporate Loan Book was set out or recommended in the papers produced and presented by Mr Alderson. Rather, Mr Alderson was focusing at the time on hiring specialist corporate banking and finance resource with experience in managing non-core assets. As a result of this delay, he failed to make sufficient progress with developing the non-core strategy.

6.23. Furthermore, although proposals for a governance framework to make decisions on the strategic options for the non-core assets were developed, these had not been implemented. Mr Alderson failed to progress in a timely manner the proposals in this regard pending the recruitment of specialist non-core banking and finance resource.

Disposal of assets

6.24. In November each year, Co-op Bank would finalise its three-year plan. This would set out the strategic actions the Firm planned to take over the following three years.

6.25. The plan for 2013 to 2017 was finalised in November 2012 and, for the first time, included the strategy to seek to sell a portfolio of assets from the non-core part of the Corporate Loan Book. Only £327 million of assets were earmarked for sale, out of the total non-core part of the Corporate Loan Book of £2.8 billion. The sale of these assets was estimated to release £6 million of capital via the reduction in risk weighted assets, but lead to a pre-tax loss of £113 million.

6.26. However, no new strategy or proposed course of action to sell assets was outlined for the remainder of the non-core part of the Corporate Loan Book. Instead, the issue was deferred once again, with Mr Alderson planning to revert to the Board with a disposal programme in the first quarter of 2013. In 2013, Co-op Bank's capital position came under increasing pressure as a result of a number of factors. First, Co-op Bank was preparing to report a large loss for 2012 which would deplete the Firm's capital resources. The losses were primarily driven by large impairments in the CABB Division, the partial impairment of Co-op Bank's programme to replace its IT systems and provisions raised to cover PPI redress. Second, the FSA had issued Co-op Bank with revised capital requirements on 15 January 2013 that meant that the Firm did not meet its modified capital planning buffer.

6.27. As a result, various projects were initiated within Co-op Bank to try to improve the Firm's capital position. At least one of these projects examined the potential to dispose of corporate assets, including loans which were in the non-core part of the Corporate Loan Book. One project was led by the Treasury function, with limited involvement from Mr Alderson or the CABB Division.

6.28. During the first few months of 2013, Co-op Bank began to reconsider its entire approach to corporate banking and to question whether it should continue providing financing to medium and large corporates, or whether it should focus on the small business market.

6.29. Co-op Bank also began to receive offers from various parties to purchase non-core assets. However, despite recognising that a governance process was required in early-2012, Mr Alderson had still not put any process in place to approve these sales in March 2013, causing confusion and delay in the Firm's decision-making.

6.30. By the time Mr Alderson left Co-op Bank in May 2013, he had not developed and implemented a clear strategy for the non-core part of the Corporate Loan Book with clearly defined objectives and timelines (although he had, by that stage, succeeded in recruiting the specialist non-core and finance resource he required in order to do this).

7. Failure to address systems and controls issues in CABB

7.1. As noted at paragraph 3.5, Mr Alderson was aware of various weaknesses in the risk management framework at Co-op Bank. These included:

(1) the lack of distinction between the first and second lines of defence, meaning that the second line was unable to provide effective oversight and challenge to the first line business; and

(2) the weakness of the third line of defence, Internal Audit, and its inability to provide effective challenge.

7.2. This should have led to an increased focus from Mr Alderson on managing risk in the CABB Division, as the first line of defence. However, between 1 August 2009 and 13 May 2013, Mr Alderson failed to take reasonable steps to ensure that the first line of defence took an adequate approach to the management of risk, including in relation to:

(1) the identification and management of distressed accounts;

(2) compliance with policies and procedures on collateral valuations; and

(3) compliance with policies and procedures on KCC.

Identification and management of distressed accounts

7.3. The identification of accounts in distress was of paramount importance for Co-op Bank. If the Firm failed to identify accounts that were in distress, they would not be transferred onto the watchlist and no consideration would be given to whether or not an impairment provision was required. This should have been an important element of a manage and hold strategy.

7.4. Co-op Bank had a number of deficiencies in its approach to identifying and managing distressed accounts.

7.5. The responsibility for identifying accounts in distress rested with the first line Relationship Managers. If they considered that the criteria for referring a case to the watchlist had been triggered, they were required to report this to the Risk function. This decision required a high degree of individual judgement and subjectivity.

7.6. Once an account had been identified as needing to be placed on the watchlist or if the case was in default, the case would either:

(1) continue to be managed by the Relationship Manager with the assistance of the Close Care Team. The Close Care Team sat in the CABB Division, was part of the first line of defence, and reported into Mr Alderson. It had been formed by Mr Alderson in March 2009;

(2) be managed by the Close Care Team; or

(3) be managed by the second line Intensive Care Team. This team was part of Corporate Business Support in the second line Risk function.

7.7. The overlap in the roles of the Close Care Team and Intensive Care Team created additional complexity and confusion about which team should manage exposures, and an overlap in roles.

7.8. Mr Alderson was aware of:

(1) the weaknesses in Co-op Bank's risk management framework;

(2) the high risk profile of the Britannia Corporate Loan Book, a high proportion of which were CRE loans; and

(3) the significant year-on-year increase in the value of combined watchlist and default exposures.

7.9. The importance of early identification and management of problem exposures was also highlighted to Mr Alderson on numerous occasions. In particular, concerns about the operating effectiveness of watchlist processes were repeatedly raised by the second line Risk function; the Firm's external advisors; and the FSA between 2009 and 2012.

7.10. Mr Alderson did take a series of steps during the Relevant Period to ensure that Relationship Managers were properly incentivised to refer cases to the watchlist at the appropriate stage, and to have in place sanctions (including the deduction of remuneration) in the event that a Relationship Manager failed to refer a case to the watchlist when the relevant triggers occurred.

7.11. Notwithstanding these steps, the PRA considers that Mr Alderson failed to take reasonable steps to ensure that systems and controls around the identification and management of problem exposures operated effectively.

<u>Collateral valuations</u>

7.12. As set out in paragraph 5.15 above, the accuracy and timeliness of collateral valuations is crucial in managing the risks of a property-based lending book.

7.13. Having up to date collateral valuations is important for any lender, but it was of even greater significance for Co-op Bank given the high risk nature of the Britannia Corporate Loan Book, a large proportion of which were CRE loans and the deteriorating prices in the CRE market.

7.14. Out of date collateral valuations could have a number of consequences:

(1) the valuation of the property affected the risk grading assigned by Co-op Bank to the loan. The risk grading in turn determined the level of capital Co-op Bank needed to hold against the loan. Therefore, an out of date and/or unreliable valuation could mean that the Firm held either insufficient capital against a loan or, conversely, too much capital against a loan;

(2) the valuation of the property had an impact when calculating both provisions to hold against individual loans; and

(3) collateral valuations played a crucial role in metrics such as a borrower's loan-to-value ratio. A reduction in the value of a property would cause a borrower's loan-to-value ratio to rise, and may therefore cause a breach of the loan covenants. This could therefore require a loan to be moved onto the watchlist and possibly prompt Co-op Bank to raise a specific provision. Out of date or unreliable collateral valuations could therefore pose a risk that this process would not function properly.

7.15. Following a report by external advisors in April 2010, various policy changes were put in place. As part of this, from June 2010 onwards, Co-op Bank's policy was that valuations should be obtained every two years for performing loans and every year for loans on the watchlist.[10]

7.16. As part of the annual review process that took place in respect of each loan, the relevant Relationship Manager would consider the collateral valuation on file, and in line with Co-op Bank's policy, make an assessment of whether it was necessary to obtain an updated external collateral valuation. Within specific limits, a Relationship Manager could decide to waive the revaluation requirement for performing loans within specific limits for a period of 12 months. If the loan exceeded the specific limits or the Relationship Manager wanted to waive the requirement in the subsequent year, the Risk function would determine whether the revaluation could be waived.

7.17. Concerns about the timeliness of collateral revaluations were raised by Co-op Bank's risk management committees and its external advisors on a number of occasions between 2009 and 2012, as set out from paragraph 5.15. This includes the report produced by external advisors in April 2010, the findings of which were that these were "legacy issues", although in fact they continued to exist throughout the Relevant Period.

7.18. Notwithstanding these concerns, as at May 2013, around £1.4 billion of the CRE loans had valuations that were more than two years old. This represented approximately 50 per cent of loans by value in the Corporate Loan Book which were secured on CRE.

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[10] Note: prior to June 2010, Co-op Bank's policy was that valuations for performing should be performed every three years or annually for those in default.

7.19. Between 1 August 2009 and 13 May 2013, Mr Alderson:

(1) did not take reasonable steps to ensure that collateral valuations were reliable; and

(2) did not take reasonable steps to ensure that he had adequate oversight of the control framework of collateral valuations. No monitoring was performed to check that waivers of the requirement for revaluation were being applied appropriately.

Key Credit Criteria

7.20. Co-op Bank's risk appetite was partly articulated through its KCC, which were a set of guidelines that were considered by Relationship Managers and the Risk function when evaluating a new or existing loan facility and when considering loans during the annual review process, as described at paragraph 5.24 above. Co-op Bank's risk appetite required 90% of all new corporate loans either to fall fully within the KCC or (where they did not fall within the KCC) to have sufficient credit mitigants in place.

7.21. Relationship Managers would submit applications to the Risk function when applying for new or increased lending, or during the annual review process. The Risk function would then consider if the application fell fully within with the KCC. For loans that were larger than the discretion granted to the Risk function, these would be considered by senior individuals or committees at Co-op Bank.

7.22. If the application did not fall fully within the KCC, the Relationship Manager was required to provide what was referred to as a credit mitigant for why non-compliance was acceptable. For example, if a loan application did not meet the loan-to-value KCC, a Relationship Manager may have been able to highlight the fact that the property was let on a long-term lease to a strong tenant as a mitigant to what would otherwise have existed. Despite this, where a credit mitigant was accepted, this was referred to as a KCC override and the loan was regarded as falling within the KCC.

7.23. Certain of the credit mitigants were weak and unlikely to decrease the risk profile of the loan. Furthermore, there was no formal guidance for Relationship Managers or the Risk function on what could be an appropriate credit mitigant or what factors should be considered when assessing a loan which did not fall fully within the KCC.

7.24. As the KCC were a key part of Co-op Bank's risk appetite, it was paramount that:

(1) the KCC were adequately implemented; and

(2) the KCC were adequately monitored. In particular, in order to understand the risk profile of the Corporate Loan Book, it was vital that the frequency and type of KCC overrides were monitored.

Implementation of KCC

7.25. Mr Alderson failed to take reasonable steps to ensure that the KCC were adequately implemented. He should have been aware of the importance of this and did not exercise adequate oversight in this area.

7.26. The PRA makes no finding that the percentage of new corporate loans written by CABB breached Co-op Bank's articulated risk tolerance in respect of KCC, as approved by Co-op Bank's Board.[11]

7.27. Despite reporting to the Co-op Bank Exposures Committee and the Portfolio Credit Committee that KCC were intended to apply in almost all circumstances, KCC overrides were used in a high proportion of cases. While this was almost inevitable for the annual review of loans from the Britannia Corporate Loan Book, given that their risk characteristics meant (from the time of their acquisition in August 2009) they almost always fell outside of Co-op Bank's KCC, this could have been avoided for Co-op Bank's new or increased lending to borrowers.

7.28. When Co-op Bank finally produced statistics on the proportion of loans that fell within the KCC, it transpired that for the sectors where KCC were in place, over half of new or increased lending in 2012 did not fall within Co-op Bank's KCC. The frequent use of KCC overrides weakened Co-op Bank's approach to KCC.

7.29. Furthermore, Mr Alderson was aware of the weaknesses in the Firm's risk management framework, which should have led to an increased focus on risk in

[11] See paragraph 7.20 for further explanation.

the first line of defence. However, Mr Alderson relied on the second line to ensure that appropriate credit mitigants were in place where loans did not meet KCC.

Monitoring of KCC

7.30. Mr Alderson failed to take reasonable steps to ensure that the KCC were adequately monitored. He should have been aware of the importance of this and did not exercise adequate oversight in this area.

7.31. The system for monitoring KCC compliance was fundamentally flawed:

(1) for new lending, Co-op Bank set a tolerance limit that 10 per cent of new facilities could fall outside of the KCC where no sufficient credit mitigants were in place. As the Risk function required a credit mitigant to approve a KCC override, KCC compliance was therefore consistently reported as being close to 100 per cent. Therefore, management information on KCC compliance did not accurately show the number and value of loans which fell outside the KCC. As noted in paragraph 7.28 above, when the statistics were manually compiled for 2012, it actually transpired that the majority of new and increased lending fell outside of Co-op Bank's KCC; and

(2) in contrast to new loans, as set out at paragraph 7.20, for increased, renewed or revised lending to existing borrowers, Co-op Bank had no measure or limit at all for how many loans could fall outside of the KCC without credit mitigants. This was therefore not monitored.

7.32. In addition, until early-2013, the Firm did not monitor the number or frequency of KCC overrides or draw together the statistics for which criteria were being overridden. The impact of this was that Mr Alderson and Co-op Bank were unable to monitor the number of loans which did not fall fully within KCC and the quality of credit mitigants across the Corporate Loan Book.

8. Failure to ensure management information was adequate

8.1. Between 1 August 2009 and 13 May 2013, Mr Alderson failed to take reasonable steps to ensure that the available management information was sufficient to enable him to monitor compliance with systems and controls.

8.2. The management information produced for CABB was deficient in a number of respects. Mr Alderson should have been aware of this from reviewing the MI and from reviewing the output of various reviews of MI conducted during the Relevant Period.

8.3. The PRA accepts that the production of key MI was constrained by system limitations at Co-op Bank, and often required a high degree of manual intervention.

8.4. Further, Co-op Bank did not produce management information in respect of the CABB Division that:

(1) put together a consolidated view of the age of collateral valuations were across the loans secured on CRE (until 2013); and

(2) drew together data on the frequency of and reasons for KCC overrides, as described in paragraph 7.28 above (until 2013).

9. Failure to recognise impairment provisions in line with Co-op Bank's risk appetite

9.1. As the Managing Director of CABB, Mr Alderson had an important role not only in managing the business area but in setting its culture.

9.2. During the Relevant Period Co-op Bank had a culture which encouraged prioritising the short-term financial position of the Firm at the cost of taking prudent and sustainable actions for the longer-term. This was not consistent with Co-op Bank's cautious risk appetite and prudent bank management generally. This resulted in an environment in which some staff felt under pressure to meet impairment forecasts that had previously been set. In the CABB Division, this meant that optimistic decisions were made on impairment budgets, forecasts and provisions. Mr Alderson placed emphasis upon previous forecasts in the process of setting subsequent forecasts for impairments. He did not always ensure that impairment budgets and forecasts were set solely by reference to an assessment of the risks within the Corporate Loan Book. On certain occasions where impairment budgets or forecasts were at risk of being exceeded, Mr Alderson challenged figures that were proposed to him for impairment forecasts or provisions. The PRA accepts that Mr Alderson did not intentionally place any member of Co-op Bank's staff under pressure to modify impairment figures in a way which was improper. However, on some occasions where such challenges were made, a more optimistic view on the impairment position was ultimately taken than would have been the case absent the challenge.

<u>Background on impairment provisions</u>

9.3. An impairment provision should be raised when a loss is first incurred on an asset. For a CRE loan, this may occur when the borrower loses a significant tenant or when it becomes clear that a borrower which needs to refinance in the short to medium term will be unable to do so. These events are known as "loss events".

9.4. Loan impairments are recognised under what is referred to as an "incurred loss" model. This means that loan losses should be recognised once they have been incurred.

9.5. For impairment provisions, there are two key areas of judgement:

(1) first, determining whether or not a loss event has occurred; and

(2) second, assuming that a loss event has occurred, estimating the size of the resulting loss.

9.6. An impairment provision has an impact on both:

(1) a firm's profit and loss figures – as the impairment charge appears as an expense, reducing the firm's net income; and

(2) a firm's capital position – as the impairment charge is a reduction in the value of the firm's assets, a corresponding reduction in capital is required.

9.7. Therefore, understating or overstating provisions can have a material effect on a firm's profitability and capital.

<u>Impairment budgets and forecasts</u>

9.8. In trying to predict the performance of a lending business, it is crucial to try and produce an accurate assessment of the likely level of impairment losses the business will incur and the corresponding impact on the firm's capital position.

9.9. At Co-op Bank, the CABB Division would:

(1) produce an initial annual budget for impairment provisions in the November of the prior year; and

(2) produce periodic reforecasts of the impairment position throughout the financial year at monthly intervals. The most important of these were the 3+9 forecast (a forecast that took into account the actual result for the first three months of the year and then forecast the result for the remaining nine months), the 6+6 forecast and the 9+3 forecast, all of which reforecasts were presented to Co-op Bank's Board.

9.10. Co-op Bank had no set approach or policy to producing impairment budgets or forecasts during the Relevant Period. The exact approach varied each year throughout the Relevant Period but often involved Finance, Risk and CABB.

9.11. Mr Alderson was responsible for recommending the proposed impairment budget for his Division to Co-op Bank's Board, and for approving impairment forecasts.

9.12. There are inherent difficulties in trying to accurately predict what the level of impairments may be given the uncertainties involved in the market generally and the impact of unpredictable events on individual borrowers. However, from late-2010 until the end of 2012, Co-op Bank repeatedly set over-optimistic budgets and forecasts for impairments. This meant that the budgets and forecasts for impairments were significantly lower than the impairment provisions that were ultimately recognised by Co-op Bank.

9.13. This can be seen by comparing the budgeted and forecasted impairment figures to the actual impairment figures in 2011 and 2012:

Year	Budget / forecast	Budgeted or forecast impairments (cumulative and net of FVA)	Actual impairments (net of FVA)
2011	Initial	£20m	£87m
	3+9	£30m	
	6+6	£30m	
	9+3	£40m	
2012	Initial	£30m	£427m
	3+9	£84.0m	
	6+6	£107.0m	
	9+3	£109.3m	

9.14. The level of over-optimism was not only apparent with hindsight. Throughout the Relevant Period, a number of individuals in the Finance and Risk functions at Co-op Bank raised concerns that the budgets or forecasts for provisions were set too low. In addition, although the 2011 budget was inadequate, as actual impairments significantly exceeded the initial and revised budgets, this was not adequately taken into account when the 2012 budget was set. Mr Alderson reported to the Board in early 2012 that the 2012 budget (set three months previously) was inadequate in respect of impairments.

9.15. There appear to be various reasons why impairment budgets and forecasts were significantly lower than the impairment charges ultimately recognised for 2011 and 2012:

(1) the initial budgets for both 2011 and 2012 were set without sufficient involvement of the team which managed the highest risk cases, the second line Intensive Care Team, and which therefore was best-placed to opine on the likely level of impairments;

(2) when the second line team was consulted on the likely level of provisions, on occasion the figures proposed were challenged, including by Mr Alderson, as set out at paragraph 9.2 above;

(3) greater than expected deterioration in the real estate market and the financial impact on Co-op Bank's customers; and

(4) changes to the impairment provisioning methodology in December 2012 following an industry wide FSA letter addressing the adequacy of banks' impairment provisioning processes which led to significant provisions being raised by Co-op Bank.

9.16. The pressure at the Firm to deliver the budgeted and forecast figures made it much more difficult for Co-op Bank to raise appropriate provisions.

<u>Actual impairment provisions</u>

9.17. During the Relevant Period, Co-op Bank took an optimistic approach to actual impairment provisions that did not reflect Co-op Bank's cautious risk appetite and prudent bank management more generally. In particular, during this period raising provisions in a timely way was made more difficult by the pressure at the Firm to ensure that budgets and forecasts were met.

Setting impairment provisions

9.18. On certain occasions where impairment budgets or forecasts were at risk of being exceeded, Mr Alderson challenged figures that were proposed to him for impairment provisions. The PRA accepts that Mr Alderson did not intentionally place any member of Co-op Bank's staff under pressure to modify impairment figures in a way which was improper. However, on some occasions where such challenges were made, a more optimistic view on the impairment position was ultimately taken than would have been the case absent the challenge.

9.19. An example of this occurred during the final four months of 2012, when Co-op Bank was determined to deliver profits matching those it had forecast to the Co-op Group in July 2012. During this period, on two occasions, Mr Alderson raised a challenge as to whether impairment charges could be kept in line with previous forecasts by reducing proposed impairment provisions.

9.20. Discussions about the final total provisions for 2012 continued, until Co-op Bank received a letter from the FSA on loan loss provisioning on 21 December 2012. For the 2011 interim and year-end financial statements, Co-op Bank's auditor approved the Firm's corporate impairments as being within the tolerable range. It categorised the Firm's prudence as being one step towards the optimistic end of the scale (5 (optimistic) out of 7).[12] The letter from the FSA resulted in Co-op Bank revising its approach to provisioning in Q1 2013, and significantly increasing impairment provisions for 2012, which were published in Co-op Bank's accounts in March 2013.

9.21. The pressure to achieve budgets and forecasts also meant that in some cases, more junior staff would take an optimistic view of distressed loans, which could result in delayed escalation to senior management.

9.22. In addition, the optimistic nature of the budgets, forecasts and provisions in relation to impairments for the Britannia Corporate Loan Book had a significant impact on Co-op Bank's capital planning.

[12] This formed part of a prudence scale which started at 1 (most prudent) and ended at 7 (most optimistic), with a score of 1 or 7 being seen by the auditors as unacceptable and 4 as being balanced.

Annex B

1. BREACHES AND FAILINGS

Breach of Principle 3 by Co-op Bank

1.1. Principle 3 states that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

1.2. During the period between 22 July 2009 and 31 December 2013, Co-op Bank breached Principle 3. This is because:

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

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

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

(ii). having set a risk appetite which was "cautious", Co-op Bank failed to manage its finances and capital in line with that appetite. This meant that the Firm neither adequately considered the level of risk which it assumed, nor had in place commensurate risk management capability. Examples of approaches which were not consistent with a cautious risk appetite included the Firm's decisions on Fair Value Adjustment and impairment on the Corporate Loan Book and accounting/capital treatment for the Leek Notes[13] and Finacle[14];

[13] Leek Notes were a series of securitisations which Britannia sponsored to raise funding.

[14] Finacle was an IT software platform which Co-op Bank was developing to replace its legacy banking IT systems.

(iii). Co-op Bank failed adequately to identify and manage the risks associated with the Corporate Loan Book and to formulate and communicate a clear and comprehensive strategy for the management of that book until early-2013;

(iv). Co-op Bank frequently overrode its own systems and controls when making decisions in relation to the Corporate Loan Book. For example, it failed to carry out regular valuations on security held, as prescribed by its internal policy, and routinely relied on exemptions to its KCC; and

(v). a number of key issues were not brought adequately to the attention of the Board on a timely basis, or at all. For example, Co-op Bank changed the assumption in its business plan in relation to the Leek Notes (which had significant implications for its capital outlook and market reputation) but the Board was not consulted on this decision prior to it being made.

(b) the second line of defence did not provide proper independent challenge. It was poorly structured and under-resourced. In particular, its structure was fragmented and, in some cases, the first and second line roles were blurred. For example, in relation to corporate lending and capital management, second line staff took responsibility for processes which should have been conducted within the first line, resulting in a lack of independent challenge;

(c) the third line of defence did not focus sufficiently on the high-risk areas of the Firm and when it did, it did not pick up on the key issues which it should reasonably have been expected to identify; and

(d) given the significant shortcomings in the control framework, there was an even greater need for an appropriate culture within Co-op Bank in order to manage risk in a manner consistent with its risk appetite and prudent bank management more generally. However, Co-op Bank had a culture which encouraged prioritising the short-term financial position of the Firm at the cost of taking prudent and sustainable actions for the longer-term.

(2) Co-op Bank did not have adequate risk management framework policies or adequate policies and procedures in relation to corporate

lending and capital management. Although the Firm, from mid-2012 onwards, took steps towards improving its risk management framework, including engagement of an external consultancy firm to assist in defining a revised framework, it was only towards the end of the period of the breach, when new senior management had been appointed, that Co-op Bank began properly to address concerns around its risk management framework structures and policies and procedures around corporate lending and capital management.

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

1.3. The PRA published a Final Notice explaining these failings in more detail on 11 August 2015.

Statement of Principle 6

1.4. Statement of Principle 6 states that an approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function.

1.5. Mr Alderson breached Statement of Principle 6 and was knowingly concerned in certain, but not all, aspects of Co-op Bank's breach of Principle 3 as follows:

(1) in relation to the assessment and escalation and of risks posed by the Britannia Corporate Loan Book:

a) between 1 August 2009 and 13 May 2013, by failing to take reasonable steps to ensure Co-op Bank adequately assessed the risks across the Britannia Corporate Loan Book holistically; and

b) between 1 August 2009 and January 2011, by not escalating specific risks inherent in the Britannia Corporate Loan Book sufficiently clearly to Co-op Bank's formal risk management forums and the Executive. As a result, Co-op Bank's governance forums could not properly consider these risks or the appropriate action to mitigate them.

These failings form part of the breach of Statement of Principle 6 and Mr Alderson was also knowingly concerned in certain, but not all, aspects of Co-op Bank's breach of Principle 3 as set out in paragraph 1.2(1).

(2) in relation to the strategy for the Corporate Loan Book between 1 August 2009 and 13 May 2013, by:

a) failing to adequately implement the "manage and hold" strategy for the Corporate Loan Book, by failing to properly identify sufficiently clear and specific objectives, timescales or metrics against which Co-op Bank could assess the strategy for managing the Corporate Loan Book as a whole (rather than on an individual basis); and

b) failing to act in a timely manner in exploring options for a different strategy for the non-core part of the Corporate Loan Book and failing to take reasonable steps to ensure that an appropriate governance framework was put in place to make decisions on the possible disposal of certain of these assets.

These failings form part of the breach of Statement of Principle 6 and Mr Alderson was also knowingly concerned in certain, but not all, aspects of Co-op Bank's breach of Principle 3 as set out in paragraph 1.2(1).

(3) between 1 August 2009 and 13 May 2013, by failing to take reasonable steps to ensure that the CABB Division, as the first line of defence, took an adequate approach to the management of risk, including in relation to the identification and management of distressed accounts and compliance with policies and procedures on collateral valuations and KCC. This failing forms part of the breach of Statement of Principle 6 and Mr Alderson was also knowingly concerned in certain, but not all,

aspects of Co-op Bank's breach of Principle 3 as set out in paragraph 1.2(1);

(4) between 1 August 2009 and 13 May 2013, by failing to take reasonable steps to ensure that the available management information was sufficient to monitor compliance with systems and controls. This failing forms part of the breach of Statement of Principle 6 and Mr Alderson was also knowingly concerned in certain, but not all, aspects of Co-op Bank's breach of Principle 3 as set out in paragraph 1.2(3); and

(5) during the Relevant Period Co-op Bank had a culture which encouraged prioritising the short-term financial position of the Firm at the cost of taking prudent and sustainable actions for the longer-term. This was not consistent with Co-op Bank's cautious risk appetite and prudent bank management generally. This resulted in an environment in which some staff felt under pressure to meet impairment forecasts that had previously been set. In the CABB Division, this meant that optimistic decisions were made on impairment budgets, forecasts and provisions. Mr Alderson placed emphasis upon previous forecasts in the process of setting subsequent forecasts for impairments. He did not always ensure that impairment budgets and forecasts were set solely by reference to an assessment of the risks within the Corporate Loan Book. On certain occasions where impairment budgets or forecasts were at risk of being exceeded, Mr Alderson challenged figures that were proposed to him for impairment forecasts or provisions. The PRA accepts that Mr Alderson did not intentionally place any member of Co-op Bank's staff under pressure to modify impairment figures in a way which was improper. However, on some occasions where such challenges were made, a more optimistic view on the impairment position was ultimately taken than would have been the case absent the challenge. This failing forms part of the breach of Statement of Principle 6 and Mr Alderson was also knowingly concerned in certain, but not all, aspects of Co-op Bank's breach of Principle 3 as set out in paragraph 1.2(1).

Annex C

SANCTION

1.1. The PRA has considered the disciplinary and other options available to it and has concluded that a financial penalty and a prohibition are the appropriate sanctions in the circumstances of this particular case.

Financial penalty

1.2. The breaches of Statement of Principle 6, and Mr Alderson's knowingly-concerned involvement in certain, but not all, aspects of Co-op Bank's breach of Principle 3 occurred from 1 August 2009 to 13 May 2013. The PRA took over prudential regulation of Co-op Bank from the FSA on 1 April 2013. As the breaches continued after 1 April 2013, pursuant to article 11(6)(b) of the Financial Services Act 2012 (Transitional Provisions) (Enforcement) Order (SI 2013/441), the PRA must apply its penalty regime set out in the PRA's Penalty Policy.

Step 1: disgorgement

1.3. Pursuant to paragraph 17 of the PRA Penalty Policy, at Step 1 the PRA seeks to deprive an individual of any economic benefits derived from or attributable to the breach of its requirements, where it is practicable to ascertain and quantify them.

1.4. There is no evidence to suggest that Mr Alderson derived any financial benefit directly from the breaches. The PRA therefore has decided not to disgorge any sum from Mr Alderson.

1.5. The Step 1 figure is therefore **£0**.

Step 2: seriousness of the breach

<u>Relevant revenue</u>

1.6. Pursuant to paragraph 18 of the PRA Penalty Policy, at Step 2 the PRA determines a starting point figure for a punitive penalty having regard to the seriousness of the breach by the relevant individual, including any threat or potential threat it posed or continues to pose to the advancement of the PRA's statutory objectives. Pursuant to paragraph 20 of the PRA Penalty Policy, the PRA will ordinarily determine a figure at Step 2 based on the individual's annual income. "Annual income" means the gross amount of all benefits, including any deferred benefits received by the individual from the employment in connection with which the breach of the PRA's requirements occurred. The PRA calculates an individual's annual income during the tax year preceding the date when the breach ended ("relevant income").

1.7. In this instance, the breach ended on 13 May 2013. Therefore, the tax year preceding this date is from 6 April 2012 to 5 April 2013 ("the 2012-13 tax year").

1.8. The PRA considers Mr Alderson's relevant income to be **£423,288**.

Step 2 factors

1.9. Pursuant to paragraph 20(d) of the PRA Penalty Policy, the PRA will apply an appropriate percentage rate to the individual's relevant income to produce a figure at Step 2 that properly reflects the nature, extent, scale, and gravity of the breach. In determining a percentage rate reflecting the seriousness of the breach, the factors to which the PRA may have regard include, as appropriate, the factors set out at paragraph 21 of the PRA Penalty Policy.

1.10. The PRA considers the percentage rate applied to Mr Alderson's relevant income should be **30%**, for the following reasons:

(1) Mr Alderson was a very senior individual, who had overall responsibility for CABB from 1 October 2010;

(2) Mr Alderson was responsible for a major division that made up approximately a quarter of Co-op Bank's total assets;

(3) Mr Alderson's misconduct occurred over a long period of time, spanning almost four years;

(4) Mr Alderson's failings were serious. They had the clear potential to impact on the safety and soundness of the Firm. Due in part to the failings themselves, it is not possible to determine whether the capital shortfall at Co-op Bank could have been avoided. Had Mr Alderson ensured that the CABB Division, as the first line of defence, had an adequate focus on risk; assessed and more effectively escalated the risks arising from the Britannia Corporate Loan Book; put in place

proper systems and controls in the CABB Division; implemented the strategy for the Corporate Loan Book; ensured that management information was sufficient to monitor compliance with systems and controls; ensured that there was an appropriate culture within CABB, and that impairment decisions were consistent with Co-op Bank's cautious risk appetite, this may have increased the prospects of the Firm dealing with the issues that it faced more effectively and in a more timely manner; and

(5) Mr Alderson did not deliberately or recklessly breach regulatory provisions and no findings of dishonesty or lack of integrity are being made in relation to him.

1.11. Therefore, the Step 2 figure is **30%** of **£423,288** = **£126,986**.

Step 3: mitigating and aggravating factors

1.12. Pursuant to paragraph 24 of the PRA Penalty Policy, the PRA may increase or decrease the starting point figure for a punitive penalty determined at Step 2 (excluding any amount to be disgorged pursuant to Step 1, which is not applicable in this instance) to take account of any factors which may aggravate or mitigate the breach or other factors which may be relevant to the breach or the appropriate level of penalty in respect of it. The factors that may aggravate or mitigate the breach include those set out at paragraphs 25 and 26 of the PRA Penalty Policy.

1.13. The PRA considers that the following factors are relevant:

(1) Mr Alderson is co-operating with the investigation as the PRA would expect (PRA Penalty Policy, para 25(c));

(2) Mr Alderson has no previous disciplinary or compliance record with the PRA or FCA (PRA Penalty Policy, para 25(e));

(3) Mr Alderson's breach took place during a period when the banking industry was under some considerable pressure (which ultimately led to the collapse of a number of well-known financial institutions). Mr Alderson should have had a greater focus on the need for a more robust approach to Co-op Bank's control framework in this environment; and

(4) Mr Alderson's breach took place during a period when he was extremely stretched as a result of significant other responsibilities that he was undertaking for Co-op Bank.

1.14. The PRA does not consider that, in the circumstances, these factors are sufficient to justify any adjustment to the Step 2 figure.

1.15. Therefore the Step 3 figure is **£126,986**.

Step 4: adjustment for deterrence

1.16. Pursuant to paragraph 27 of the PRA Penalty Policy, if the PRA considers the penalty determined following Steps 2 and 3 is insufficient effectively to deter the person who committed the breach and/or others who are subject to the PRA's regulatory requirements from committing similar or other breaches, it may increase the penalty at Step 4 by making an appropriate adjustment to it.

1.17. The PRA does not consider an adjustment for deterrence is appropriate in this instance. The Step 4 figure is, therefore, **£126,986**.

Step 5: settlement discount – application of any applicable reductions for early settlement or serious financial hardship

1.18. Pursuant to paragraph 29 of the PRA Penalty Policy, the PRA and the individual on whom a penalty is to be imposed may seek to agree the amount of the penalty and any other appropriate settlement terms. The PRA Settlement Policy provides that the amount of the penalty which would otherwise have been payable may, subject to the stage at which a binding settlement agreement is reached, be reduced. Paragraph 26 of the PRA Settlement Policy provides that where the PRA proposes to impose a financial penalty under the Act and a proposed settlement agreement is negotiated by the parties, approved by the PRA's settlement decision makers and concluded, the person concerned will be entitled to a reduction in the amount of the financial penalty (as set out at paragraph 28 of the PRA Settlement Policy).

1.19. As the PRA and Mr Alderson reached an agreement at an early stage of the PRA's investigation, a 30% discount therefore applies to the Step 4 figure.

1.20. The Step 5 figure would therefore be **£88,890**.

Conclusion

1.21. The PRA therefore considers it appropriate to impose on Mr Alderson a financial penalty of **£126,986** (before the Stage 1 discount) reduced to **£88,890** (after Stage 1 discount) for his breaches of Statement of Principle 6 and his knowingly-concerned involvement in certain, but not all, aspects of Co-op Bank's breaches of Principle 3.

Prohibition

1.22. Pursuant to paragraph 35 of the PRA Penalty Policy, the PRA may, in addition to imposing a penalty, make a prohibition order under section 56 of the Act. Such an action reflects the PRA's assessment of the individual's fitness to perform regulated activity or suitability for a particular role and does not affect its assessment of the appropriate penalty in relation to a breach of its requirements.

1.23. Under section 56 of the Act, the PRA may make a prohibition order if it appears to it that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by a PRA-authorised person or a person who is an exempt person in relation to a PRA-regulated activity carried on by the person.

1.24. The Act does not prescribe the matters which the PRA should take into account when determining fitness and propriety for the purposes of making a prohibition order. When considering whether a person is fit and proper in this context, the PRA may, amongst other things, take account of any matter to which it may have regard under section 60 when an application for approval is made. In deciding on an application for approval, section 61 of the Act permits the PRA to have regard to the qualifications, training, competence and personal characteristics of the applicant.

1.25. Under FIT 1.3.1 G, the most important considerations in such assessment are the person's: (1) honesty, integrity and reputation; (2) competence and capability; and (3) financial soundness. When determining a person's competence and capability, FIT 2.2.1A G explains that the PRA will have regard to all relevant matters including, but not limited to, whether the person has demonstrated by experience and training that the person is suitable, or will be suitable if approved, to perform the controlled function. In relation to Mr Alderson, the PRA has reflected on this guidance, and taken account also of guidance previously set out in the FSA Handbook, and from 1 April 2013, the PRA Handbook, which was in effect during the Relevant Period.

1.26. Mr Alderson breached Statement of Principle 6 and was knowingly concerned in certain, but not all, aspects of Co-op Bank's breach of Principle 3. The gravity of Mr Alderson's breaches, as described in paragraph 1.10 of Annex C above, mean that he is not a fit and proper person to carry out a significant influence function, in relation to a regulated activity carried on by a PRA-authorised person, or a person who is an exempt person in relation to a PRA-regulated activity carried on by the person, as a result of his lack of competence and capability.

1.27. Accordingly, it is appropriate for the PRA to make an order, pursuant to section 56 of the Act, prohibiting Mr Alderson from performing any significant influence function in relation to a regulated activity carried on by a PRA-authorised person, or a person who is an exempt person in relation to a PRA-regulated activity carried on by the person on the grounds that Mr Alderson is not a fit and proper person to perform such functions.

Annex D

PROCEDURAL MATTERS

Decision maker

1.1. The settlement decision makers made the decision which gave rise to the obligation to give this Notice.

1.2. This Final Notice is given under sections 57 and 67 of the Act and in accordance with section 390 of the Act. The following statutory rights are important.

Manner of and time for Payment

1.3. The financial penalty must be paid in full by Mr Alderson to the PRA by no later than 28 January 2016, 14 days from the date of the Final Notice.

If the financial penalty is not paid

1.4. If all or any part of the financial penalty is outstanding on 29 January 2016, the PRA may recover the outstanding amount as a debt owed by Mr Alderson and due to the PRA.

Publicity

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

PRA contacts

1.6. For more information concerning this matter generally, contact Robert Dedman at the PRA (tel: 020 7601 4444).

APPENDIX 1

DEFINITIONS

The definitions below are used in this Final Notice:

1.1. "the Act" means the Financial Services and Markets Act 2000;

1.2. "Britannia" means the Britannia Building Society;

1.3. "CABB" means Corporate and Business Banking, the division of Co-op Bank led by Mr Alderson during the Relevant Period, also known as "Corporate";

1.4. "CAM" means Corporate and Markets;

1.5. "Close Care Team" means the first line team that managed distressed cases;

1.6. "Common Equity Tier 1 Capital" means the sum of: common shares that meet the criteria for classification as common shares for regulatory purposes and which meet the criteria for inclusion in CET1 capital, stock surplus (share premium), retained earnings, accumulated other comprehensive income and other disclosed reserves and regulatory adjustments applied in the calculation of CET1;

1.7. "Co-op Bank" means The Co-operative Bank PLC;

1.8. "the Co-op Group" means The Co-operative Group, the mutual society that operates a diverse range of businesses;

1.9. "Corporate" means the Corporate Banking division of Co-op Bank, also known as "CABB";

1.10. "Corporate Loan Book" means the corporate and commercial loan book overseen by the Corporate and Markets (CAM)/Corporate and Business Banking (CABB) directorates of Co-op Bank;

1.11. "Corporate Business Support" means the second line Risk division which included the Intensive Care Team and the recoveries team;

1.12. "CRE" means Commercial Real Estate;

1.13. "Credit Underwriting" means the team responsible for credit control and monitoring of performing Corporate loans;

1.14. "Exposures Committee" means the committee of Co-op Bank formed of non-executive directors and responsible for, amongst other things, reviewing and approving management actions on large Corporate loans and considering the overall risk profile of the bank's counterparty exposures;

1.15. "the FCA" means the body corporate known as the Financial Conduct Authority;

1.16. "Finance" means the Finance function of Co-op Bank;

1.17. "the FSA" means the body known until 1 April 2013 as the Financial Services Authority;

1.18. "FVA" means Fair Value Adjustment –a merger-related adjustment which brought the book value of an asset or liability in line with the notional price that market participants would pay or receive in an orderly transaction as at the merger date, or 1 August 2009 in this case;

1.19. "Intensive Care Team" means that second line team that was part of Corporate Business Support and managed problematic cases;

1.20. "KCC" means Key Credit Criteria;

1.21. "LCO" means Legal Cutover – being the date on which the FCA and PRA came into existence i.e. 1 April 2013;

1.22. "LME" means Liability Management Exercise;

1.23. "Platform" means Britannia's intermediary business for mortgages and loans;

1.24. "the PRA" means the body known as the Prudential Regulation Authority;

1.25. "the PRA's Penalty Policy" means "The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure April 2013 – Appendix 2 – Statement of the PRA's policy on the imposition and amount of financial penalties under the Act";

1.26. "Principle" means a principle of the FSA's or PRA's Principles for Businesses;

1.27. "the Relevant Period" means the period between 1 August 2009 and 13 May 2013;

1.28. "Risk" means Co-op Bank's second line Risk function;

1.29. "RSL" means Residential Social Landlord;

1.30. "Statement of Principle 6" means the statement of principle 6 of the Statements of Principle and Code of Practice for Approved Persons;

1.31. "the Transitional Provisions Order" means the Financial Services Act 2012 (Transitional Provisions) (Enforcement) Order 2013;

1.32. "the Tribunal" means the Upper Tribunal (Tax and Chancery Chamber);

1.33. "UEL" means useful economic life – a measurement of the life of an asset; and

1.34. "Verde" or "Project Verde" is the name used within Co-op Bank to describe the proposed acquisition of 632 branches of the Lloyds Banking Group.

APPENDIX 2

RELEVANT STATUTORY AND REGULATORY PROVISIONS

RELEVANT STATUTORY PROVISIONS

1.1. The PRA's general objective, set out in section 2B(2) of the Act, is promoting the safety and soundness of PRA-authorised persons. Section 2B(3) of the Act provides that the PRA's general objective is to be advanced primarily by (a) seeking to ensure that the business of PRA-authorised persons is carried on in a way which avoids any adverse effect on the stability of the UK financial system, and (b) seeking to minimise the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system.

1.2. Section 66 of the Act provides that the PRA may take action against a person if it appears to the PRA that he is guilty of misconduct and the PRA is satisfied that it is appropriate in all the circumstances to take action against him. A person is guilty of misconduct if, while an approved person, he has failed to comply with a statement of principle issued under section 64 of the Act, or has been knowingly concerned in a contravention by a relevant authorised person of a relevant requirement imposed on that authorised person.

1.3. Section 56 of the Act provides that the PRA may make an order prohibiting an individual from performing a specified function, any function falling within a specified description or any function, if it appears to the PRA that that individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by a PRA-authorised person or a person who is an exempt person in relation to a PRA-regulated activity carried on by the person. Such an order may relate to a specified regulated activity, any regulated activity falling within a specified description, or all regulated actives.

RELEVANT REGULATORY PROVISIONS

Statements of Principle and Code of Practice for Approved Persons

1.4. The FSA and the PRA's Statements of Principle and Code of Practice for Approved Persons have been issued under section 64 of the Act.

1.5. FSA's Statement of Principle 6 (in force until 31 March 2013) states:

"An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function."

1.6. PRA's Statement of Principle 6 (in force from 1 April 2013) states:

"An approved person performing an accountable function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his accountable function."

1.7. The Code of Practice for Approved Persons sets out descriptions of conduct which, in the opinion of the FSA or the PRA (as applicable), do not comply with a Statement of Principle. It also sets out factors which, in the FSA or the PRA's opinion (as applicable), are to be taken into account in determining whether an approved person's conduct complies with a Statement of Principle.

Principles for Businesses

1.8. The FSA and PRA's Principles for Businesses' ("PRIN") have been issued under section 64 of the Act.

1.9. Principle 3 states:

"A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems."

The Fit and Proper Test for Approved Persons

1.10. The part of the PRA Handbook entitled "The Fit and Proper Test for Approved Persons" ("FIT") sets out the criteria that the PRA will consider when assessing the fitness and propriety of a candidate for a controlled function. FIT is also relevant in assessing the continuing fitness and propriety of an approved person.

1.11. FIT 1.3.1G states that the PRA will have regard to a number of factors when assessing the fitness and propriety of a person. The most important considerations will be the person's honesty, integrity and reputation, competence and capability and financial soundness.

The PRA's policy for exercising its power to impose penalties and make a prohibition order

1.12. The PRA's policy in relation to the imposition and amount of financial penalties and making prohibition orders is set out in the PRA's Penalty Policy.

1.13. The PRA's Penalty Policy states that the PRA may, in addition to imposing a penalty, make a prohibition order under section 56 of the Act and that such action would reflect the PRA's assessment of the individual's fitness to perform a regulated activity or suitability for a particular role.