The Co-operative Bank plc

RISK FACTORS

9 May 2014

The following text is proposed to be included in a circular (the "Circular") to Shareholders of the Co-operative Bank plc to be published on or about 9 May 2013 in substantially similar form, subject to various amendments to reflect its context. Relevant defintions can be found in the Annex to this document.

"RISK FACTORS

Shareholders and other prospective investors should carefully consider the factors and risks associated with any investment in the New Ordinary Shares, the Company's business and the financial services industry in the United Kingdom in which the Company operates, together with all the other information contained in the Circular and all information referred to in the Circular, including, in particular, the risks and uncertainties described below.

This section describes the risk factors which are considered by the Company to be material to the Company and the decision to make an investment in the Company. However, these risk factors should not be regarded as a complete and exhaustive statement or explanation of all potential risks and uncertainties which Shareholders and other prospective investors may face when making a decision with respect to any investment in respect of the Company and should be used as guidance only. There may be other risks and uncertainties which are currently not known to the Company or which the Company currently does not consider to be material. Should any of the risks described below, or any other risks or uncertainties occur, this could, individually or cumulatively, have a material adverse effect on the Company's business, operating results, financial condition and/or prospects, including its ability to meet regulatory threshold conditions which, in turn, would be likely to cause the price of the New Ordinary Shares to decline and, as a result, a Shareholder or other prospective investor could lose some or all of its investment. Shareholders should consider carefully whether or not participating in any part of the Placing and Open Offer is suitable for them in the light of the information contained in the Circular and their personal circumstances.

RISKS RELATING TO THE COMPANY AND ITS BUSINESS

A failure to successfully implement or a delay in implementing the Company's strategy may adversely impact the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with its regulatory capital requirements

In November 2013, the Company adopted a four to five year business plan and began to implement a range of measures aimed at improving its financial and operational performance and capital position. These included measures intended to improve its capital position (for example the Recapitalisation Plan which included the Liability Management Exercise); and measures intended to improve its operational performance (for example separating its Non-core Business from its Core Business and refocusing the Core Business on its core relationship with retail and SME banking customers, overseeing a controlled run-off and exit of its Non-core Assets over the medium term, and embarking on a significant cost reduction programme across the Company). Further, the Company has begun to implement steps designed to significantly and urgently re-engineer its operational processes and IT systems for the Core Business.

Since December 2013, the Company's continuing review has identified additional conduct and legal issues which have contributed to the need to further strengthen the Company's capital position by way of the Capital Raising. Whilst the existence of conduct and legal risks was disclosed in the Prospectus, the financial impact of these items, together with the significant costs and tax consequences of separation from the Co-operative Group, mean that the starting capital position of the Company for the four to five year recovery period is weaker than in the plan adopted in November 2013. By way of the Capital Raising, the Company intends to reset this starting point and continue with the execution of its business plan, which remains largely unchanged. The ability of the Company to raise funds through this Capital Raising and other capital raisings is assumed in the business plan.

The Company's strategy was developed in a relatively short timeframe and is in the early stages of implementation, its performance and effectiveness are not yet proven. There is a risk that this strategy may still not sufficiently address the Company's problems or deliver the expected benefits. Many of the risk factors set out in this document could have an impact on the Company's ability to deliver its strategy. The Company does not have a track record of successfully executing large-scale changes and past projects have failed, resulting in large write-offs and/or lost opportunities. The successful execution of the Company's strategy requires the simultaneous execution of a number of complex and overlapping changes, in a manner that seeks not to impact negatively the Company's brand, reputation, customer satisfaction or its relationship with, and ability to retain, its employees. These changes include:

- the finalisation of the separation arrangements between the Company and the Co-operative Group following the Liability Management Exercise;
- significant cost reductions;
- a substantial and urgent re-engineering of its IT platform;
- the reorientation of its distribution network;
- improving revenue in its business in the medium term;
- streamlining its product offering; and
- managing its Non-core Assets in a manner intended to achieve optimal economic outcomes (after taking into consideration capital requirements, liquidity provisions, the nature of the assets and the underlying trends of value of such assets).

In delivering its strategy the Company is reliant on the collective skill, experience and commitment of its Directors, senior management team and persons working for the Company. The Board was strengthened last year through the appointment of Richard Pym as Chairman of the Board, Niall Booker as Chief Executive Officer and others, and the Company intends to strengthen the Board further, particularly in light of the fact that two of the current Directors have indicated to the Board that they will retire at the Company's AGM. Richard Pym has indicated to the Board that, subject to the successful completion of the Capital Raising, he intends to step down from his position as Chairman by the end of 2014. The Senior Independent Director, Dennis Holt, will act as interim Chairman should Richard's successor not be in position at the time he stands down. Should the arrangements for an interim Chairman not be able to be implemented or should there be any delay or failure to recruit a permanent successor, the Board could fail to operate effectively and the governance of the Company could be adversely affected. The Directors and senior managers have a relatively limited track record of working for the Company and have yet to work together for an entire financial year. Notwithstanding recent appointments, a number of further senior appointments are still required to strengthen the Board and the senior management team, and need to be embedded. The failure to recruit or a delay in recruiting suitable members of the Board and senior management team, the loss of one or more members of its executive team, including the Chief Executive Officer, or other members of senior management without finding suitable replacements, or any adverse perception resulting from the recent change to the Company's ownership structure, may delay or impact on the ability of the Company to successfully implement its strategy.

The delivery of the strategy is also dependent on the commitment and ability of persons working for the Company to effectively and appropriately implement and support the numerous changes required by the strategy (including a more performance-based culture), at the same time as implementing both cost reductions and redundancies and the recruitment of skilled persons where the Company lacks or does not have a sufficient number of skilled persons. A failure by the Company to change its culture, (several elements of which were identified as key weaknesses by the Kelly Review), a failure by persons working for the Company to advocate or implement the changes required by the strategy, a deterioration in employee engagement, the loss of skilled and experienced employees, or a failure to attract and retain skilled employees or to do so within the timescales envisaged may negatively impact on the Company's business, operating results, financial condition and prospects. The ability of the Company to retain and recruit skilled and experienced employees is currently negatively impacted by uncertainty as to the impact of the Capital

Raising, the implementation of the business plan on the Company and the media speculation and adverse publicity connected directly or indirectly with either the Company or the Co-operative Group. See the risk factors entitled "*The Company is dependent on its Directors, senior management team and skilled personnel and the loss of one or more Directors or members of senior management or the loss of or failure to recruit and retain skilled personnel may have an adverse effect on the Company's business, operating results, financial condition and prospects and its ability to achieve its strategy*" and "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co-operative values and ethics*" for further information.

The Company may be unable to successfully implement all or part of its strategy or implement it when expected or targeted. The Company has already found that the costs of separation from the Co–operative Group have been significant and the Company may experience further costs or cost increases, delays and other execution problems in implementing its strategy. For example, any significant delay in or failure by the Company to implement the required steps to separate from the Co-operative Group as a result of the Company ceasing to be a wholly owned subsidiary of the Co-operative Group, or failure to complete the Capital Raising, or costs incurred in re-engineering or resulting from a failure to or delay in re-engineering its existing IT platform, may result in a significant delay in delivering planned cost savings and may impact on the Company's ability to achieve its business strategy. The Company has identified that there are significant costs and tax consequences of separation from the Co-operative Group.

The implementation of the Company's strategy has a number of specific risks, including the following:

- The Company's strategy includes leveraging the Company's differentiated brand and commitment to customer satisfaction. Investigations into the Company (such as the recent Kelly Review and certain investigations by the PRA, the FCA, HM Treasury and the Treasury Select Committee), as well as investigations connected with the Company (including the FRC investigation under the Accountancy Scheme) or investigations including criminal proceedings relating to individuals connected or previously connected with the Company, may have a negative impact on the Company's brand and may harm the Company's ability to attract and retain customers. Additionally, media speculation and adverse publicity connected (directly or indirectly) with either the Company or the Co-operative Group may have a negative impact on the Company's brand and its ability to deliver its business plan. Further, the implementation of significant cost reductions, branch closures and redundancies, and the reorientation of the Company's distribution network, may have a negative impact on the Company's brand and levels of customer satisfaction (and may not achieve the targeted cost savings). Recently, the Company has seen its performance fall in an industry satisfaction survey and, if this continues, it may harm the Company's ability to attract and retain customers. Further, actions taken by the Company in the execution of its strategy may inadvertently be, or may be perceived to be, contrary to the principles of the co-operative movement and could negatively impact the Company's brand, business and its relationship with the Co-operative Group. Each of these may, in turn, result in significant retail and business customer attrition. For example, if the negative newsflow continues for a significant period of time, there is a risk that the Company will lose a material number of customers and liability/asset balances to competitors and this may have an adverse impact on cross-sales. If this risk materialises, it may impact the Company's ability to deliver its turnaround plan. The Company may also be unsuccessful in achieving the required shift in customer behaviour towards self-service and digital banking such that the Company may fail to meet its cost saving objectives. Similarly, there is a risk that even if there is such a shift in customer behaviour, customers may choose to purchase their products from competitors. See the risk factor entitled "*The Company will continue to rely on the Co-operative brand*", "*The Company is under intense regulatory scrutiny and expects that environment to continue. The Company is also the subject of multiple regulatory and other investigations and enquiries into events at the Company and circumstances surrounding them and may also be subject to other legal and/or regulatory proceedings*" and "*There is a risk that the Company's ownership structure following the Liability Management Exercise and the Capital Raising may undermine the Company's reputation as being more focused on values and ethics than its competitors. Such a reputation has been a competitive advantage for the Company*" for further information.

- The Company's strategy also includes improving revenue in its Core Business in the medium term through improved pricing of its products, appropriate re-pricing of existing products towards market rates, growing primary account customers in the Company's key market segments, cross-selling products and growing the volume of higher margin unsecured lending. The Company's ability to improve revenue in its Core Business is dependent upon a number of factors, including prevailing macroeconomic conditions (including the level of interest rates), the Company's relative position versus its competitors, the Company's brand and reputation, the acquisition and retention of customers and the ability of persons working for the Company to cross-sell products appropriately. See the risk factors entitled "*The Company's business and financial performance have been and may continue to be affected by general economic conditions in the UK, and adverse developments in the UK or global financial markets could cause the Company's earnings and profitability to decline*", "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co operative values and ethics*", "*The Company will continue to rely on the Co-operative brand*" and "*The Company's earnings and net interest margins have been adversely affected by a number of factors, including a prolonged period of low Bank of England base rates and competition for retail funds, and may continue to be adversely affected for so long as one or more of these factors persist. In addition, regulatory capital shortfall and other recent events impacting the Company may have an adverse effect on the Company's net interest margin*" for further information.

- There is also a risk that the credit rating downgrades of the Company's debt securities in 2013, combined with the Company's capital shortfall, the Company's disappointing financial results for the twelve months ended 31 December 2012 and 2013, the need for and implementation of the Recapitalisation Plan, continuing media reporting and public scrutiny of the same and the circumstances leading thereto, and/or actions by the Shareholders or the Co-operative Group may, individually or cumulatively, over the longer term have a negative impact on the Company's brand and reputation or on the strength of the co-operative movement as a whole. See the risk factors entitled "*The Company will continue to rely on the Co-operative brand*" and "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co-perative values and ethics*" for further information.

- The ability of the Company to raise funds through this Capital Raising and other capital raisings is assumed in the business plan and is one of the factors the PRA will take into account in its current decision to exercise forbearance. Failure to raise funds through the Capital Raising could have a material adverse effect on the Company's regulatory capital position. This would impact upon the actions that the management are able to take to implement the business plan and risk the PRA exercising its wide-ranging powers over the Company. These could include the PRA's power to impose a resolution procedure under the PRA's stabilisation powers. The PRA has noted that one of the factors that it is taking into account in its assessment as to whether the conditions for it being able to exercise its stabilisation powers under the Banking Act are met, is the likelihood of the Company being able to meet the 7 per cent. CET 1 ratio. Media speculation as to the success of the Capital Raising and the impact on the Company if the Capital Raising fails could cause material outflows of current accounts and deposits which further threatens the success of the Company and the business plan (including liquidity issues for the Company and risks relating to the Company's regulatory capital position). See the risk factors entitled "*The Company's business, operating results, financial condition and prospects and/or its ability to implement its strategy may be adversely impacted by it not maintaining adequate regulatory capital, by future changes to its regulatory capital requirements whether as a result of stress tests or otherwise and by changes to PRA expectations, including with respect to current forbearance*" and "*The Company's business is subject to inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail deposits becomes limited and/or becomes more expensive, and this may have an adverse effect on the Company's business, profitability and ability to meet its liabilities as they fall due*" for further information.

- The Company's high cost-to-income ratio continues to impact on its profitability and its capital position and reducing its cost base remains a priority for the Company. This cost reduction will be delivered through actions, such as; (i) the simplification of the Company's product offering, allowing for efficiency gains in the Company's operations and IT functions, (ii) greater levels of self-service through the reorientation of the Company's distribution model towards digital and other self-service channels, (iii) business process re-engineering (both IT and non-IT enabled), which will remove middle and back office costs, (iv) delayering of management, and (v) full integration of Britannia within the Company. These actions may not achieve the intended cost benefits and may not be successful or delivered on time. In addition, the reorientation of the Company's distribution model and its cost reduction programme may negatively impact the Company's customer service, which may result in customer attrition.

- The Company's processes and controls are weak and currently under remediation. The Company needs to urgently and significantly improve and re-engineer its existing IT platform, as the existing infrastructure is unsuitable and inherently fragile. There are also significant concerns around its resilience as the Company's IT disaster recovery plan is not proven. The urgent re-engineering of the Company's IT platform is, therefore, necessary and significant, in terms of scale, complexity and cost. The act of re-engineering the system itself involves a number of risks. Any failure in systems as a result of not mitigating the IT risks, or in the period before this re-engineering is complete (including as a result of any delay in or failure by the Company to deliver the re-engineering of its IT platform), could result in significant additional investment costs, negatively affecting the Company's ability to conduct its business and/or lead to further regulatory scrutiny of the Company, which in turn may negatively impact the Company's business, operating results, financial condition and prospects and strategy. Further, the Company is willing, subject to commercial considerations, to outsource a significant amount of IT requirements to accelerate the remediation plan and manage costs. Reliance on a third party brings further risks. In addition, the Non-core Business and the Core Business also share the same IT platform. As the IT platform is remediated, digitalised and re-engineered in line with the Core Business strategy, the systems may, over time, cease to be suitable for the activities of the Non-core Business and the Non-core Business may, as a consequence, be negatively impacted and/or required to move to alternative IT systems. See the risk factor entitled "*The Company's operations are highly dependent on the proper functioning of IT and communication systems which are currently in need of urgent and extensive remediation. Any significant delay in or failure of the Company to remedy the existing IT platform and re-engineer it to meet the requirements of its business strategy may adversely affect the future operational and financial performance of the business. The Company's disaster recovery plan for this IT infrastructure is not proven, creating a material resilience risk*" for further information.

- The inability of the Company to deleverage its Non-core Assets in a controlled and capital efficient manner may have a negative impact on the Company's business, operating results, financial condition (including its net interest margin) and prospects, its regulatory capital position and its ability to comply with its regulatory capital requirements. In addition, any greater than expected costs or delays in deleveraging the Non-core Assets may divert funding from and adversely impact the longer-term development and growth of the Core Business. Further, the Non-core Business has significant impairment risk, especially given the concentration of the Non-core corporate asset book. See the risk factors entitled "*The inability of the Company to deleverage its Non-core Assets in a controlled and capital efficient manner may have a negative impact on the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with its regulatory capital requirements. Any greater than expected costs or delays in deleveraging the Non-core Assets may divert funding from and adversely impact the growth of the Core Business*" and "*The Company's earnings and net interest margins have been adversely affected by a number of factors, including a prolonged period of low Bank of England base rates and competition for retail funds, and may continue to be adversely affected for so long as one or more of these factors persist. In addition, regulatory capital shortfall and other recent events impacting the Company may have an adverse effect on the Company's net interest margin*" for further information.

- The Company's business and financial performance have been and may continue to be affected by general economic conditions in the UK and adverse developments in the UK or global financial markets could cause the Company's earnings and profitability to decline. High operating costs, credit impairment, higher than expected conduct provisions and one-off costs have significantly impacted on the Company's profitability. The Company expects that it will not be profitable in 2014 or 2015. See the risk factor entitled "*High operating costs, credit impairment, higher than expected conduct provisions and one-off costs have significantly impacted the Company's profitability. The Company expects that it will not be profitable in 2014 or 2015*" for further information.

- The Company's business plan anticipates that the Co-operative Group (via CBG) will make the payments due under the 2014 Commitment Agreement (and any other commitments due to the Company) as they fall due in June 2014 and December 2014. Failure by the Co-operative Group (via CBG) to meet its commitments could materially impact the Company's liability to meet its strategy and business plan. More generally, the total amount owed by the Co-operative Group to the Company exceeds that owed by any other single counterparty and could exceed the Company's risk appetite in the normal course of business. In addition, the failure of the Co-operative Group to provide any other services or functions upon which the Company is dependent would have an adverse affect on the business and operations of the Company. See the risk factor entitled "*The Company is operationally dependent on the Co-operative Group and has significant counterparty exposure to the Co-operative Group. Further deterioration or personal deterioration in the soundness of the Co-operative Group may have a material adverse effect on the Company's business, financial conditions, operating results, reputation and prospects*" for further information.

- Given the relative size of the Company's retail deposit base as compared with other sources of funding, the Company is particularly exposed to liquidity risks caused by any serious loss of confidence by its depositors and customers, which results in unusually high levels of withdrawals. See the risk factor entitled "*The Company's business is subject to inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail deposits becomes limited and/or becomes more expensive, and this may have an adverse effect on the Company's business, profitability and its ability to meet its liabilities as they fall due*" for further information.

- Until the end of 2013, the focus of the Company's management team needed to be on the Liability Management Exercise. During that time, there was less management time to spend implementing the business plan. Focus on the ongoing separation of the Company's business from the Co-operative Group has also diverted management time. Following the Liability Management Exercise, the management was able to give greater attention to "business as usual" matters. However, through this, they have identified additional cost, conduct and operational issues. Dealing with the implications of identifying such issues (e.g. the Capital Raising), as well as the continued separation process, which has proven to be significantly time consuming, costly and complex, has again meant a diversion of management time. Further, the proposed change to the Company's auditors as a result of the recently completed tender process may be disruptive, take up further management time, result in greater operational scrutiny, lead to a reassessment of current accounting practices and increase reputational risk. The Board intends to recommend a change in auditors to the Shareholders at the AGM notwithstanding these potential consequences. See the risk factors entitled "*The Company faces competition in all of the core markets in which it operates. There is a risk that the Company may lose market share to its competition and this could have a material adverse affect on the Company's business, operating results, financial condition and prospects*" for further information.

- The Company may be required to hold more regulatory capital or to take other steps to mitigate risks identified as part of the stress tests of capital adequacy, profitability and capital ratios that the Company and seven other UK banks will submit by June 2014, to the FCA and the PRA for consideration by the fourth quarter of 2014. See the risk factor entitled "*The Company's business, operating results, financial condition and prospects and/or its ability to implement its strategy may be adversely impacted by it not maintaining adequate regulatory capital, by future changes to its regulatory capital requirements whether as a result of stress tests or otherwise and by changes to PRA expectations, including with respect to current forbearance*" for further information.

- The Company is currently not compliant with its capital requirements, including its ICG. Its non-compliance relies on the PRA exercising forbearance in this regard. The PRA has discretion to revisit, change or withdraw that forbearance. If the Company fails to meet its capital requirements including its ICG or fails to maintain capital in excess of 7 per cent. CET 1, there is a risk that the PRA may exercise any of its wide-ranging powers over the Company including imposing a resolution procedure on the Company. See the risk factor entitled "*The Company's business, operating results, financial condition and prospects and/or its ability to implement its strategy may be adversely impacted by it not maintaining adequate regulatory capital, by future changes to its regulatory capital requirements whether as a result of stress tests or otherwise and by changes to PRA expectations, including with respect to current forbearance*" for further information.

The successful development and implementation of the Company's strategy requires difficult, subjective and complex judgements including about a range of factors which are not within the Company's control, e.g. forecasts of economic conditions. Furthermore, the successful implementation of the Company's strategy is contingent upon a range of factors which are beyond the Company's control, including market conditions, the general business environment, regulation (including currently unexpected regulatory change), the activities of its competitors and consumers and the legal and political environment.

High operating costs, credit impairment, higher than expected conduct provisions and one-off costs have significantly impacted the Company's profitability. The Company expects that it will not be profitable in 2014 or 2015

The Company's statutory loss prior to the Liability Management Exercise was £1,275 million (having had a £674 million loss for the year ending 31 December 2012). Although the Liability Management Exercise generated a profit of £688 million, this still resulted in an overall statutory loss of £586 million for the year ending 31 December 2013. This included an operating loss of £507 million. Statutory profits were affected further by provisions of £412 million in respect of conduct, risk and legal issues, £516 million in respect of credit impairment issues (primarily in the Non-core book) and IT write-downs of £148 million. Therefore, although the Company's Core Business remained profitable at an operating level at year end 2013, the Company still incurred a statutory loss of £586 million. The Company expects that it will not be profitable in 2014 or 2015. See the risk factors entitled "*A failure to successfully implement or a delay in implementing the Company's strategy may adversely impact the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with its regulatory capital requirements*" and "*No dividends to be paid in respect of the Ordinary Shares in the near future*" for further information.

The Company's business, operating results, financial condition and prospects and/or its ability to implement its strategy may be adversely impacted by it not maintaining adequate regulatory capital, by future changes to its regulatory capital requirements whether as a result of stress tests or otherwise and by changes to PRA expectations, including with respect to current forbearance

The Company is not currently compliant with its capital requirements, including its ICG, which is the PRA's statement as to the regulatory capital it expects the Company to hold. The Company has discussed with the PRA the Company's recently revised business plan which contemplates that the Company will meet its ICG by the end of the four to five year business plan period. The PRA has acknowledged this plan. The plan also envisages that the Company will raise approximately £400 million of CET 1 capital (by way of the Capital Raising) and £400 million of additional capital not regarded as CET 1 capital during the four to five year business plan period. The Company expects the CET 1 ratio to decline after 2014, before subsequently recovering. As a result the leverage ratio is not expected to be consistently above 3 per cent. until the latter stages of the four to five year business plan.

Whether the Company is able to meet its ICG during the period of the plan will depend on a number of factors, both within and outside the control of the Company, including the Company's ability to implement its business plan, to successfully complete the Recapitalisation Plan or to successfully implement the Capital Raising and changes in regulatory risk appetite and economic and market conditions generally in the UK. See the risk factor entitled "*A failure to successfully implement or a delay in implementing the Company's strategy may adversely impact the Company's business, operating results, financial condition and prospects,*

its regulatory capital position and its ability to comply with its regulatory capital requirements" for further information. While the PRA has acknowledged the Company's plan to meet its ICG, the PRA has the discretion to revisit the Company's ICG and the Company's non-compliance with its ICG. It is not possible to predict with any degree of certainty if, and, therefore, when, the PRA would revisit them and, if so, the nature or extent of any possible changes to the ICG or the PRA's forbearance. Should the Company fail to meet its ICG or its plan to comply with its ICG, it is not possible to predict how the PRA would react. The PRA may, in any such circumstances, at its discretion elect to exercise one or more of its various powers over the Company. This could include a variation of the Company's permissions, restricting the Company's business or, in conjunction with the other Authorities, imposing a resolution procedure on the Company. The PRA has noted that one of the factors that it is taking into account in its assessment as to whether the conditions for it being able to exercise its stabilisation powers under the Banking Act are met, is the likelihood of the Company being able to meet the 7 per cent. CET 1 ratio including the ability of the Company to successfully execute an equity capital raise by the end of May 2014. See the risk factor entitled "*Risk that the Company may become subject to a resolution procedure under the Banking Act*" for further information.

There is a risk that the Company's regulatory capital requirements or PRA expectations and approach with respect to such capital requirements may increase beyond those currently planned for by the Company. For example, on 1 October 2013, the Bank of England published a discussion paper – "*A framework for stress testing the UK banking system*" setting out proposals for annual, concurrent stress tests of the UK banking system. The discussion paper follows the FPC recommendation in March 2013 that "looking to 2014 and beyond, the Bank of England and the PRA should develop proposals for regular stress testing of the UK banking system". The main purpose of the proposed stress testing framework is to provide a quantitative, forward-looking assessment of the capital adequacy of the UK banking system and individual institutions within it. The discussion paper states that the Bank of England expects that the stress testing framework will use a suite of models to translate both common and bespoke scenarios into projections of bank profitability and capital ratios.

The stress testing for 2014 will cover only the eight major UK banks. These banks (including the Company) will be required to submit the results of the analysis to the PRA by 14 July 2014. The outcome of the analysis will be considered by the FPC and PRA during the fourth quarter of 2014, and will be used to inform remedial actions either at a systemic or individual bank level. Reflecting the relatively depressed economic conditions, the Company's risk appetite includes the requirements, to hold sufficient capital to meet a moderate downturn in activity, such as is experienced approximately once in every ten years "one in ten stress". The Company is currently finalising its ICAAP for submission to the PRA in May 2014 and has not yet prepared analysis to demonstrate whether or not the Company's planned capital levels will be sufficient to meet its target ratio under more severe stress scenarios. The key elements of the stress scenario to be used for the PRA's new stress testing regime were published on 29 April 2014. This stress scenario is more severe than the 'one in ten stress' that the Company currently uses to assess the vulnerabilities in its business plan. As a result, it is expected to impact the Company more severely and, consequently, there is a greater possibility that the Company might forecast a breach of the 4.5 per cent. CET1 ratio, although it is not yet possible to predict with any certainty what the output of the 2014 stress testing might be.

The PRA has noted that if "a firm's capital ratio was projected to fall below the 4.5% CET1 ratio in the stress, there is a strong presumption that the PRA would require the firm to take action to strengthen its capital position over a period of time to be agreed between the firm and the PRA. Firms that are already taking action to strengthen their capital position may not be required to take further action if, after considering the results of the stress test, the PRA is satisfied that the measures currently in place are sufficient".

It is important to note that the Company is currently in the process of executing a capital strengthening plan which was recently shared with the PRA. Therefore, in the event that the Company were to forecast a breach of the 4.5 per cent. CET1 ratio after applying the new stresses, the Company does not believe that this would necessarily result in the PRA requiring the Company to raise further capital. However the decision as to whether any additional actions are needed above and beyond the current plan shared with the PRA will reside with the PRA and FPC as part of their analysis conducted in the second half of 2014. As a result of such

stress tests, the Company may be required to hold more regulatory capital, or to take other steps to mitigate risks identified as part of the stress tests.

Accordingly, it is not yet possible to predict with certainty what the outputs of the 2014 stress testing might be or how the PRA might react to them. As a result of these stress tests, the Company may be required to hold more regulatory capital, or to take other steps to mitigate risks identified as part of the stress tests.

There may be future capital calls as a result of regulatory requirements or guidance or as a result of further costs or losses exceeding the Company's estimates and assumptions underlying its business plan contained in its business plan

The Capital Raising is being undertaken in anticipation of current regulatory requirements and the amount being raised is based on certain assumptions being made in the Company's business plan. There is no guarantee that the PRA will not enforce stricter regulatory capital requirements on the Company (whether specifically applicable to the Company or to banks more generally), resulting in a need for the Company to raise further additional equity and/or debt capital. There may be future capital calls as a result of regulatory requirements or guidance, or as a result of further costs or losses or shortfall in revenues exceeding the Company's estimate. The Company may be unable to raise any additional capital it may need on favourable terms, when needed or at all (for example, as an unlisted entity, the Company has limited access to the capital markets and there are situations in which the consent of the Co-operative Group is required for a capital raising). In such cases, the Company may be breaching its regulatory requirements or expectations and, without continuing PRA forbearance, there may be a risk of the PRA exercising any of its wide-ranging powers over the Company, including resolution under the Banking Act.

The Company is operationally dependent on the Co-operative Group and has significant counterparty exposure to the Co-operative Group. Further deterioration or perceived deterioration in the soundness of the Co-operative Group may have a material adverse effect on the Company's business, financial condition, operating results, reputation and prospects

Given the high level of interdependence between the Company and the Co-operative Group, the Company is and will continue to be subject to the risk of deterioration of the commercial and financial soundness or perceived soundness of the Co-operative Group, until recently its parent undertaking and currently its single largest shareholder (through CBG). To the extent that the Co-operative Group is prevented from or is or becomes unable to meet its obligations towards the Company, this could lead to significant operational risks, capital and liquidity requirements.

The Company is dependent upon the Co-operative Group taking a number of actions or decisions in a variety of different capacities, including as a shareholder, debtor, customer and supplier. A number of these actions or decisions could require the approval of the Co-operative Group's board and/or the consent of its banking syndicate. For example, where the Co-operative Group has contractual funding commitments to the Company, the Co-operative Group may need to dispose of certain assets or take other actions to fund its obligations. Given the complex nature of the Co-operative Group's governance structures and banking arrangements it may prove difficult for the Co-operative Group to undertake the actions required to meet these contractual commitments. Further, in the context of the Company's separation from the Co-operative Group, a number of agreements are being negotiated and progress on this has been slow. The Co-operative Group's current (and future) processes of consulting on and implementing any changes in its governance arrangements could serve to prolong the already protracted process.

Having been a member of the Co-operative Group, the Company participates in Pace, a "last-man standing" pension scheme. This means that while the Company continues to participate in Pace, there is a risk that all employers other than the Company (including the Co-operative Group) exit Pace or become insolvent without satisfying their liabilities towards the scheme, with the effect that the Company becomes solely responsible for funding the scheme. The Company's liability could be up to the level of the entire deficit in Pace calculated by reference to the cost of buying out the scheme's liabilities in the insurance market. See

the risk factor entitled "*The contributions that the Company is required to make to its pension schemes may change over time. The Company may be obliged to make large one-off payments to its pension schemes, or pension schemes to which it is connected and/or associated, if certain events occur*" for further information. This may affect the regulatory capital that the Company is required to maintain in respect of its pensions obligation risk.

In its 31 December 2013 annual report, the Co-operative Group reported that it was in a "weakened state" and that its "[group] balance sheet reflect[ed] the recent history of poor results". It further noted that debt "had risen from £0.6 billion from five years ago to £1.4 billion at 4 January 2014". As at 31 December 2013, the Company had a total exposure of approximately £540 million to the Co-operative Group. This exposure exceeds that owed to any other single non-financial institution counter-party and is equivalent to approximately 28 per cent. of the Company's total equity. The majority of the exposure is unsecured and is currently on the Company's internal watch list (with no provision held against it) with actions under review to reduce the exposure if required.

In addition to the above-mentioned funding and counterparty risks:

- approximately £126.6 million (gross £183.5 million less £56.9 million discount) of the Company's exposure to the Co-operative Group (which is unsecured) is contingent upon the Co-operative Group generating sufficient future taxable profits to absorb gross surrendered tax losses of £907 million; and
- The Company is engaged in funding the working capital for CFSMS which is used for expenses and fixed asset purchases, the majority of which are used by the Company. This may result in either a debit or a credit balance on the intercompany recharge account depending on cash requirements and payment cycles. Any amounts owed by CFSMS to the Company are unsecured and no assets historically purchased for the use of the Company, owned by CFSMS, act as legal security.

There are many ways in which the weakened position of the Co-operative Group or a further deterioration or perceived deterioration in the soundness of the Co-operative Group or CFSMS may have a material adverse effect on the Group's business, financial condition, operating results, reputation and prospects. These include:

- the Co-operative Group's ability (via CBG) to fund its 2014 Commitment. See the risk factor entitled "*The ability of CBG and/or the Co-operative Group to fund its 2014 capital commitment is dependent on certain actions, some of which are partially outside the control of the Co-operative Group*";
- failure to distinguish between the Co-operative Group's brand and the Company's brand and reliance upon the "Co-operative" brand. See the risk factors entitled "*The Company will continue to rely on the Co-operative brand*" and "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co-operative values and ethics*";
- failure to protect employee/customer information where, for example, the Company and the Co-operative Group share IT infrastructure. See the risk factor entitled "*Failure to adequately maintain corporate records or to adequately maintain and protect customer and employee information could have a material adverse effect on the Company*";
- exposure to Pace and changes in accounting for Pace. See the risk factors entitled "*Provisions for liabilities in the Company's accounts may not be adequate*" and "*The contributions that the Company is required to make to its pension schemes may change over time. The Company may be obliged to make large one-off payments to its pension schemes, or pension schemes to which it is connected and/or associated, if certain events occur*";
- the process of separation from the Co-operative Group and the complexities surrounding this. See the risk factor entitled "*There are numerous risks associated with the separation of the Company from its former parent, CBG, and its ultimate former parent, the Co-operative Group*". For example:

- if CSFMS were to be financially destabilised there is a risk that assets in CSFMS on which the Company is dependent for its operation would not be accessible to it. See the risk factor entitled "*The Company is dependent on CFSMS to provide key assets and to on-supply certain services, data and assets supplied by third party providers*";
- the possibility that appropriate arms-length and commercial agreements will not be agreed. See the risk factor entitled "*It may not be possible to agree new arrangements between the Company and the Co-operative Group (including CFSMS and CISGIL) following the separation of the Company from the Co-operative Group. Even where arrangements are agreed, the new arrangements may be less favourable to the Company than the existing arrangements*";
- a dependence on the Co-operative Group in relation to its principal establishments. See the risk factor entitled "*The Company does not have any documented right to occupy several of its principal establishments and places of business. The Company's current occupation of some properties is in potential breach of the terms of the lease for that property*"; and
- provisions indemnification and tax on separation. See the risk factor entitled "*Provisions for liabilities in the Company's accounts may not be adequate*".

The ability of CBG and/or the Co-operative Group to fund its 2014 capital commitment is dependent on certain actions, some of which are partially outside the control of the Co-operative Group

As part of the Recapitalisation Plan CBG has a contractual commitment to commit £333 million of CET 1 capital to the Company by the end of 2014. On 4 November 2013 (being the date of the launch of the Recapitalisation Plan), CBG entered into a legally binding and irrevocable Undertaking to Pay in favour of the Company in consideration for the issuance of 54,058,442 Ordinary Shares immediately prior to the completion of the Liability Management Exercise (the "**2014 Commitment Agreement**"). CBG has already paid £70 million of the 2014 Commitment and £263 million remains due to be paid by way of two instalments of £100 million in June 2014 and £163 million in December 2014. This is a key part of the Recapitalisation Plan. If, and to the extent that, for whatever reason, CBG is prevented from, becomes unable to, or does not meet its obligations to pay the remaining £263 million, this could materially impact the Company's ability to meet its strategy and the Recapitalisation Plan.

To provide support to CBG's obligations under the Undertaking to Pay, the Company and CBG entered into a loan with the Co-operative Group (the "**Intra-group Loan**"). The Intra-group Loan allows CBG to draw down sufficient amounts to satisfy the Undertaking to Pay taking into account CBG's existing cash resources. CBG, under the terms of the Intra-group Loan, is obliged to pay any amounts drawn down under that loan from the Co-operative Group to the Company in satisfaction of the Undertaking to Pay.

Given CBG's potential reliance on the Intra-group Loan to fund its obligations under the 2014 Commitment Agreement, CBG may, as a result, be dependent on the ability of the Co-operative Group to satisfy, in turn, its obligations under the Intra-group Loan. There is a risk that the Co-operative Group may not be able to meet its obligations under the Intra-group Loan and that, in turn, CBG may not be able to meet its obligations under the 2014 Commitment Agreement. If the Co-operative Group is relying on a disposal of assets or financing to meet its obligations, there is a risk that these might not be successful – such transactions are by their nature dependent on purchasers and finance providers being willing to enter into the transactions which, in turn, are dependent on market conditions at the time of the transactions. Furthermore, it is possible that the Co-operative Group's current process of consulting on, and implementing any changes in, its governance arrangements (including any resulting changes in the composition of its board and/or executive team) or any adverse findings of the various investigations underway may affect the decision-making process in the short or longer term and may impact on the actions required to generate the cash necessary to allow CBG to make the 2014 Commitment payments. As a result of such dependencies, it is possible that CBG may be unable to successfully draw down under the Intra-group Loan in the envisaged manner if the Co-operative Group has insufficient funds to comply with its funding obligations under the loan.

If CBG defaults on its obligations under the 2014 Commitment Agreement, for whatever reason, the Company may be able to exercise certain rights under the 2014 Commitment Agreement and/or to take legal action against CBG to recover any amounts owed. The Company may fail to recover some or all of such amounts in such circumstances. This would adversely impact its regulatory capital position as the Ordinary Shares which have been issued under the 2014 Commitment Agreement do not constitute CET 1 capital until the Undertaking to Pay in respect of them has been satisfied. Should CBG default on, or delay its outstanding Undertaking to Pay, it is likely that the Company will have a further significant shortfall in its CET 1 capital and will be in breach of the PRA capital requirement that the Company raise an additional £1.5 billion of CET 1 capital by the end of 2014. Possible consequences of breach include the PRA exercising any of its wide-ranging powers over the Company, including resolution under the Banking Act. See the risk factor entitled "*Risk that the Company may become subject to a resolution procedure under the Banking Act*" for further information.

Future legislative and regulatory changes could impose operational restrictions on the Company, increase the Company's costs and/or capital requirements and/or otherwise materially adversely affect its business, operating results, financial condition and prospects

Future changes in regulation, fiscal or other policies are unpredictable, beyond the Company's control and could materially adversely affect its business or operations. Regulators and other bodies in the UK and worldwide have produced a range of proposals for future legislative and regulatory changes which could impose operational restrictions on the Company, cause the Company to raise further capital, increase the Company's expenses and/or otherwise adversely affect its business, operating results, financial condition and prospects. These include, amongst others:

- several elements of the Basel III (and related CRD IV/CRR) package of reforms which remain subject to ongoing review, potential adjustment and uncertainty as to their application within the UK generally and to the Company specifically. These include:
    - consultation by the Basel Committee in March 2013 on the measurement of and limits on large exposures;
    - prospective allocation of capital surcharges to G-SIBs from 2016 with uncertainty as to if and how this will be rolled-out to banks of national importance (D-SIBs);
    - application of a systemic risk buffer that Member States can apply to all, or a subset, of banks;
    - in relation to the Liquidity Coverage Ratio ("**LCR**"), a request by the FPC to the PRA to consider whether additional liquidity requirements are needed to supplement the LCR;
    - ongoing work in relation to the net stable funding ratio, requiring firms to retain sufficient stable deposits, which is subject to an observation period until 2016 and will then be finalised and binding from 2018; and
    - the leverage ratio which, although it is already being reported, will not be finalised and become a part of Pillar 1 Requirements until January 2018. The Basel Committee will continue to assess the appropriateness of the 3 per cent. ratio and its calculation methodology with the most recent amendments announced in January 2014;
- in July 2013, the Basel Committee published an analysis of risk-weighted assets for credit risk in the banking book. This, in addition to a consultation paper in October 2013 in relation to a fundamental review of the trading book (where proposals are more fully formed), may result in restrictions to the extent to which model-based approaches can be utilised, e.g. through the introduction of benchmarks of minimum parameters;
- an increasing focus of regulators (at a global/European and UK level) is data quality and reporting. In January 2013, the Basel Committee published fourteen principles on the aggregation and reporting of risk data. These are to be applied to G-SIBs by 2016. In the future they will also apply to D-SIBs

which will be required to implement the principles three years after designation by their national supervisors as such;

- measures contained in the Financial Services (Banking Reform) Act 2013 (the "**Banking Reform Act**"). These include provisions that allow HM Treasury to implement the main reforms recommended by the UK Independent Commission on Banking including but not limited to:
  - ring-fencing domestic retail banking services of UK banks;
  - increasing UK banks' and building societies' primary loss-absorbing capacity (including by way of bail-in bonds); and
  - increasing the ranking of insured depositors on a winding-up to tank ahead of all other unsecured creditors.

  The Banking Reform Act also amended the Banking Act 2009 to introduce a bail-in stabilisation option that allows UK bank resolution authorities to impose losses on creditors through bail-in (see the risk factor entitled "*Risk that the Company may become subject to a resolution procedure under the Banking Act*" for further information). In March 2014, HM Treasury began a consultation on the detailed implementation of the new bail-in tool. The UK government plans to implement the bail-in tool by 1 January 2015 and does not plan to take advantage of the option to delay bail-in until 2016, which is the expected date for implementation of the EU Bank Recovery and Resolution Directive. The Company's revised strategy is designed to meet the requirements of the Banking Reform Act by 2016.

- at the EU level, structural reform measures that are similar to some of those contained in the Banking Reform Act are also under consideration, following the report of the Liikanen Group, which was published in October 2012 and the finalisation of the EU Bank Recovery and Resolution Directive in April 2014. The Liikanen report's proposals were heavily influenced by the UK experience, however there remains a risk that any subsequent EU legislation implementing the recommendations in the report may impose requirements which are more onerous than those in the Banking Reform Act or which may not be completely consistent with those in the Banking Reform Act. Furthermore, it is possible that further or different changes will be required to the UK resolution framework beyond those provided for in the Banking Reform Act in order to ensure that the UK regime is fully harmonised with the regime contemplated by the EU Bank Recovery and Resolution Directive. The Company (and, therefore, holders of its securities) may be negatively affected if the EU reforms impose requirements on the Company in excess of those prescribed in the UK;

- also at the EU level, the EU Bank Recovery and Resolution Directive ("**BRRD**"), which requires Member States to ensure that regulatory authorities have, amongst other things, powers to intervene in failing banks. The BRRD also provides for Resolution Authorities to have the power to require institutions and groups to make structural changes to ensure legal and operational separation of "critical functions" from other functions where necessary, or to require institutions to limit or cease existing or proposed activities in certain circumstances. The exercise of these powers may require the Company to change its current structure or operations, having negative consequences for the Company's strategy and causing the Company to incur potentially significant costs. BRRD will be implemented in Member States by 1 January 2015 with bail-in provisions to enter into force by 1 January 2016. The BRRD was adopted on 15 April 2014 by the European Parliament along with Single Resolution Mechanism and Deposit Guarantee Schemes Directives;

- a number of other EU proposals are also currently going through consultation and legislative processes and will create new, amend or update existing Directives and Regulations. These include: the new Mortgage Credit Directive, which was effectively adopted in February 2014 and must be implemented in the UK by March 2016; a new Payment Accounts Directive, which was adopted on 15 April 2014; revisions to the Payment Services Directive; a fourth Money Laundering Directive and a new Wire Transfer Regulation; revisions to the DGSD; revisions to the Insurance Mediation

Directive. MiFID II and a new associated Regulation MiFIR, which were adopted by the European Parliament on 15 April 2014;

- on 1 April 2013, the Financial Services Act 2012 established an independent Financial Policy Committee (FPC) charged with identifying, monitoring and taking action to remove or reduce systemic risk in order to enhance the resilience of the UK financial system. The FPC has direction powers over sectoral capital requirements, which can be set in relation to exposures to specific sectors judged to pose a risk to the financial system as a whole. The FPC further has powers to make recommendations to the PRA and FCA which can direct capital changes (including raising capital requirements above microprudential standards on exposures to specific sectors such as commercial or residential property) in response to macroeconomic conditions;

- on 19 June 2013, the Parliamentary Commission on Banking Standards published its final report – "*Changing banking for good*". This was followed by the publication of the Government's response on 8 July 2013, which accepted the overall conclusions of the report and all of its principal recommendations. Amongst other things, this included proposals for a new banking standards regime governing the conduct of bank staff, the introduction of a criminal offence for reckless misconduct by senior bank staff, and steps to improve competition in the banking sector. Depending on how the Government decides to implement these proposals, they may have a substantial impact on banks in the UK generally, including the Company, and ensuring future compliance with the requirements is likely to cause the Company to incur potentially significant costs; and

- in the UK, the Immigration Bill is currently going through a Parliamentary reporting stage. It is currently anticipated that this will need to be implemented by October 2014 and includes proposals around the control of illegal immigrants' ability to gain access to the UK banking system.

There is also a risk that the recent restructuring of regulatory bodies and, in particular, the creation of multiple regulators in the UK (including the new Payment Systems Regulator) and increasing the role of various European regulatory bodies could lead to a lack of co-ordination and the emergence of inconsistencies between policies of the different regulatory bodies. Any such development could adversely impact the Company's ability to manage its business efficiently and subject it to increased costs as a result of the need to manage an increasingly complex compliance burden.

It is not possible to predict with any certainty the effect that any of the proposed changes listed above will have on the Company's operations, business, financial condition and prospects or how any of the proposals discussed above will be implemented in light of the fundamental changes to the regulatory environment proposed by the Government. Depending on the specific nature of the requirements and how they are enforced, such changes could have a significant impact on the Company's operations, structure, costs and/or capital requirements. Accordingly, implementation of any of the foregoing matters and any other regulatory or legislative changes, that may be proposed, may have a material adverse effect on its business, operating results, financial condition and prospects.

The inability of the Company to deleverage its Non-core Assets in a controlled and capital efficient manner may have a negative impact on the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with its regulatory capital requirements. Any greater than expected costs or delays in deleveraging the Non-core Assets may divert funding from and adversely impact the growth of the Core Business

The Company's Non-core Assets consist of asset classes of the Company which are not consistent with the Company's Core Business strategy. As at 31 December 2013, the Non-core Business had total segment assets of £13,134.4 million constituting 30.27 per cent. of the Company's total assets. The Company's Non-core Assets therefore constitute a significant part of the Company's total assets.

A key part of the Company's overall strategy is a controlled run-off and exit of the Non-core Assets in a manner that seeks to ensure that the anticipated future losses from such run-off and exit do not materially exceed the capital which is released from the reduction in risk weighted assets, and which the Directors believe minimises any adverse impact on the realisation of the Company's Core Business strategy and the

Company's core customers. As part of this process, the Company has reviewed its corporate loan book on an asset-by-asset basis, identified Non-core Assets for run-off and exit and changed the work-out approach on a significant number of such assets. The assets are managed taking into consideration their capital requirements provisioning (both past and future), the nature of any security over the assets, returns, and the ability to improve economic outcomes by proactive management of the assets. Depending on the asset, this may involve the sale or refinancing of the asset or the holding of the asset until maturity. The Company has also adjusted its credit risk management approach and the data upon which impairment assessments are made. These factors, in part, resulted in significant impairment charges of £516 million for the year ended 31 December 2013.

A failure by the Company to deleverage its Non-core Assets in a controlled manner in accordance with its strategy (for example, through greater than currently expected losses from the run-off or sale of Noncore Assets) may negatively impact on the Company's business, operating results, financial condition (including its net interest margin) and prospects as well as its regulatory capital position and its ability to comply with its regulatory capital requirements. The Company may, for example, be unable to exit or run down its Non-core Assets as anticipated due to unfavourable market conditions, lack of appetite from buyers, or because sales take longer to execute than assumed. In addition, the Company may be competing against other financial and other institutions also seeking to exit from their Non-core Assets, in particular given the continuing Europe-wide deleveraging of similar assets, which may impact on secondary market pricing and demand for its Non-core Assets, and the Company may be required to compete on price and ease of execution. In addition, given the period over which the Company will be running off and exiting from its Non-core Assets, the Company is exposed to market conditions, including declines in commercial property values, and other macro-economic factors. See the risk factor entitled "*Worsening economic and market conditions could result in increased commercial property loan losses beyond what the Company has already provided for, which would adversely impact the Company's financial and operational performance*" for further information. The Company may also be required or may decide to exit on short notice and at unfavourable prices for liquidity, funding or other needs.

Notwithstanding the significant impairments already made to the Non-core Assets, the Non-core Business also has significant additional impairment risk given the underlying assets, which includes Optimum, a book of predominantly interest-only intermediary and acquired mortgage book assets valued, as at 31 December 2013, at £6.887 billion ("**Optimum**"). Worsening economic and market conditions and/or increasing interest rates and/or a fall in housing prices could result in the Non-core Assets suffering from greater than expected impairments which would adversely impact on the Company's operating results, financial condition (including a reduction in its net interest margin) and regulatory capital position and its ability to comply with its regulatory capital requirements. See the risk factor entitled "*Worsening economic and market conditions and/or increasing interest rates and/or a fall in house prices could result in increased residential mortgage and unsecured loan losses which would adversely impact the Company's financial and operational performance*" for further information.

The Non-core Business' corporate asset book is relatively concentrated, with the result that a small number of borrowers account for a large proportion of the total loans outstanding. A significant impairment of any of these borrowers would result in a disproportionate impact on the Company's operating results and financial condition. See the risk factor entitled "*A number of the Non-core Asset classes have a small number of borrowers accounting for a large proportion of the total loans outstanding*" for further information).

The failure of the Non-core Business to deleverage its assets in a controlled manner in accordance with its strategy may hinder or restrict the longer-term development and growth of the Core Business' business and divert management attention from the Core Business. For example, it may restrict the ability of the Core Business to grow its existing loan portfolios or to expand its growth of other products, such as unsecured lending. In addition, the Non-core Business is partially funded by retail deposits from the Core Business. Any greater than expected expenses or operating costs or delays in the exiting and running down of the Non-core Assets may require additional funding from the Core Business (and which cannot reasonably be funded from elsewhere), which may divert funding from the Core Business to the Non-core Business and may adversely impact the development and growth of the Core Business.

A number of the Non-core Asset classes have a small number of borrowers accounting for a large proportion of the total loans outstanding

As at 31 December 2013, the Company's Non-core Business gross loans and advances to customers totalled £13.426 billion of exposure, comprising the Optimum mortgage book, commercial real estate, general corporate borrowers, private finance initiative, registered housing associations, energy and local authorities.

The nature of such assets and the complexity of the issues potentially involved require detailed and careful management. The Company may, in appropriate circumstances, decide to increase lending to a borrower in order to better facilitate a more successful exit. The complexity of the risks involved also increases the possibility of not being able to successfully exit or run down such assets. The concentration within certain asset classes also increases the risk that a failure to achieve a timely exit or to achieve an exit in a capital neutral or accretive manner in respect of one or more of such assets will have a greater negative impact on the Company's operating results and financial condition.

The Company faces competition in all of the core markets in which it operates. There is a risk that the Company may lose market share to its competition and this could have a material adverse affect on the Company's business, operating results, financial condition and prospects

Competition in the UK personal financial services market may adversely affect the Company's operations. The Company competes mainly with other providers of personal financial services, including other banks, building societies and insurance companies, and operates in an increasingly competitive UK personal financial services market. Each of the main personal financial services markets in which the Company operates is mature and slow-growing, so that growth requires taking market share from competitors. This places elevated focus on price and service as the key differentiators, each of which carries a cost to the provider. The quality of the Company's products and systems, including distribution and IT, in turn impact on price and service. If the Company is unable to match its competitors in these respects, it risks losing customers to its competitors which may adversely affect its business and prospects and consequently its ability to meet its business plan in the intended four to five year timescale.

The UK market for financial services and the mortgage market in particular have been reshaped by the recent financial crises. Lenders have moved increasingly towards a policy of concentrating on the highest quality customers, judged by credit score and loan-to-value criteria, and there is strong competition for these customers.

Notwithstanding the Funding for Lending Scheme, which other banks appear to have drawn upon rather than pricing up in the retail deposit market, there remains significant competition for retail deposits, which has inevitably impacted lenders' margins. Competition may intensify further in response to consumer demand, technological changes, the impact of consolidation by the Company's competitors, regulatory actions and other factors. If increased competition were to occur as a result of these or other factors, the Company's business, operating results, financial condition and prospects could be materially adversely affected. In particular, the implementation of the Banking Reform Act in the UK between 2015 and 2019, which requires, amongst other things, the separation of retail banking activities from the wholesale and investment banking activities carried on by large banking groups could reduce the distinctiveness of the Company's offering. The Company's revised strategy is designed to meet the requirements of the Banking Reform Act by 2016.

In addition, each of the major UK banks has announced that it will focus on improving its customer service. Recently the Company has seen its performance fall in an industry satisfaction survey. If the Company's customer service levels were perceived to be negatively impacted by the implementation of its strategy (including, as a consequence of the Company's cost reduction programme and the reorientation of its distribution channel, e.g. branch closures), or were perceived by the market to be only in line with, or materially below, those of competitor UK financial institutions, it could lose existing and potential new business. In contrast to the Company, a number of the Company's competitors have recently increased the marketing of their brands and products. Whilst such increased marketing efforts are not specifically directed at the Company, there is a risk that such efforts are successful in attracting customers of the Company to transfer their banking relationship or primary account relationships to the Company's competitors.

If the Company is not successful in retaining and strengthening its core relationship with retail and SME customers, it may lose market share as a result of the targeting of the Company's customers by its competitors or otherwise incur losses on some or all of its activities or fail to attract new deposits or retain existing deposits, which could have a material adverse effect on its business, operating results, financial condition and prospects. In September 2013, a new Current Account Switching Service was launched. This has given rise to increased competition for the Company. Since the introduction of the Current Account Switching Service, the Company has experienced a period of significant incremental advertising spend by its competitors and sustained negative newsflow about the Company, the combination of which has contributed to an increase in the number of accounts switching from the Company. If the negative newsflow continues for a significant period of time, there is the risk that the Company will lose a material number of customers and liability/asset balances to competitors and this may have an adverse impact on cross-sales. If this risk materialises, it may impact the Company's ability to deliver its turnaround plan. See the risk factor entitled "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co-operative values and ethics*" for further information.

There have been significant changes in retail banking distribution models driven by the move to, and take up of, digital and mobile banking services. The Company has under-invested in this area of its business and now has to make significant investment to deliver a market-competitive digital and mobile banking offering. The Company is subject to the execution risk of this transformation in its business model and also to the risk that competitors continue to enhance their services so that the Company is still playing catch up. These risks, if they materialise, could mean the Company struggles to acquire new and retain existing customers.

A need for management time to be spent on matters other than "business as usual" activities potentially makes the Company more susceptible to competition from other banks driving forward their brand and business through marketing and strategy and hinders the Company's ability to deliver its business plan in the intended four to five year timescale. See the risk factor entitled "*A failure to successfully implement or a delay in implementing the Company's strategy may adversely impact the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with its regulatory capital requirements*" for further information.

The Company's business is subject to inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail deposits becomes limited and/or becomes more expensive, and this may have an adverse effect on the Company's business, profitability and ability to meet its liabilities as they fall due

The Company is subject to liquidity risk as an inherent part of its business. Liquidity risk is the risk that an institution may not have sufficient funds at any point in time to make full payment in respect of liabilities falling due, or can only do so at excessive cost. This may result in an inability to operate in the ordinary course and/or a failure to meet liquidity or regulatory capital requirements, and/or may adversely impact the Company's business and/or the implementation of its strategy.

The Company raises the majority of its funding through accepting retail and corporate deposits. The Company also maintains a range of funding programmes (including medium-term note, securitisation and covered bond programmes) targeting wholesale investors. The Company's funding programmes are used for both short-term and medium-term funding, whilst its covered bond issues serve to satisfy longer-term funding requirements.

Depositors are a significant source of funding for the Company and the maintenance and growth of the level of the Company's lending activities depend in large part on the availability of deposit funding on appropriate terms. The Company's deposits are split between retail and corporate deposits. As at 31 December 2013, the Company's retail customer deposits totalled £27.9 billion and the Company's corporate customer deposits totalled £3.5 billion, equal to 89 per cent. and 11 per cent., respectively, of the Company's total customer funding as at that date. The Company offers savings products which generally give rise to liabilities to repay depositors either "on demand" or on relatively short notice. The Company's mortgage products, by contrast, are long-term assets repayable to the Company over relatively long repayment terms. As a result, and given that the Company's main source of funds is deposits, the Company faces the risk of not being able to replace

funds when they are withdrawn or, should a significant number of depositors seek to withdraw their funds, of not being able to meet its obligations to fund such withdrawals, repay lenders in accordance with its financing arrangements or fulfil commitments to lend.

The Company monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed and regularly assesses its funding position. This is supported with detailed contingency funding plans and recovery options which are tested and reviewed on a regular basis. The Company's liquidity management framework is designed in line with the BIPRU regulations and industry guidelines. The Company calculated its total liquidity resources as at 31 December 2013 as £11,193.4 million compared with £8,657.7 million as at 31 December 2012.

The Company uses a combination of asset pools to manage its liquidity, with "primary liquidity" (being assets that are eligible under BIPRU 12.7, being operational balances with central banks, gilts and central government and multilateral development bank bonds) used predominantly for short-term cash flow movements, while "secondary liquidity" (being all other liquid assets (excluding non-buffer assets)) is used for creating longer-term or contingent liquidity. Regular realisation through repo transactions and outright sales provides assurance that these asset pools remain sufficiently liquid. Loss of access to repo markets will reduce the Company's ability to test and realise funding from the primary liquidity portfolio.

Overall, there has been a substantial reduction in non-buffer assets (from £1,927.2 million as at 31 December 2012 to £5.3 million as at 31 December 2013). This reflected the change in the Company's funding profile as a result of the Company's rating downgrades and the sale of non-buffer assets which has been used to maintain sufficient levels of primary liquidity as balances at central banks.

However, notwithstanding the steps that the Company has taken to maintain its levels of total liquidity, given the reliance by the Company on its customer deposits to provide funding for the Company, any severe decline in customer confidence in the Company could increase the amount of deposit withdrawals in a short space of time or over a sustained period. Given the relative size of the Company's deposit base as compared with its other sources of funding, the Company is particularly exposed to any serious loss of confidence by its depositors. Negative media attention and commentary to which the Company is subject (and is likely to continue to be subject), could adversely affect customer confidence. Should the Company experience an unusually high level of withdrawals which exceed the Company's ability to manage through the application of its liquidity controls and contingency planning, this may have an adverse effect on the Company's day-to-day operations, its ability to maintain the Company's planned lending. This in turn may have an adverse effect on the Company's business, operating results and financial condition and could, in extreme circumstances, prevent the Company from meeting its financial obligations as they fall due, meeting its regulatory minimum liquidity requirements or fulfilling its commitments to lend. In such circumstances, the PRA may exercise any of its wide-ranging powers over the Company, including imposing a resolution procedure under the Banking Act.

In connection with the Company's securitisation and covered bond programmes, the Company makes various representations and warranties relating to the mortgage loans sold to the programmes, including in relation to ownership, enforceability, compliance with legislation and origination procedures. If the representations and warranties are breached, subject to any applicable materiality determination, the Company may be required to repurchase the affected mortgage loans or in some circumstances pay compensation to the relevant special purpose vehicle.

There is a risk that a number of the underlying matters giving rise to conduct and legal provisions could have given rise to breaches of such representations and warranties which are considered to be material by third parties, regardless of the assessment of the Company. If this is the case, the Company may be required to repurchase affected mortgage loans. The repurchase of mortgage loans would accelerate the repayment of the securitisations and may require that further mortgage loans are sold to the covered bond programme.

The accelerated repayment of the securitisations and/or sale of further loans to the covered bond programme would reduce the Company's primary liquidity and could also impact the value and quantum of collateral available for use at the Bank of England's Discount Window Facility, thereby reducing the level of secondary liquidity. The early repayment of securitisations will also reduce funding balances and primary liquidity

balances. The accelerated repayment of some securitisations may also bring forward the fair value unwind upon merger costs relating to some of the Company's issued securities.

The Company is unable to estimate the extent to which the matters described above will have an adverse effect on its securitisations and covered bond programmes. Any of these matters, should they materialise, could have an adverse impact on the Company's primary and secondary liquidity position.

The Company's ability to access retail and wholesale funding sources on satisfactory economic terms or at all is subject to a variety of factors, some of which are outside the control of the Company. Factors which apply generally include; general economic conditions (including interest rates) and market volatility, market dislocation, confidence in the UK banking system and the economy in general and the financial services industry specifically, regulatory requirements and major disasters. These risks can be exacerbated by enterprise-specific factors, such as over-reliance on a particular source of funding. There is also a risk that the funding structure employed by the Company may prove to be inefficient, giving rise to a level of funding cost that is not sustainable in the long term for the Company to grow its business.

If the Company's sources of short-term funding become volatile or unavailable, the Company may be required to utilise other, possibly more expensive, sources to meet its short-term funding needs. The availability of wholesale funding depends on a variety of factors, including market conditions, the general availability of credit, the volume of trading activities, the overall availability of credit to the financial services industry, and rating agencies' and funding markets' assessment of the Company's credit strength.

The Company is also a participant in the Bank of England's sterling monetary framework and, as such, is subject to certain eligibility criteria at the Bank of England's discretion (as detailed in Chapter VIII of the Bank of England's Red Book). The Company may be granted access to the Bank of England's Discount Window Facility (the "**DWF**"). This is a bilateral facility which offers liquidity insurance for idiosyncratic and system-wide shocks and is designed in order to address short-term liquidity shocks without disturbing the Bank of England's incentives for prudent liquidity management. At the Bank of England's discretion, eligible banks may, therefore, borrow gilts or cash for 30 days, against a wide range of collateral in return for a fee. Eligible banks can apply to roll DWF drawings in order to achieve an effectively longer term of drawing. In the event that the Company was not granted access to the DWF and the Company at such time was dependent on the provision of liquidity from the DWF, the absence of such liquidity may have an adverse effect on the Company's business, results and financial position, and could, in extreme circumstances, prevent the Company from meeting its financial obligations as they fall due, from meeting its minimum liquidity requirements or from fulfilling its commitment to lend.

The Company's access to wholesale and corporate funding has further been impacted by rating downgrades and/or negative market sentiment. See the risk factor entitled "*Rating downgrades and/or negative market sentiment with respect to the Company, the sector and/or the UK may have an adverse effect on the Company's performance*" for further information.

While the Company has managed its retail offering in order to mitigate against the risk of depositors withdrawing funds, a failure by the Company to achieve its strategy, a deterioration in the Company's operating results or financial condition, or the continued press attention and speculation to which the Company is subject may result in a severe decline in customer confidence which could result in the withdrawal of retail funds. This could have a material adverse effect on the Company's liquidity, which in turn could adversely affect the Company's business, profitability and ability to meet liabilities as they fall due.

Rating downgrades and/or negative market sentiment with respect to the Company, the sector and/or the UK may have an adverse effect on the Company's performance

The Company's ratings have been adversely affected by concerns regarding the Company's capital position. The Company's debt does not have an investment grade rating. Fitch ratings are now B (long-term and outlook negative) and B (short-term). On 23 April 2014, Moody's further downgraded the Company's long-term credit rating from Caa1 to Caa2 with outlook negative. The downgrade reflected Moody's opinion of a reduced likelihood of systemic support coming from the UK authorities in the event that additional capital

is required for the Company. Moody's reduced the rating uplift from three notches to two notches. In Moody's opinion, the two notch uplift reflected the; (i) cushion for senior creditors provided by the Capital Raising and outstanding subordinated bonds, and (ii) Moody's continued expectation of regulatory forbearance, giving the bank several years to ensure that it can again meet ICG regulatory capital requirements.

The Company raises the majority of its funding through accepting retail and corporate deposits. The Company also maintains a range of funding programmes (including medium-term note, securitisation and covered bond programmes) targeting wholesale investors.

The total amount of the Company's corporate deposits fell by approximately £2.5 billion from year ended 31 December 2012 to year ended 31 December 2013. This may have been caused by the downgrading of the Company's credit rating by the credit rating agencies. In addition, the credit rating downgrades have:

- led to sub-investment grade ratings on the Company's senior debt leading to a significant reduction in the demand for these types of instruments;
- negatively impacted the Company's ability to access short-term unsecured wholesale funding; and
- increased the Company's collateral requirements used in the clearing and payment systems.

The credit rating downgrades in 2013 and, to a lesser extent, the announcement of the Company's regulatory capital shortfall on 24 March 2014, its results for the year ended 31 December 2013, and the continued media attention and speculation to which the Company is and will be subject have affected the Company's funding profile and the cost to the Company of raising new funding. The Company's business plan also envisages that the Company will raise £400 million CET 1 capital in the Capital Raising and approximately £400 million by way of additional non-CET 1 capital during the four to five year business plan period. This continued impact on access to funding and increased cost of funding may, over the longer term, have adverse effects on the Company's business, operating results, financial condition and/or prospects and/or adversely affect the Company's ability to achieve its strategy.

The securitisation and covered bond programmes have been amended primarily due to the downgrades received by the Company from the rating agencies in 2013. These amendments related to the appointment of back up servicing and back up cash management. Additionally, collection account bank account triggers within the Silk Road Finance Number One Plc and Silk Road Finance Number Two Plc securitisations, and the covered bond programme were amended to accommodate, amongst other things, the latest structured rating agency methodology and changes to the rules relating to direct debits and payment schemes. The Company may consider further issuance from these programmes if market conditions permit.

There can be no guarantee that the implementation of the Company's strategy or other actions taken by the Company will restore the Company's investment grade rating. Further negative change in sentiment towards the Company as a result of continued adverse publicity and market or other conditions could result in the Company's credit rating being kept at below investment grade and/or reduced further. Any future declines in those aspects of the Company identified by the rating agencies as significant business or a failure by the Company to achieve its strategic objectives could also adversely affect the rating agencies' perception of the Company's credit and cause them to take further negative ratings actions. In addition, the Company's credit rating may be adversely affected by further downgrading in the credit ratings of the Co-operative Group.

The continuation of the Company's current rating or any further downgrade in the Company's credit ratings could:

- trigger additional collateral requirements on derivative contracts and other unsecured funding arrangements;
- undermine confidence in the Company and/or result in an outflow of deposits from the Company;
- increase its borrowing costs; and/or

- further limit its access to the capital markets or limit the range of counterparties willing to enter into transactions with the Company, as many institutions require their counterparties to satisfy minimum ratings requirements.

By way of an illustration of the potential financial effect of a downgrade, the Company is party to contracts which specify collateral requirements based on the Company's rating. As a result, a downgrade of the Company's long-term debt rating results in cash outflows to meet the new collateral requirements. However, the contractually required cash outflow would not necessarily match the actual cash outflow as a result of other actions that could be taken by management to reduce the impact of the downgrades.

Furthermore, in February and April 2013, both Moody's and Fitch reduced the UK's long-term ratings, from Aaa to Aa1 (in the case of Moody's) and from AAA to AA+ (in the case of Fitch). Although these actions have not impacted the respective agencies' ratings of the Company, any further downgrade of the UK sovereign credit rating or the perception that such a downgrade may occur could destabilise the markets, impact the Company's own rating and borrowing costs and have a material adverse effect on the Company's operating results and financial condition. In addition, on 13 December 2012, S&P affirmed its AAA/A-1+ long- and short-term unsolicited sovereign credit ratings for the UK, but revised the outlook to negative from stable. A further UK sovereign downgrade or the perception that such a downgrade may occur could depress consumer confidence, restrict the availability, and increase the cost, of funding for the Company and/or its customers, further depress economic activity or inhibit any recovery, increase unemployment and reduce asset prices. These risks are exacerbated by concerns over the levels of the public debt of, the risk of further sovereign downgrades of, and the weakness in the economies in Greece, Italy, Ireland, Portugal and Spain (the "**GIIPS countries**") in particular. Further instability within these countries or others within the Eurozone might lead to contagion.

The Company could be negatively affected by a deterioration or a perceived deterioration in the soundness of other financial institutions and counterparties

Given the high level of interdependence between financial institutions, the Company is and will continue to be subject to the risk of deterioration of the commercial and financial soundness, or perceived soundness, of other financial services institutions. Within the financial services industry, the default of any one institution could lead to defaults by other institutions. Concerns about, or a default by, one institution could lead to significant liquidity problems, losses or defaults by other institutions, as was the case after the bankruptcy of Lehman Brothers in 2008. This is because the commercial and financial soundness of many financial institutions may be closely related as a result of their credit, trading, clearing or other relationships. Even the perceived lack of creditworthiness of, or questions about, a counterparty may lead to market-wide liquidity problems and losses or defaults by the Company or by other institutions. This risk is sometimes referred to as "systemic risk" and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges with whom the Company interacts on a daily basis. Systemic risk could have a material adverse effect on the Company's ability to raise new funding and on its business, financial condition, results in operations, liquidity and/or prospects.

The Company routinely executes a large number of transactions with counterparties in the financial services industry, resulting in large daily settlement amounts and significant credit exposure. As a result, the Company faces concentration risk with respect to specific counterparties and customers. A default by, or even concerns about the creditworthiness of, one or more financial services institutions could, therefore, lead to further significant systemic liquidity problems, or losses or defaults by other financial institutions.

There is a risk that the Company's ownership structure following the Liability Management Exercise and the Capital Raising may undermine the Company's reputation as being more focused on values and ethics than its competitors. Such a reputation has been a competitive advantage for the Company

Until 20 December 2013, the Company had been wholly owned by the Co-operative Group, which is a mutual organisation owned by, and run for the benefit of, its members. As a result, the Company has sought to manage its business by targeting a higher quality of service and product offering to its customers, sometimes including more customer-attractive interest rates, rather than focusing specifically on profit maximisation.

Following completion of the Liability Management Exercise, 70 per cent. of the equity of the Company has ceased to be owned by the Co-operative Group. As a result of the Company's revised ownership structure, the Company may find itself in conflict between its obligations to its institutional shareholders and its mutual ethos and heritage, in particular around profit maximisation. There is a risk, therefore, that the Company may decide to follow a course of action which is inconsistent with its mutual ethos and heritage and there is a risk that the Company's reputational competitive advantage may be undermined. Following completion of the Capital Raising, the Co-operative Group's shareholding in the Company is likely to be further diluted. In addition, conditional on the Capital Raising being completed, certain rights have been granted to the Committed Shareholders pursuant to the Shareholder Rights Agreement, including the right to appoint Directors. These developments may, unless the consequential reputational damage is mitigated, make customers, depositors and investors unwilling to do business with the Company which may, in turn, result in customer attrition. Furthermore, such conflict may lead to the Company reconsidering all or certain aspects of its strategy, such as building on the Company's co-operative brand strength and high levels of customer satisfaction. Recent customer feedback has indicated that the Company's brand has been impacted by the change in ownership following the Liability Management Exercise and there is a risk that further dilution of the Co-operative Group's shareholding will continue to impact the Company's brand. See the risk factor entitled "*The Company will continue to rely on the Co-operative Group. The Co-operative Group may also continue to exert substantial influence over the Company*" for further information.

The Company has entrenched provisions relating to co-operative values and ethics into its Articles of Association. However, if the shareholders of the Company decided to remove those entrenched provisions without the Co-operative Group's consent, the Company would be obliged, under the Agreed Co-existence Principles to cease the conduct of any business under a brand that combines the words "Co-operative" or "Co-op" and "Bank". This would, in turn, conflict with those aspects of the Company's current strategy that are focused on building on the co-operative brand strength and leveraging the Company's relationship with the Co-operative Group and the Co-operative Group's membership. It is, therefore, likely that the removal of these entrenched values and ethics would result in the Company changing its strategy, which could adversely affect the Company's business, financial condition, results of operations and could damage its relationships with its regulators. The removal of the entrenched values and ethics could also increase the risk of the FCA and the Secretary of State for Business, Innovation and Skills taking action in respect of use by the Company of the Co-operative brand. See the risk factor entitled "*The Company will continue to rely on the Co-operative brand*" for further information.

The Company is under intense regulatory scrutiny and expects that environment to continue. The Company is also the subject of multiple regulatory and other investigations and enquiries into events at the Company and circumstances surrounding them and may also be subject to other legal and/or regulatory proceedings

As a financial services firm, the Company is subject to extensive and comprehensive regulation under the laws of the jurisdictions in which it does business. These laws and regulations significantly affect the way that the Company does business, and can restrict the scope of its existing businesses and limit its ability to expand its product offerings, or can make its products and services more expensive for clients and customers. There has also been an increased focus on regulation and procedures for the protection of customers and clients of financial services firms. This has resulted in increased willingness on the part of regulators to investigate past practices of financial services firms both on an industry-wide basis and focusing on particular firms.

The Company is exposed to many forms of risk relating to regulatory and legal proceedings, including that:

- business may not be, or may not have been, conducted in accordance with applicable laws and regulations and financial and other penalties may result;
- contractual obligations with customers, suppliers or other third parties may either not operate or be enforceable as intended or may be enforced in a way adverse to the Company;

- the Company's assets such as intellectual property may not be adequately protected and the Company may use intellectual property which infringes, or is alleged to infringe, the rights of third parties; and
- litigation by or against the Company is not appropriately managed to protect the Company's reputation and achieve the best outcome and that liability for damages may be incurred to third parties harmed by the conduct of the Company's business.

On 12 July 2013, the Co-operative Group and the Company announced the launch of an independent review, to be chaired by Sir Christopher Kelly, into the events that led to the requirement for the Company's plan to address its £1.5 billion capital shortfall, the decision to merge the Company with Britannia in 2009 and the proposed acquisition of the Verde Business (the "**Kelly Review**"). The Kelly Review includes an analysis of strategic decision-making, management structures, culture, governance and accounting practices and aspects of the role of the Company's auditors. The findings of the Kelly Review were published on 30 April 2014. The Kelly Review is highly critical of the Company's previous corporate governance, the oversight of the Company by its Board, actions of the Company's former management, previous accounting practices, the conduct of the acquisition by the Company of the Britannia Building Society and the Company's general acquisition and business strategy. Publication of the report has led to and is likely to further lead to extensive negative publicity which may have an adverse effect on the Company's reputation or negatively affect its brand. The Kelly Review and related adverse publicity may adversely affect the perception of the Company by its customers and other stakeholders. If the negative newsflow continues for a significant period of time there is an increased risk that the Company will lose a material number of customers and liability/asset balances to competitors and this may have an adverse impact on cross-sales. If this risk materialises, it may impact the Company's ability to deliver its business plan. In addition, the contents of the Kelly Review may have an effect on the investigations and enquiries which are currently underway or have been previously announced by expanding or altering their scope, while matters contained in the report may lead to a risk of associated litigation or of new investigations and enquiries being launched, which could include criminal investigations.

The Treasury Select Committee has been conducting an ongoing review which began in the second quarter of 2013 and has focused on numerous concerns surrounding the Company. The committee will publish a report of its findings in due course, expected to be in the next few months.

The PRA announced on 6 January 2014 that it is undertaking an enforcement investigation in relation to the Company and as part of that investigation will consider the role of former senior managers.

The FCA announced on 6 January 2014 that it will be undertaking enforcement investigations into events at the Company. The investigation will look at the decisions and events up to June 2013.

HM Treasury announced on 22 November 2013 that it would conduct an independent investigation into events at the Company and the circumstances surrounding them from 2008, including the proposed acquisition of the Verde Business and the Britannia merger. The investigation will include a review of the conduct of regulators and Government but is not anticipated to commence until it is clear that it will not prejudice the outcome of the FCA and PRA enforcement investigations.

In September 2013, the Conduct Committee of the Financial Reporting Council ("**FRC**") commenced an enquiry into the Company's 2012 Annual Accounts. The enquiry related to the disclosure in the 2012 Annual Accounts of the Company's regulatory capital position, and also the Company's loan impairment, impairment of its investment in its replacement banking IT platform, and its fair value disclosures.

The Conduct Committee of the FRC has recently concluded its enquiry on the basis of correspondence with the Company and the inclusion of specific disclosures in 2013 Annual Accounts. The relevant disclosures relate to the following matters:

- the PRA's assessment of the Company's capital requirements;
- clarification of the nature of the acquisition fair value adjustment made in respect of loans acquired in the merger with the Britannia Building Society;

- comparative fair value disclosures for loans and advances at 31 December 2012 using the revised valuation methodologies applied at 31 December 2013; and
- recognition of the investment in the new core IT banking system as an intangible asset of the company as at 31 December 2012 by way of a prior period adjustment and disclosure of the rationale for this change in treatment.

The Conduct Committee of the FRC has been provided with confirmation that loan impairments at 31 December 2013 have been accounted for in accordance with IAS 39 "Financial Instruments; Recognition and Measurement". The Committee has indicated that although it accepts this confirmation, it has not expressed a view about the historic progression of impairment losses on loans acquired at a deep discount in the Britannia merger.

In January 2014, the FRC announced that it had launched a separate investigation under its Accountancy Scheme (which provides a system for investigating the conduct of and, if warranted, bringing disciplinary proceedings against members of participating accountancy bodies) into the preparation, approval and audit of the Company's accounts up to and including the 2012 Annual Accounts. Due to the preliminary nature of the investigation, the Company is unable to give any further comment in relation to it.

The outcome of these enquiries or any other existing, potential or future legal, regulatory or other enquiries, investigations or proceedings, including any legal, regulatory or other enquiries, investigations or proceedings arising out of any other allegations made against the Company, or members of its former management (including in each case with respect to prior public disclosure relating to financial or other information concerning the Company), is difficult to predict.

However, the Company may incur significant expense in connection with those and other legal, regulatory or other enquiries, investigations or proceedings, regardless of their ultimate outcome. Such enquiries, investigations or proceedings, the events leading up to them and/or any related negative publicity could expose the Company to any of the following; substantial monetary damages and fines, other penalties and injunctive relief, potential for additional civil or private litigation, potential for criminal prosecution in certain circumstances, potential regulatory restrictions on the Company's business, greater scrutiny and/or investigation from regulators and/or regulatory or legislative actions, and/or a negative effect on the Company's reputation and its brand and its ability to recruit and retain personnel and customers. Any of these risks, should they materialise, could have an adverse impact on the Company's business, operating results, financial condition and prospects, its regulatory capital position or its ability to comply with regulatory capital requirements, as well as taking a significant amount of management time and resources away from management of the Company's business, including execution of the Company's business plan.

Any adverse findings of the investigations may, therefore, reduce, directly or indirectly, the attractiveness of the Company to stakeholders and may lead to customer attrition, reduced workforce morale and difficulties in recruiting and retaining talent. Sustained damage arising from any adverse findings of the investigations could, therefore, lead to loss of revenue for the Company and could have a materially negative impact on the Company's business, operating results, financial condition and prospects.

See the risk factors entitled "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's co-operative values and ethics*" and "*The Company is currently involved in litigation and may in the future become involved in further litigation. The outcome of any legal proceedings is difficult to predict", "A failure to successfully implement or a delay in implementing the Company's strategy may adversely impact the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with its regulatory capital requirements*" and "*The Company is exposed to a number of conduct risks*" for further information.

The Company is currently involved in litigation and may in the future become involved in further litigation. The outcome of any legal proceedings is difficult to predict

The Company is engaged in various other legal proceedings in the United Kingdom, involving claims by, and against it, which arise in the ordinary course of business, including debt collection, mortgage enforcement, consumer claims and contractual disputes. The Company does not expect the ultimate

resolution of any of these other known legal proceedings to which the Company is party to have a material adverse effect on the results of operations, cash flows or the financial position. Provisions have been recognised for those cases where the Company is able reliably to estimate the probable loss where the probable loss is not *de minimis*.

In addition, the Company is exposed to the inherent risks relating to the mis-selling of financial products, and giving negligent advice or other conduct determined by the Company or the regulators to be inappropriate, unfair or non-compliant with applicable law or regulations (including regulatory principles or guidance). Any failure to manage these risks adequately could lead to further significant provisions, costs and liabilities and/or reputational damage.

The Company also faces both financial and reputational risk where legal or regulatory proceedings are brought against it or other financial institutions. Liability for damages may be incurred by third parties harmed by the conduct of the Company's business. See the risk factor entitled "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co-operative values and ethics*" for further information.

Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co-operative values and ethics

The Company's reputation is one of its most important assets and its ability to attract and retain customers and conduct business with its counterparties could be adversely affected to the extent that its reputation or its brand is damaged. The act of addressing or failing to address, or appearing to fail to address, various issues that could give rise to reputational risk is likely to cause harm to the Company and its business prospects. The Company's reputation could be impacted by both known issues and issues not yet identified (some of which could only have an ancillary connection to the Company). For example, litigation, or the misconduct of employees or other persons (including criminal activity) at any time associated with the Cooperative brand or the "Co-operative Bank" brand, operational failures, accidents, the outcome of regulatory investigations, media speculation and negative publicity, breaches of data protection or other laws, products considered to be inappropriate and sub-standard customer service, among other factors, could impact the Company's reputation. Reputational issues could include, without limitation, any of the following (along with media speculation regarding the same where relevant):

- the reputational damage arising from the downgrades to the Company's credit ratings and the implementation of the Recapitalisation Plan, including the Capital Raising;
- litigation or objections, including from creditors in connection with the Liability Management Exercise and interest groups and associated media coverage;
- a requirement to raise further capital in the future, which could affect, or be perceived to affect, confidence in the Company;
- a failure to implement the Company's strategy and execute the Company's business plan;
- a perception that the Company has moved away from its co-operative values and ethics, notwithstanding having entrenched provisions relating to values and ethics in its Articles of Association;
- a reduction in the Company's customer service levels resulting from cost-cutting to the Company's Core Business and/or the reorientation of the Company's distribution channels;
- the Company no longer being wholly owned by the Co-operative Group, with the result that the mutual and ethical reputation of the Co-operative Group could conflict with the profit maximisation objective of other holders of Ordinary Shares and the Board's duties to such shareholders;
- any potential impact to the Company's brand or reputation in the event that the shareholding of the Co-operative Group reduces below its current shareholding;

- any potential impact to the Company's brand or reputation as a result of the Company ceasing to provide facilities for particular high-profile customers as a result of its reconsideration of risk appetite and of its re-focussing on retail and SME customers;
- the potential risk that the Secretary of State for Business, Innovation and Skills may direct the Company to change its registered name if, in his opinion, it gives so misleading an indication of the nature of its activities as to be likely to cause harm to the public;
- the risk that the FCA exercises its power to prevent the use of the "Co-operative" name, or to take other action regarding the Company's branding, if the FCA considers this desirable to protect consumers, to promote competition in the interests of consumers or to protect the integrity of the UK financial system;
- an impact on the Company's reputation as a result of matters relating to the Co-operative Group or its current or former employees or management which adversely impacts the Company brand;
- any impact on the Company's reputation as a result of adverse findings following from any legal or regulatory investigation into the Company's conduct or investigations connected to the Company; for example, criticism arising from the report of the Treasury Select Committee when published; the independent Kelly Review into the events which led to the announcement of the Company's Recapitalisation Plan; the enforcement investigations announced by the PRA and FCA, respectively, on 6 January 2014; the independent HM Treasury investigation into events at the Company and the circumstances surrounding them, including the Verde Transaction and the Britannia merger; and the FRC investigation. See the risk factor entitled "*The Company is under intense regulatory scrutiny and expects that environment to continue. The Company is also the subject of multiple regulatory and other investigations and enquiries into events at the Company and circumstances surrounding them and may also be subject to other legal and/or regulatory proceedings*" for further information;
- any impact on the Company's reputation or negative impact on the Company's brand as a result of its association with the Co-operative brand, including any actions or omissions or speculation by or about the Co-operative Group including as a result of a failure to understand the distinction between the Company and the Co-operative Group, for example as a result of adverse findings about the Co-operative Group arising out of investigations into past actions or adverse commentary or organisational disruption to the Co-operative Group as a result of the Myners Report. See the risk factor entitled "*The Company will continue to rely on the Co-operative brand*" for further information;
- failing to appropriately address potential conflicts of interest;
- breaching or facing allegations of having breached legal and regulatory requirements (including money laundering and anti-terrorism financing requirements and conduct risk events such as past business reviews);
- acting or facing allegations of having acted unethically (including having adopted inappropriate sales and trading practices);
- failing or facing allegations of having failed to maintain appropriate standards of customer privacy, customer service and record-keeping;
- technology failures that impact upon customer services and accounts;
- internal fraud;
- failing to properly identify legal, reputational, credit, liquidity and market risks inherent in products offered;
- the change to the Company's auditors; and
- generally poor Company performance or customer service.

A failure to address these or any other relevant issues appropriately could make significant numbers of customers, depositors and investors unwilling to do business with the Company. For example, if the negative newsflow continues for a significant period of time, there is the risk that the Company will lose a material number of customers and liability/asset balances to competitors. This could materially adversely affect the Company's business, operating results, financial condition and prospects and could damage its relationships with its regulators. The Company cannot ensure that it will be successful in avoiding damage to its business from reputational risk.

The Company is exposed to a number of conduct risks

The Company is exposed to many forms of legal and regulatory risk, which may arise in a number of ways. As part of its strategy to identify and resolve outstanding liability issues, the Company has started a structured risk-based assessment, of which the primary focus is the discovery and remediation of existing and new issues. These efforts have already resulted in the discovery of existing and new issues and the Company is seeking to remediate such matters.

However, while much work has been undertaken and progress has been made in identifying conduct issues, no assurance can be given that further issues will not be identified. Examples of legal and regulatory risk potentially faced by the Company include:

- certain aspects of its business may be determined by the PRA, the FCA, HM Treasury, the Financial Ombudsman Service, the OFT or the courts as not being conducted in accordance with applicable laws or regulations, or, in the case of the Financial Ombudsman Service, in accordance with what is fair and reasonable in the opinion of the Financial Ombudsman. If the Company fails to comply with any relevant regulations, there is a risk of an adverse impact on its business due to sanctions, fines or other actions imposed by the regulatory authorities. There is also a risk of greater scrutiny and/or intervention from regulators, further regulatory action and/or litigation. This would take a significant amount of management time and resources away from management of the Company's business;

- the alleged mis-selling of financial products, including as a result of having sales practices and/or reward structures in place that are determined to have been inappropriate, may result in disciplinary action (including significant fines) or requirements to amend sales processes, withdraw products or provide restitution to affected customers, all or any of which could result in the incurrence of significant costs, may require provisions to be recorded in the Company's financial statements and could adversely impact future revenues from affected products. Examples of potentially affected products include card and identification protection products, upgrades and downgrades of linked savings accounts, mortgages, mortgage fees, secured arrears and arrears charges;

- the Company may be liable for damages to third parties harmed by the manner in which the Company has conducted one or more aspects of its business;

- there is increasing regulatory scrutiny with respect to mortgages, for example in respect of forbearance, and issues relating to irregularities in mortgage documentation. There is a risk that past forbearance may have given rise to customer detriment. The Kelly Review found that the Company's forbearance levels were higher than in many other firms. A review by an external consultant of a selection of medium and high risk files concluded that in certain instances, policy was not followed and this currently requires further identification to assess if a redress is required. The Company is currently going through a process of ensuring compliance with the FCA's Mortgages and Home Finance Code of Conduct sourcebook ("**MCOB**") and is, therefore, reviewing its mortgage origination, administration and arrears process. Should the Company not comply with MCOB requirements in relation to mortgage selling in the future, absent FCA forbearance, it could be required to cease this activity until such time that it can demonstrate compliance with the relevant rules and guidance;

- the Company may need to provide customer redress for the miscalculation of interest on corporate loans;

- there is a risk of enforcement action or requirement to give redress if the Company has entered into unauthorised transactions with customers;
- there has recently been a focus on the Consumer Credit Act 1974, as amended ("**CCA**") which regulates consumer lending and governs the way in which banks provide consumer credit to retail customers. The CCA includes very detailed, prescriptive and highly technical requirements for lenders affecting customer documentation and which, in turn, impact how operational processes and IT systems are configured. In the event that the highly technical requirements of the CCA are not precisely complied with, the Company is exposed to the risk that its agreements with customers are not enforceable without the benefit of a court order or that during a period of non-compliance the Company's customer is not liable to pay interest or default charges. As mentioned below, the Company has identified various CCA breaches of compliance and provision has been made for such breaches. However, while the Company is conducting an ongoing review into such issues and has identified certain instances of non-compliance, there may be others that have not yet been identified. From 1 April 2014, the Financial Services and Markets Act 2000 also applies alongside certain retained provisions of the CCA. As a result regulatory responsibility for the CCA has passed to the FCA from the OFT which may lead to additional sanctions being imposed on the Company and/or a requirement to make additional payments to customers; and
- failure by the Company to implement and maintain adequate policies, procedures and controls to combat money laundering, bribery and terrorist financing or to ensure economic sanction compliance could have serious legal and reputational consequences, including exposure to fines, public censure, penalties and damages. The Company has identified a number of significant control weaknesses and there may be instances in which UK and European law obligations with respect to anti-money laundering and terrorist financing controls may not have been met. See the risk factor entitled "*Anti-money laundering, anti-bribery, sanctions and other compliance risks*" for further information.

Failure to manage these risks adequately could lead to significant liabilities or reputational damage, which could have a material adverse effect on the Company's business, operating results, financial condition, prospects, regulatory capital position, ability to comply with regulatory capital requirements and relations with customers. Recent events relating to the Company (as well as relating to the Co-operative Group), including media coverage thereof and net promoter scores, have already adversely impacted the Company's brand and reputation. The Company has already seen evidence of customer attrition and deposit and current account outflows. Further damage to the Company's brand or reputation could risk further increasing deposit and current account outflows which could have an impact on the Company's liquidity. See the risk factor entitled "*The Company's business is subject to inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail deposits become limited and/ or becomes more expensive, and this may have an adverse effect on the Company's business, profitability and ability to meet its liabilities as they fall due*" for further information. The Company also faces both financial and reputational risk where legal or regulatory proceedings are brought against it or members of its industry generally, or where complaints are made against it or members of its industry generally to the Financial Ombudsman Service or another relevant body.

The Company's provision for customer redress is reflected in a significant item charge, which includes provisions for potential customer compensation claims relating to past sales of payment protection insurance ("**PPI**"), alleged failings relating to the introduction of third party sales of card and identity protection and other products, arrears fees and associated charges, early repayment charges ("**ERC**"), the processing of first payments on certain mortgages, and the mis-selling of interest rate swaps as well as an additional provision following identification of breaches of the CCA.

In the past, the Company sold PPI alongside mortgage and non-mortgage credit products i.e. loans, overdrafts and credit cards. The Company stopped selling single premium PPI in January 2009 and mortgage associated PPI in May 2011 for the Company's sales and in March 2012 for Britannia related sales. Provisions have already been made in respect of PPI which have increased over time due to a number of internal and external factors. Examples of potential issues faced include additional potential breaches identified in 2014 relating to matters such as the incorrect disclosure of the costs of PPI, failure to reject PPI

complaints properly and failure to disclose in all cases that PPI insurance is not mandatory. There can be no assurance that its estimates for potential liability are correct and the Company's provisions taken to date might prove inadequate.

The Company has identified defects in certain of its historic mortgage documentation. An analysis of such defects identified that they raised legal and conduct risks, including potentially rendering certain previously paid mortgage related fees and charges not payable by the customer. A provision relating to additional costs arising from such defects, including the estimated cost of redress for such fees and charges and of reissuing correct documentation was raised in its 2013 financial statements. There is a risk that such provision may prove inadequate if the actual costs of remediation and redress and any additional costs of enforcing affected mortgages, are higher than currently estimated or that the assessment of the impact of such defects proves to be incorrect or incomplete.

The Company, in selling regulated mortgages must adhere to specific guidelines, principles and regulations. There are instances where the sales of these products have fallen short of the required standard and include issues relating to ERC, arrears fees, product charges and interest charges. There are several regulatory requirements regarding both the features such products must have and the disclosure process that must be completed when offering a mortgage. The disclosure process requires specific documentation to be sent to the customer at the offer stage. Failure to observe the regulatory requirements can make the ERC, arrears fee and associated charges and processing of first payment unenforceable and could lead to actions by regulators. Some or all of these fees or charges can also be construed as penalties, where they do not represent a genuine pre-estimate of loss, or unfair terms, where they are not individually negotiated. There is a risk that, where the Company has failed to satisfy the relevant regulatory requirement, these fees or charges could be deemed a penalty or the ERC is held to be an unfair term and it is possible that the Financial Ombudsman Service or the courts may order the Company to refund any charge and pay compensation for any additional cost, distress or inconvenience. The Company may have difficulty in complying with the FCA requirements in relation to mortgage selling in the future, and may be required to cease selling regulated mortgages until such time as the Company can demonstration compliance. An inability to sell mortgage products would have a material adverse effect on the Company's business, operating results, financial condition and prospects. Mortgages are a significant part of the Company's Core Business and any restriction on this activity could, for example, impact the Company's liquidity and its securitisation programmes. There is also a risk that the Company could be subject to enforcement action by the FCA/PRA.

The Company has identified that it has breached the provisions of the CCA which are highly technical and prescriptive. Breaches may have the effect of rendering customer agreements unenforceable without a court order or the customer not being liable to pay interest and default fees. Provisions have been made in the 2013 financial statements in respect of the costs associated with such breaches. Certain of the breaches which have been identified are failures to comply with section 77A of the CCA, which requires the Company to send its customers statements which comply with particular requirements. Having sent statements which fail to comply with section 77A, the Company must refund all interest and charges paid by customers during the period of non-compliance. The period of non-compliance only stops when a compliant statement is sent to the Customer, which may involve re-calculation of statement entries over an extended period of time. Such re-calculation involves extensive IT systems interaction and operational activity which can take an extended period of time to execute and during which time interest paid by customers will have to be subsequently refunded. The operational implementation of ending the period of non-compliance and executing customer refunds is being worked through. Estimated operational costs may prove insufficient and the timeframe anticipated may prove inadequate, leading to additional operational costs and a longer period over which interest, which is collected, will then have to be repaid. In addition, the Company has made no provision to pay interest on any sums which are being refunded.

In addition, the Company was notified on or about 16 April 2014 by its third party credit card servicer of a deficiency in their processing of notices of sums in arrears ("**NOSIAs**") which they had identified affected a number of their financial services clients. Such deficiency has potentially similar consequences to the statement deficiency described above by creating a period of non-compliance during which the Company is unable to enforce the agreement and the customer is not liable to pay interest or default charges. The third party servicer has informed the Company that the defect relates to NOSIAs issued since October 2011 and,

based on the information provided to the Company it is estimated that the defect will impact 250-300 individual credit card accounts. If the indications provided by the third party servicer are correct the issue would not have a material impact on the Company's financial position. However, in the event that the third party supplier's information and estimates are incorrect and the defects are more wide ranging or extend over a greater period of time than they have indicated, there could be a greater financial impact on the Company. The Company is planning to conduct a full review of its third party credit card servicer in relation to CCA and there is a risk that this may identify further issues.

No assurance can be given that further breaches will not be identified.

Detailed and technical legal analysis has been carried out as to whether breaches of the technical requirements of the CCA have in fact occurred, the nature of those breaches and the consequences of which will follow. Such legal analysis by its nature involves judgment and assessment of the facts of particular circumstances. In the event that such legal analysis and judgments are determined to be wrong, the Company could be exposed to material additional liability and provisions taken to date may be inadequate.

The Company is also reviewing conduct issues relating the sale of its historic packaged accounts. The review is at an early stage and the outcome is therefore uncertain.

Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media and politicians, there is a risk that aspects of the Company's current or historic business (including those referred to above) may be determined by the FCA and other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion. For example, there is currently a significant regulatory focus on the sales practices and reward structures that financial institutions have used when selling financial products. The Company faces the possibility of regulatory investigations and actions against it in relation to conduct and other issues (including those that the Company is not presently aware of). Examples include investigations and actions against it, resulting from alleged mis-selling of financial products such as interest-only mortgages, packaged accounts, packaged products and card protection and in regard to alleged control failures, including with respect to customer first mortgage payments, arrears fees and charges, collection of default fees and other mortgage fees and charges, ERC and lending into retirement plans.

The nature of any future disputes and legal, regulatory or other investigations or proceedings into such matters cannot be predicted in advance. Furthermore, the outcome of any ongoing disputes and legal, regulatory or other investigations or proceedings is difficult to predict. However, it may be that the Company will incur significant expense investigating and, where applicable, defending ongoing and future claims. In addition, such action could lead to substantial monetary damages and/or fines, public reprimands, a negative effect on the Company's reputation or potential regulatory restrictions on the Company's business. Any of these risks, should they materialise, could have an adverse impact on the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with regulatory capital requirements. There is also a risk that the outcome of such investigations or proceedings may give rise to changes in law or regulation as part of a wider response by relevant law makers and regulators. An adverse decision in any one matter, either against the Company or another financial institution facing similar claims, could lead to further claims against the Company.

Potential regulatory investigations could cause reputational damage to the Company's brand and question the Company's commitment to co-operative values and ethics arising from any association, action or inaction which is perceived by stakeholders to be inappropriate or unethical. Failure to appropriately manage conduct and reputation risks may reduce, directly or indirectly, the attractiveness of the Company to stakeholders, including customers, and may lead to negative publicity, loss of revenue, litigation, higher scrutiny and/or intervention from regulators, regulatory or legislative action, loss of existing or potential client business, reduced workforce morale, and difficulties in recruiting and retaining talent. Sustained damage arising from conduct and reputation risks could have a materially negative impact on the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with regulatory capital requirements. See the risk factors entitled "*The Company is under intense regulatory scrutiny and expects that environment to continue. The Company is also the subject of multiple regulatory and other investigations and enquiries into events at the Company and circumstances surrounding them and may also be subject to other legal and/or regulatory proceedings*" and "*Reputational risk could cause harm to the Company, its business, operating results,*

financial condition and prospects and question the Company's commitment to co-operative values and ethics" for further information.

Anti-money laundering, anti-bribery, sanctions and other compliance risks

Combating money laundering, bribery and terrorist financing and compliance with economic sanctions has been a major focus of government policy relating to financial institutions in recent years (most notably in the UK and the EU). UK and EU law and regulations impose obligations on the Company to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing. Failure by the Company to implement and maintain adequate policies, procedures and controls to combat money laundering, bribery and terrorist financing or to ensure economic sanction compliance could have serious legal and reputational consequences for the institution, including exposure to fines, public censure, penalties and damages. The Company has identified a number of significant control weaknesses with respect to its anti-money laundering, sanctions and terrorist financing controls and there may be instances in which obligations imposed by UK and EU law with respect to anti-money laundering, sanctions and terrorist financing controls have not been met. There is a risk of the FCA exercising its powers over the Company (including imposing fines) in respect of such control weaknesses. However, the Company has discussed these shortcomings with the FCA and has provided a commitment to the FCA to strengthen its anti-money laundering, sanctions and terrorist financing controls. A remediation programme is in progress with close executive oversight. However, any weaknesses in the Company's anti-money laundering, sanctions and terrorist financing controls and/or failure to remediate them could have a significant adverse effect on the Company's business, operating results, financial condition and/or prospects. While the Company has committed no known sanctions breaches, the Company's CDD processes, systems and procedures are inadequate at training new employees and throughout the customer account life cycle to provide assurance that it has not breached sanctions obligations.

The Company's guidelines and policies for risk management may prove inadequate for the risks faced by its business and any failure to properly manage the risks which it faces could cause harm to the Company and its business prospects

The Company's systems of control have been weak and there have been failings in a number of areas in the past. The Company's risk-management framework ("**RMF**") was re-defined in the second half of 2012, incorporating a clearer "three lines of defence" model (business teams and first line management being the first line of defence; compliance and risk functions being the second line of defence; and the internal audit team being the third line of defence) and was supported by the recruitment of a stronger risk leadership team in the first quarter of 2013. The enhanced risk function was largely responsible for the identification of many previously un-remediated policy, process and control failings. However, although the foundation of the Company's more robust controls has been laid, further time and significant work is required to embed all elements of the RMF across the Company in 2014. This will need to be supported by improved capability across the three lines of defence, as well as a cultural shift in driving accountability for actions. This may lead to the identification of further risks and control failings.

The Company has a range of tools designed to measure and manage the various risks which it faces. These methods may prove to be inadequate for predicting risk exposure, which may prove to be significantly greater than is predicted. Methods for risk management are based on evaluation of information regarding markets or customers or other information that is publicly known or otherwise available to the Company. Such information may not always be correct, updated or correctly evaluated. In addition, even though the Company constantly measures and monitors its exposures, there can be no assurance that its risk management methods will be effective, particularly in unusual or extreme market conditions. It is difficult to predict with accuracy changes in economic or market conditions and to anticipate the effects that such changes could have on the Company's financial performance and business operations.

Various elements of operational risk management were concluded to be ineffective in 2013. Some examples of weaknesses include that the Company's underlying business and financial systems are dated and suffer from a lack of integration and investment since the Britannia merger, an over-reliance on manual intervention in processes, inadequate business continuity and disaster recovery arrangements, poor logical access management and ineffective outsourcing. Progress has been achieved in a number of areas but significant

work is still required from a people, process and systems perspective to embed an effective and sustainable operational risk framework and to enhance the control culture. See the risk factor entitled "*The Company's operations are highly dependent on the proper functioning of IT and communications systems which are currently in need of urgent and extensive remediation. Any significant delay in or failure of the Company to remedy the existing IT platform and re-engineer it to meet the requirements of its business strategy may adversely affect the future operational and financial performance of the business. The Company's disaster recovery plan for its IT infrastructure is not proven, creating a material resilience risk*" for further information.

Significant control failings were identified in relation to regulatory, legal and conduct matters in 2013, and, similar to other organisations, material provisions were required. Significant efforts are being made to rectify these control failings and prevent their reoccurrence. This includes work to embed a far more effective operational risk framework and to enhance the control culture.

However, there can be no assurance that further risks and control failings will not be identified, or that the Company's approach to risk management will prove to be adequate. Such further risk and failings could have a significant adverse effect on the Company's business, operating results, financial condition and/or prospects.

Inadequate risk management processes could lead to exposures outside the Company's risk appetite and unforeseen losses

Credit risk is an inherent part of the business activities of the Company (and all other banks). It is inherent in both traditional banking products (loans, credit) and in "traded products" (derivative contracts such as forwards, swaps and options), repurchase agreements, securities borrowing and lending transactions. The inherent risks arising from general economic conditions have been increased by the period of significant turbulence and uncertainty affecting the global economy and the global financial system. The Company continues to be exposed to these risks and their consequences, including lower consumer confidence, high levels of unemployment, interest rate volatility and the increased cost of credit, which may result in increased credit risk and could have a material adverse effect on the Company's business, operating results, financial condition and prospects.

In the past, there have been failings by the Company's business units in their adherence to the Company's credit risk policies, including in the origination and documentation of corporate loans. The Kelly Review's findings were that the Company's executive failed to exercise sufficiently prudent and effective management of capital and risk. The Kelly Review also found that there were deficiencies in the way that the Company implemented its risk management framework and that such failings in risk management had severe consequences for the Company, ultimately underpinning the Company's capital failings. Weaknesses in the credit challenge and control process resulted in such failings not being brought to the attention of senior management quickly enough or, in a number of cases, the failure of senior management to act on the information provided to them. These historic failings contributed to the impairment charges of the Company's corporate loans, which were recognised in 2012 and 2013 respectively. As a consequence, in March 2013, the Company performed an internal review of its credit controls in order to establish more robust control standards and to improve the ability of the Company to identify and anticipate credit risk issues. In addition, a number of independent reviews, including in relation to corporate credit risk, have been undertaken by external advisers. As a consequence of such internal and external reviews, the Company has documented and approved new credit control standards and a number of changes have been made to limit the amount of credit control and discretion which can be exercised within the business units themselves versus that which required senior management approval, and more detailed checks are now being performed by the credit risk function. While these reviews did not result in any amendments to the impairment provisions recorded in prior financial years, there can be no guarantee that the Company's new control standards will be sufficient to minimise further credit losses in the future. See the risk factor entitled "*The Company's guidelines and policies for risk management may prove inadequate for the risks faced by its business and any failure to properly manage the risks which it faces could cause harm to the Company and its business prospects*" for further information.

In addition to credit risks, the Company faces a wide range of risks in its business activities, including, in particular:

- liquidity risk, particularly if the availability of traditional sources of funding such as retail deposits becomes limited and/or becomes more expensive. This may have an adverse effect on the Company's business, profitability, financial condition and ability to meet its liabilities as they fall due. See the risk factor entitled "*The Company's business is subject to inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail deposits becomes limited and/or becomes more expensive, and this may have an adverse effect on the Company's business, profitability and ability to meet its liabilities as they fall due*" for further information;

- market risk, which is the risk of loss as a result of the value of financial assets or liabilities (including off-balance sheet instruments) being adversely affected by movements in market rates or prices. This loss can be reflected in the near-term earnings by changing net interest income, or in the longer term because of changes in the economic value of future cash flows. The main source of market risk within the Company is driven by mismatches between the re-pricing profiles of asset and liability customer products within the retail and corporate businesses and certain characteristics embedded within these products and basis risk. The Company's Treasury function also creates market risk through its various portfolio management and trading activities along with currency risk;

- interest rate risk, which is the risk arising out of changes in interest rate levels, yield curves and spreads, which may affect the Company's interest rate margin realised between lending and borrowing costs (a type of market risk). Changes in currency rates, particularly in the sterling-dollar and sterling-euro exchange rates, affect the value of assets and liabilities denominated in foreign currencies and may affect income from assets and liabilities denominated in foreign currency. The performance of financial markets may also cause changes in the value of the Company's investment and liquidity portfolios. The Company seeks to minimise the volatility of future earnings from interest rate changes and all fixed interest rate risk exposure is removed from the Core Business and the Non-core Business and consolidated at the centre where it is managed from the core balance sheet within agreed limits. The Company's Treasury function is responsible for interest rate risk management for the Company. See the risk factors entitled "*The Company's earnings and net interest margins have been adversely affected by a number of factors, including a prolonged period of low Bank of England base rates and competition for retail funds, and may continue to be adversely affected for so long as one or more of these factors persist. In addition, regulatory capital shortfall and other recent events impacting the Company may have an adverse effect on the Company's net interest margin*" and "*Worsening economic and market conditions and/or increasing interest rates and/or a fall in housing prices could result in increased residential mortgage and unsecured loan losses which would adversely impact the Company's financial and operational performance*" for further information; and

- model risk, which is the risk that an adverse outcome occurs as a direct result of weaknesses or failures in the design or use of a model. Models are mathematical representations of business systems designed to help describe, predict, experiment with or optimise decisions and scenarios and are used throughout the Company's business.

Failure to adequately maintain corporate records or to adequately maintain and protect customer and employee information could have a material adverse effect on the Company

The general corporate records, statutory books, books of accounts and other records required by law or regulation to be maintained by the Company and its past and present subsidiaries including those entities acquired as part of the Britannia acquisition, may not be up-to-date and therefore may not contain records which are complete and accurate in all material respects as required by law or regulation. There is a risk that the retained records may not be adequate for current purposes of the Company and the Company may not have adequate accessibility to required records. This may lead to, among other things, the Company being unable to access sufficient information to ascertain the sequence of past events and defend itself against litigation or in the course of regulatory or other enquiries and potentially lead to adverse reputational impact, financial costs regulatory censure and fines.

The Company processes personal data (including name, address, date of birth, bank and credit card details and other personal data) of its customers, third-party claimants, business contacts and employees as part of the operation of its business. It must, therefore, comply with data protection and privacy laws and industry standards in the UK and the EU. Such compliance may also be contractually required. Those laws and standards impose certain requirements on the Company in respect of the collection, use, storage and destruction of such personal data. For example, under UK and EU data protection laws, when processing personal data, certain information must be provided to the individual whose data is being processed. This information includes the identity of the data controller, the purposes for which the data is being processed and any other relevant information relating to the processing. There is a risk that the processing of data by the Company and its appointed third parties is not conducted in accordance with notifications made to, or obligations imposed by, regulators, the rights of data subjects, or applicable law. Failure to operate effective data protection controls could potentially lead to regulatory censure, fines, reputational and financial costs as well as result in potentially inaccurate rating of risks or overpayment of claims.

The separation of the Company from the Co-operative Group has increased the risk of the Company breaching data protection and privacy laws and industry standards as the Company and the Co-operative Group continue to share physical and digital information assets and access to them notwithstanding that they are no longer part of the same group. For example, the Company's mainframe is owned by CFSMS but shared with CISGIL. The increased risk includes an increased risk of loss, theft and/or unauthorised access or disclosure of customer and employee information. Examples of areas of concern with respect to the treatment of shared data include marketing and customer data and systems; HR and payroll data; e-mail systems and IT infrastructure. The Company is currently seeking to ensure that CFSMS transfers to it assets owned by CFSMS of which the Company is the sole or predominant user as part of the separation activities. See the risk factor entitled "*The Company relies on the provision of certain services by the Co-operative Group, including IT and pensions services, and on the performance by the Co-operative Group of certain activities in order to transfer certain services currently provided by the Co-operative Group back to the Company*" for further information. Breaches of data protection and privacy laws and/or industry standards could impact the Company in a number of ways, including sanctions and/or fines from regulators (including the Information Commissioners Office (the "**ICO**") in relation to personal data).

Owing to issues arising from separation (including the ability of the Co-operative Group to access the Company's customer and employee information), the Company is unable to comply across its entire operation with the seventh principle of the Data Protection Act 1998 which requires that personal data must be kept secure against loss or disclosure, as certain personal data will be held on shared assets. The Company has advised the ICO of this fact and of the data risks associated with the separation process and the ICO has noted that it is comfortable with the measures which the Company is putting in placed to reduce the risk, no assurance can be given that the ICO will not change its approach to the Company's breach or any other potential or actual breach of data protection and privacy laws and industry standards and the Company remains at risk of potential enforcement action by the ICO.

The Company is seeking to mitigate the risks of breach of data protection and privacy laws and industry standards by seeking to implement certain separation projects (including to separate digital information assets stored in shared technologies and separation of physical information assets). However, there are risks to the successful implementation of these separation projects as these projects are highly complex and face significant challenges. These include that the agreements which have been negotiated in respect of data management and processing between the Company and the Co-operative Group have not yet been signed. This could, for example, mean that the Company is exposed to poor use by the Co-operative Group of the Company's data, that the Company has no audit rights over the Co-operative Group and that the Company may not be able to share the cost of data separation; the Company is relying on the Co-operative Group's resources to provide access to those assets which the Company uses in a timely manner; the separation projects could encounter delays during negotiations and planning, including, due to the Co-operative Group's complex governance arrangements, different working practices and absence of understanding of the Company's regulated environment; information could be lost during the separation process; lack of an information asset register within the business could impact the ability to separate such assets; there is a risk of increased key person dependencies and the possibility of increased staff turnover owing to the increased workload arising from separation; the technology environment relies in part on archaic technology that

increases the degree of difficulty required in separating the data environments (potentially increasing the time and cost of data separation); physical records may not be adequately stored or able to be reached easily, requiring extra time and investment to appropriately separate; and the Company may not be legally compliant in its business around data processing arrangements.

Further, there is an increased risk of loss, theft or disclosure of the Company's commercial information (or a third party's confidential information) as a result of separation of the Company from the Co-operative Group. Much of the information is held on the systems of CFSMS or the Co-operative Group. For example, as a major processor of payments from payment cards, the Company is required to comply with the Payment Card Industry Data Security Standard as part of its contractual obligations. Examples of areas of concern include e-mail systems, IT infrastructure (e.g. shared network drives), finance systems and marketing, customer data and systems. Risks to commercial data could impact the Company in a number of ways, including making it less competitive, negative impact on its reputation and/or negative impact on its commercial relations with third parties (including potential contractual breach of confidentiality provisions and damages which might arise from this).

There is a risk that certain types of data security breaches could subject the Company to liability and/or damage to the Company's brands and reputation. For example, the Company's systems, processes and controls with respect to the use of marketing data are weak, including with respect to recording and applying customer marketing preferences. Such weaknesses could lead to the Company contacting customers or sharing customer details where customers had not provided the relevant permissions. This could result in the Company losing customers and liability/asset balances to competitors which may have an adverse impact on cross sales. Similarly, the Company is exposed to the risk that the personal data processed for its purposes could be accessed and/or used without authorisation, whether by employees or other third parties, or otherwise lost or disclosed in breach of data protection laws. If the Company or any of the third-party service providers on which it relies (including the Co-operative Group) fails to process such personal data in a secure manner or if any such theft or loss of personal data were otherwise to occur, the Company could face action under data protection laws. This could also result in damage to the Company's brands and reputation, as well as the loss of new or repeat business, any of which could have a material adverse effect on the Company's business, operating results, financial condition and/or prospects.

The Company is dependent on its Directors, senior management team and skilled personnel and the loss of one or more Directors or members of senior management or the loss of or failure to recruit and retain skilled personnel may have an adverse effect on the Company's business, operating results, financial condition and prospects and its ability to achieve its strategy

The Company depends on the continued contributions of its Directors, senior management and other key persons with the experience, knowledge and skills in banking necessary for its success. The Kelly Review identified that the Board did not include a sufficient number of technically competent Directors during the period covered by its review. However, the Board was strengthened last year through the appointment of Richard Pym as Chairman of the Board, Niall Booker as Chief Executive Officer and other non-executive directors. The Company intends to further strengthen the Board and to recruit new non-executive directors to replace Merlyn Lowther and Anne Gunther, who intend to retire from the Board with effect from AGM.

Richard Pym has indicated to the Board that, subject to the successful completion of the Capital Raising, he intends to step down from his position as Chairman by the end of 2014. The Senior Independent Director, Dennis Holt, will act as interim Chairman should Richard Pym's successor not be in position at the time he stands down. Should the arrangements for an interim Chairman not be able to be implemented or there be any delay or failure to recruit a permanent successor, the Board could fail to operate effectively and the governance of the Company could be adversely affected.

The failure to have succession plans in place for the Chairman, Senior Independent Director and other members of the Board and to recruit in an orderly and timely fashion and thereafter retain non-executive directors to serve on the Board could negatively impact on the effective governance and oversight of the Company. The Directors and senior managers, have a relatively limited track record of working for the Company and have yet to work together for an entire financial year. Notwithstanding recent appointments, a number of further appointments are still required. In particular, the Company currently intends to appoint

a finance director to the Company's Board as a Director of the Company. Grahame McGirr is currently both head of CoAM and Chief Risk Officer; the Company is progressing the identification and appointment of a new Chief Risk Officer which will allow Grahame McGirr to focus solely on CoAM. In addition, Rodney Bulmer, former Deputy Chief Executive Officer of the Company and the executive director who had been responsible for the Company's Core Business, recently left the Company. The Company is currently seeking a replacement for Rodney Bulmer and Steve Britain has been appointed on an interim contract as his interim replacement. The failure to recruit or delay in recruiting suitable members of the senior management team, the loss of one or more members of its executive team, including the Chief Executive Officer or other members of senior management, without finding suitable replacements or having appropriate succession plans in place, or any adverse perception resulting from the recent change to the Company's ownership structure, may delay or impact on the ability of the Company to successfully implement its strategy. Such risks may arise in relation to various members of the senior management and Board, including the Chief Financial Officer, the HR director, the CEO, the Chairman and other non-executive directors or members of senior management.

Further, the Company has a reliance on short-term contractors. For example, the Chief Financial Officer and HR Director are both employed on interim contracts with short notice periods and there is no written contract in place with the Chief Operating Officer. Remuneration Committee approval to offer permanent remuneration packages has been received and plans are in place to offer all three representatives permanent contracts. If any of them were to depart from their roles at short notice, the Company would lose valuable specialist knowledge and could lose momentum in the execution of the business strategy. The Company would need to seek permanent replacements for all three roles. Attracting permanent replacements could be challenged by the risk of reputational damage, the split geographic locations and the turn-around nature of the roles.

Further, Niall Booker, as CEO, has publicly stated that while he will stay to see the Company stabilised, he would expect a new CEO to lead the Company through its next phase. The departure of Niall Booker along with any other departures of the senior management team would likely lead to disruption of the business and implementation of strategy, as well as a loss of specialist knowledge. The Company may, depending on progress with the implementation of the strategy, still find it difficult to recruit at that time.

In the delivery of its strategy, the Company is reliant on the skill, commitment and support of appropriately skilled and experienced persons working for the Company to deliver the required changes. A significant majority of the personnel engaged in the Company's business who had been employed by CFS Management Services Limited ("**CFSMS**") and seconded to the Company (being all except approximately 60 such personnel), have now been transferred to, and are employed by, the Company. However, the Company remains reliant on other personnel employed by members of the Co-operative Group. The successful implementation of the strategy will necessitate a shift to a more performance-based culture, with clear accountability and with more commercially driven decision-making while retaining the co-operative principles, ethics and values that help differentiate the Company. At the same time, in areas where the Company lacks or does not have a sufficient number of skilled persons, the Company is reliant on being able to attract and recruit such persons and to do so within the timescales envisaged by the Company. Building a team and increased bench strength within the business takes time, and core elements of the Company's proposals for employees, including a long-term incentive scheme, are still in development. The current difficult situation facing the Company poses further challenges to attracting and retaining appropriately skilled and experienced individuals. The challenges which the Company faces in the implementation of its strategy include the impact of any proposed staff redundancies and cost reductions. Any significant reduction in staff morale may have a consequential impact on service delivery and customer service and, potentially, the Company's brand, positioning and ability to maintain its retail funding. In addition, and more generally, competition for personnel with specialist skills, particularly those with financial, banking, IT and specialist control competencies such as risk, legal and finance, is intense among financial institutions. This creates an additional challenge in the northwest region where there is a shortage of specialist banking skills.

The Kelly Review identified that the Company's failings in the lead-up to June 2013 were 'driven significantly by weakness in its recruitment and subsequent management of talent'. The overall "people risk" exposure is currently flagged as a key risk for the Company in recognition of the level of recruitment

required to rebuild the team, business reliance on contractors and the impact of separation. In addition, employee turnover and sickness absences continue to rise and indicate that employee engagement is declining. This situation is compounded by the level of change required in the business to achieve the business plan. Progress with key appointments, a focus on reducing dependency on contractors and improved insight into turnover are all positive indicators; however, the level of change required and the lag time in developing and implementing large-scale projects such as change to culture and long-term incentive plans keep this risk at red status.

Examples of risks associated with the recruitment, employment and management of individuals within the Company include the following:

- the Company is dependent on a small number of individuals working on a large number of initiatives. Resource is stretched and there is a risk that a sufficient number of skilled employees might not be recruited to alleviate the resource issues;
- the risk that the Company's employees will act outside of policies, discretions and accepted codes of behaviour without authorisation;
- the risk that the Company will fail to comply with relevant employment codes and legislation;
- the risk that the Company will fail to comply with relevant trade union agreements and/or will face industrial action, resulting in operational losses and reputational damage;
- the risk that the Company's organisational design does not support its business strategy and/or that individuals are not directly engaged by the Company, are on short-term contracts or are not fully aware of the scope or accountability of their role;
- the risk that the Company's staff are not adequately engaged in the course of their work and particularly throughout periods of change, resulting in fraudulent or unauthorised activities or poor customer service;
- the risk that the Company will not meet its obligations in respect of its employees and/or any external requirements in respect of payroll provision; and
- the risk that the Company will fail to attract, select, performance manage, engage and retain appropriate or sufficient resources.

There is no guarantee that the Company will be able to retain, attract or recruit a sufficient number of appropriately skilled and experienced employees to deliver the required changes and a failure to do so may impact on the Company's ability to achieve its strategy which, in turn, may negatively impact on its business, operating results, financial condition and prospects. The Company's inability to attract, retain and (where relevant) obtain PRA and/or FCA approval for directors and highly skilled personnel, and to retain, motivate, train and manage the performance of its staff effectively, could adversely affect its competitive position, which could in turn result in an adverse effect on its business, operating results, financial condition and prospects.

Union representation subjects the Company's business to the risk of interruptions through strikes or delays resulting from any restructuring of the Company or in renegotiating labour contracts

The Company collectively recognises two trade unions: Britannia Staff Union and Unite. As at 9 April 2014, approximately 63 per cent. of the Company's employees are union members. While the Company has not experienced any significant business interruption as a result of labour disputes at any of its businesses since September 2005, and the Company considers its relations with employees to be sound, the Company does have a high proportion of staff, including senior individuals, who are members of a trade union. Union representation subjects the Company's business to increased risk of interruptions through strikes or delays resulting from any restructuring of the Company or in renegotiating labour contracts.

The Company's strategy includes a significant cost-cutting exercise, which includes workforce redundancies. In addition, the terms and conditions for the majority of the staff are negotiated through collective bargaining

with the unions. The Company may be unsuccessful in concluding any negotiations with unions or reaching an agreement with the unions, including regarding redundancies. A failure to conclude negotiations and reach agreement, or any protracted negotiations, or any breach of an agreement with the unions may result in interruptions to the business through strikes or delays, a diversion of management time from running the Company's business and implementing the Company's strategy, a deterioration in employee relationships, an adverse impact on the Company's reputation and/or an adverse impact on the Company's customer relationships. Such interruptions may, in turn, impact on the Company's business, operating results, financial condition and ability to achieve its strategy.

There can be no assurance that such arrangements will always be in place in the future or that the Company will be able to continue to negotiate wages and salaries and terms and conditions of employment on terms that support its ability to offer its services at competitive prices.

The contributions that the Company is required to make to its pension schemes may change over time. The Company may be obliged to make large one-off payments to its pension schemes, or pension schemes to which it is connected and/or associated, if certain events occur

The Company participates in The Co-operative Pension Scheme ("**Pace**") (whose sponsoring employer is the Co-operative Group). The Company is a guarantor of the Britannia Pension Scheme (the "**Britannia Scheme**") (whose sponsoring employer and main participating employer is CFSMS). Pace and the Britannia Scheme are both hybrid pension schemes which provide defined contribution benefits and defined benefits.

Pension risk arises from these schemes because there may be insufficient assets to meet the defined benefit liabilities. The most recent finalised actuarial reports indicated that there was an actuarial funding deficit of £715 million in Pace and £61 million in the Britannia Scheme as at 5 April 2013. These figures are being updated. A deficit can arise (or grow) because the value of the schemes' asset portfolios, and returns from them, may be less than expected and/or because there may be greater than expected increases in the estimated value of the schemes' liabilities, for example due to rates of investment return, pensioner mortality, changes in interest rates, changes in pension regulations, changes in expenses (including the Pension Protection Fund levy) and/or changes in the trustees' view of the strength of the participating employers. In such circumstances, the Company could be obliged, or may choose, to make additional contributions to the pension schemes and/or set aside additional capital in respect of pensions risk.

The employers participating in Pace make aggregate contributions towards the deficit as agreed between the Co-operative Group and the trustee of Pace following the advice of the independent scheme actuary. These contributions are reviewed by the trustee and the Co-operative Group following each triennial actuarial valuation. A triennial actuarial valuation with an effective date of 5 April 2013 is currently being prepared. The time by which the trustees and the Co-operative Group are required, under pensions legislation, to agree contributions is 15 months after the effective date of the valuation. However, sometimes employers and trustees fail to reach agreement by the statutory deadline - if this occurs the Pensions Regulator could intervene but typically the Pensions Regulator expects the employers and trustees to continue their discussions with a view to reaching agreement. There is a risk that the deficit shown in the triennial actuarial valuation as at 5 April 2013 will be higher than as at the date of the previous triennial valuation and/or a shorter period will be agreed to address the deficit. There is a risk that this will lead to an increase in the aggregate rate of contributions that the participating employers are required to make to Pace. If this occurs, additional capital may need to be set aside in respect of pensions risk.

The Co-operative Group conducts negotiations with the trustee of Pace on behalf of all the employers in Pace and then allocates the agreed aggregate employer contributions among the participating employers. The Co-operative Group has undertaken to agree with the Company its proportion of the employer contributions to Pace (and, if not agreed, the matter will be referred to, and decided by, an independent actuary). On 23 January 2014, following the legal separation of the Company from the Co-operative Group, employment contracts for those employees who spend the majority of their time working on behalf of the Company were transferred from CFSMS to the Company, which will increase the number of Company employees participating in Pace in 2014. The proportion of employer contributions payable by the Company may be

calculated on a basis which involves the Company funding a share of liabilities that cannot be attributed to any employer in Pace, for example where liabilities have been transferred in from another scheme and relate to an entity which has not been an employer in Pace or where other employers have ceased to participate in the pension scheme without satisfying their liabilities. The level of such liabilities in Pace has not been formally worked out and may be substantial. There is a risk that the proportion of employer contributions to Pace paid by the Company while it continues to participate in Pace will increase. If this occurs, additional capital may need to be set aside in respect of pensions risk.

Pace is a "last-man standing scheme", meaning that, while the Company continues to participate in Pace, there is a risk that all employers other than the Company (including the Co-operative Group) exit Pace or become insolvent without satisfying their liabilities towards the scheme, with the effect that the Company becomes solely responsible for funding the scheme. The Company's liability could be up to the level of the entire deficit in Pace calculated by reference to the cost of buying out the scheme's liabilities in the insurance market (which commonly produces a greater deficit than the actuarial funding deficit – in some cases a substantially greater deficit).

The Co-operative Group and the Company have entered into an undertaking pursuant to which the Co-operative Group has agreed with the Company, subject to certain exceptions, not to require the Company to exit Pace. Due to the ongoing funding risks and last-man standing risks in relation to Pace as set out above, the Company may choose to exit Pace. Liabilities may arise for the Company as an employer participating in a defined benefit pension scheme (or as the guarantor of such employers) in certain circumstances set out in legislation, including the winding up of the scheme, for an employer ceasing to participate in the pension scheme or for an employer becoming insolvent. The liability arising (absent an alternative approach to such liability being agreed, see further below) will be the value of the employer's share of the deficit at the time. The proportion of Pace liabilities accrued by members while employees of the Company is believed to represent a minority of total Pace liabilities; however, the employer's share of the deficit may include liabilities that cannot be attributed to any employer in the scheme (sometimes referred to as "orphan" liabilities), for example where liabilities have been transferred in from another scheme and relate to an entity which has not been an employer in Pace or where other employers have ceased to participate in the pension scheme without satisfying their liabilities (for example due to insolvency, see above). There are substantial liabilities in Pace which relate to employees associated with the Co-operative Group's insurance business. The Company's business plan assumes that, on any separation of Pace, none of these liabilities will be attributed to the Company. This assumption has been shared with the Co-operative Group who have not agreed to it. In the event that material liabilities relating to employees associated with the Co-operative Group's insurance business are attributed to the Company on the separation of Pace, this could have a material adverse effect on the Company's business, operative results, financial condition and prospects.

The Co-operative Group and the Company have agreed that, at either party's request, the parties will enter into good faith discussions to agree on the separation of Pace, so that the scheme liabilities properly attributable to the Company and an equivalent proportion of the assets would be transferred to a separate tax registered pension arrangement, or a segregated section of the scheme but, as no arrangements have yet been agreed (and there is a risk that none can be agreed as neither party is under an obligation to agree to any separation of the scheme that would result in a requirement to make material payments to or in respect of the scheme) there is uncertainty over the amount that the Company will have to pay in the event that it exits Pace. Any such arrangement would require the consent of the trustees of Pace and in some cases the Pensions Regulator. If the Company's share of the deficit at the time of exit is greater than expected, significant additional capital may need to be set aside in respect of pensions risk.

If CFSMS becomes insolvent or otherwise ceases to participate in the Britannia Scheme (for example as part of separating the Company's pension arrangements from the Co-operative Group's), CFSMS could incur a liability as described above which would have to be met by the Company. It is possible to agree arrangements that would reduce CFSMS's liability on ceasing to participate in the Britannia Scheme. Any such arrangement would require the consent of the trustees of the Britannia Scheme and, in some cases, of the continuing sponsoring employers after CFSMS's exit and the Pensions Regulator. No arrangements have been agreed and there is a risk that none can be agreed.

The Pensions Regulator also has the power to require an employer of a defined benefit scheme or a person connected or associated with it to make a contribution to or provide financial support for that scheme in certain circumstances. There are eight defined benefit pension schemes within the Co-operative Group in addition to Pace and the Britannia Scheme and there is a risk that the Pensions Regulator could impose significant liabilities in respect of any of these Co-operative Group pension schemes on the Company. These liabilities could have a material adverse effect on the Company's business, operating results, financial condition and prospects.

At 31 December 2012 Pace was a group plan, since all participating entities were within the Co-operative Group. It was accounted for on a defined contribution basis since there was no contractual agreement or stated Co-operative Group policy for charging the net defined benefit cost for the scheme as a whole to individual Co-operative Group companies. Therefore, the Company did not recognise its share of the net defined benefit cost. The net defined benefit cost was recognised fully by the sponsoring employer, which was the Co-operative Group. Following separation of the Company from the wider Co-operative Group as a result of the Liability Management Exercise, the Company is still a participating employer in Pace and Pace is considered to be a multi-employer scheme under IAS 19. There is currently insufficient information to consistently and reliably identify the Company's share of Pace liabilities and employer costs. The Company has not recognised a liability in respect of any part of the existing deficit funding and currently accounts under IAS 19 for its payments to Pace on a defined contribution basis, which is recognised as an expense on the income statement as incurred and based on a fixed percentage as agreed with the trustees. The Company adopted amended IAS 19 in its financial statements for its financial year ending 31 December 2013. However this amendment did not lead to a change in the pension costs disclosed by the Company in respect of Pace on the defined contribution basis. The Company is working towards an objective of agreeing the share of the deficit it will fund, and therefore, it is likely that, in future periods the Company will have to account for Pace on a defined benefit basis and, as such, there is a risk that the Company will have to recognise significant additional liabilities in respect of Pace in its accounts.

The pension costs in respect of the Britannia Scheme are also accounted for on a defined contribution basis. There is a risk that, in future periods, the Company will have to account for the Britannia Scheme on a defined benefit basis and, as such, could have to recognise significant additional liabilities in respect of the Britannia Scheme in its accounts.

The Company's operations are highly dependent on the proper functioning of IT and communication systems which are currently in need of urgent and extensive remediation. Any significant delay in or failure of the Company to remedy the existing IT platform and re-engineer it to meet the requirements of its business strategy may adversely affect the future operational and financial performance of the business. The Company's disaster recovery plan for this IT infrastructure is not proven, creating a material resilience risk

The Company relies heavily on its operational processes and on IT and communication systems to conduct its business, including the pricing and sale of its products, payment processing, data collection, assessing acceptable levels of risk exposure, setting required levels of provisions and capital, and maintaining customer service and accurate records and security.

These processes and systems are currently inherently fragile and unsuitable for their intended purpose. The systems and technology are unsupported and out of date, there are weak internal processes (including for changes to the IT estate), the systems are largely owned by CFSMS and provided under what are currently inadequate contractual arrangements. See the risk factors entitled "*The Company relies on the provision of certain services by the Co-operative Group, including IT and pensions services, and on the performance by the Co-operative Group of certain activities in order to transfer certain services currently provided by the Co-operative Group back to the Company", "Failure to adequately maintain corporate records or to adequately maintain and protect customer and employee information could have a material adverse effect on the Company*" and "*It may not be possible to agree new arrangements between the Company and the Cooperative Group (including CFSMS and CISGIL) following the separation of the Company from the Cooperative Group. Even where arrangements are agreed, the new arrangements may be less favourable to the Company than the existing arrangements*" for further information. There is a large number of single points of failure to the systems. As a result of this, extensive IT remediation is now urgently required. Even after any remediation there remains

a risk that the processes and systems may not operate as expected, may not fulfil their intended purpose or may be damaged or interrupted by increases in usage, human error, unauthorised access, implementation/change activities, natural hazards or disasters or similarly disruptive events. Any failure of these IT and communications systems and/or third party infrastructure on which the Company relies, including that of the Co-operative Group (including CFSMS) or other suppliers, could lead to significant costs and disruptions that could adversely affect the overall operational or financial performance of the business, as well as harm the Company's reputation and could cause the Company to breach its obligations as a regulated entity and/or attract increased regulatory scrutiny.

These issues have been identified following a major review of the IT resilience risks associated with the IT platform and infrastructure used by the Company. This review has been more detailed and extensive than the Company's previous review of its IT infrastructure towards the end of 2013 (as discussed in the Prospectus), and presents a significantly worse situation than previously understood. In particular, the Company has found that its disaster recovery plan for its IT infrastructure is not proven. Were there to be a natural hazard, disaster or similarly disruptive event impacting the IT infrastructure used by the Company, the Company may not be able to recover its infrastructure in a timely manner (or at all). This is a material risk. In particular the review has identified risks that fall broadly into the categories of "disaster recovery", "design of IT systems", "single points of failure", "end of life technology" and "third-party suppliers". The output from this revised risk review has been shared with the PRA and the FCA. The Company is undertaking a three-year IT resilience remediation programme to remediate the critical risks identified by its reviews, and has committed significant additional investment to this programme. The resilience review also identified risks in the Company's data centre facilities and the committed investment covers the required remediation activities. The Company will continue to be subject to these risks until such time as it has completed its planned remediation activities, scheduled for the end of 2016 (albeit that incremental improvements will be made as the plan develops) and the intention is to prioritise remediation of high priority risks by the end of 2014 wherever possible. Any failure in systems as a result of not remediating the IT risks, or in the period leading up to such remediation being completed, could adversely affect the Company's ability to conduct its business and could lead to the PRA imposing additional requirements on the Company or subjecting the Company to additional regulatory scrutiny. Further, the actual act of working on and changing the Company's legacy IT systems increases the risk that the systems might fail.

There are also access control issues across the Company that have been highlighted within past internal and external audit reports and internal assessments highlighting associated risk exposures. These issues include the overall governance of logical access and how access to data is managed within IT and the wider business. In response, there is targeted activity to address key areas of control weaknesses such as the "Logical Access Management" project. The need for further remediation is being assessed and will be reported to the Company's Risk Committee.

In addition to seeking to remedy the IT systems, the Company has undertaken a strategic review of its overall IT requirements against the backdrop of the strategy of the Core Business, and has agreed a new IT strategy. This strategy involves incremental re-engineering of the existing platform to create a target platform that supports the Core Business, including introduction of new digital channel applications with improved capabilities (as the Company's digital channel offerings lag significantly behind those of its competitors); enhancements to the core mainframe platform to allow for simpler product development and management; improved reporting and analytics; and improved process and workflow automation. This re-engineering will be combined with the simplification of IT systems in order to reduce running costs (as the IT running costs are currently above the Company's industry peers), e.g. rationalisation of existing savings and mortgage platform. Cost reductions from improvements in IT operating efficiency will also be targeted, although this will require management of the risk so that these reductions do not reduce service below acceptable levels. The Company further intends to outsource a significant amount of its IT requirements to accelerate the remediation plan and further manage the costs. Reliance on a third-party by way of outsourcing brings further risks. See the risk factor entitled "*The Company is dependent on third-party providers of services, IT, software, data and other assets*" for further information.

These IT initiatives are significant, particularly in terms of scale, complexity and cost, and the Company has a poor historic track record of successfully implementing large-scale changes. Therefore, these initiatives involve delivery risk, although this is partially mitigated by the modular and iterative delivery approach that is being adopted. Any significant delay in or failure of the Company to deliver these IT re-engineering initiatives may result in significant additional investment costs and also significantly impact the Company's ability to achieve its business strategy, and may adversely affect the future operational and financial performance of the business. The Company recognises that there are aspects of the delivery of this re-engineering programme and the implementation of the IT strategy which will require the Company to engage third parties in order to complement its internal delivery capability, including in respect of the digitalisation aspects of the programme (although others may be identified in due course).

As part of the Company's wider strategy, the Company is still transitioning from the merger with Britannia and is continuing to integrate heritage systems and processes. As a result, there are risks associated with the ongoing integration of two organisations of the size of the Company and Britannia. Areas of risk include difficulties or unexpected costs relating to the integration of technology platforms, financial and accounting systems and difficulties or unexpected costs in realising synergies from the remaining consolidation of head office and back office functions. If the implementation of any such projects is not delivered on time, and/or the costs of implementation rise significantly and the Company fails to exploit such projects once implemented, there is a risk that there could both be a delay to the future benefits and an increased cost for the transformation process, which may have an adverse effect on the Company's business, operating results, financial condition and prospects.

The Company is dependent on third-party providers of services, IT, software, data and other assets

There is a risk that third-party providers could fail to supply services, IT, software, data or other assets that they have agreed to provide, either adequately or at all. If third-party providers fail to provide or procure the services that they have contracted to provide, or to provide them in a timely manner or to agreed levels, or the arrangements with those providers are terminated for whatever reason, such failure could have a material adverse effect on the Company's business, operating results, financial condition and prospects. The Company may be unable to source an alternative provider for the services, IT, software, data or other assets on a timely basis, on equivalent terms or without significant expense, or at all. The additional costs and expenses incurred in doing so may have a material adverse effect on the Company's cost base. This could have a material adverse effect on the Company's business, operating results, financial condition and prospects.

There is also a risk that contracts with third-party providers on which the Company relies may be or may have been poorly negotiated and/or poorly managed, particularly as the Company has limited experience in negotiating such contracts with third parties. Prior to the Liability Management Exercise, many of these services were provided or procured by the Co-operative Group and CFSMS – this will continue to be the case until the Company has been able to separate itself from the Co-operative Group and CFSMS. See the risk factor entitled "*There are numerous risks associated with the separation of the Company from its former parent, CBG and its ultimate former parent, the Co-operative Group*" for further information. The risk of poorly negotiated and/or poorly managed contracts will increase as the Company decreases its dependencies on the Co-operative Group and seeks to build an internal procurement and supplier management function and to engage more third-party providers.

Any reduction in third-party product quality or any failure by a third-party to comply with the Company's licensing or regulatory requirements, including requirements with respect to the handling of customer data, could cause a material disruption to or adverse financial and/or reputational impact on the Company's business. Any of these events could have a material adverse effect on the Company's business, operating results, financial condition and prospects.

There are numerous risks associated with the separation of the Company from its former parent, CBG, and its ultimate former parent, the Co-operative Group

In the period up to 20 December 2013, the Company began working on logistically separating from its former parent, CBG, its ultimate former parent, the Co-operative Group, and its former sister company,

CFSMS, with all of whom it shares premises, systems, personnel and services. The separation process has been continuing for some time but progress is slow and there are risks associated with execution. As the work is complex and time consuming, the costs of separation have already been significant and further significant costs will likely be incurred. Examples of the risks associated with the separation process include:

- new commercial agreements between the Company and the Co-operative Group entities (including CFSMS) are still to be agreed – these agreements also deal with the separation of functions to enable the Company to operate on a stand-alone basis. More time will be required to finalise remaining open issues, including who bears responsibility for the costs of separation. Until final agreement has been reached between the Company, the Co-operative Group and CFSMS on these new agreements, the execution of the separation exercise cannot be finalised. Until then, the Company will remain operating under the existing agreements that were put in place while the Company was a wholly-owned subsidiary of the Co-operative Group. These existing agreements are, in various regards, neither commercial nor fully "arm's length", in particular for the Company's relationship with CFSMS. This could mean that there are certain legal and regulatory risks associated with the business (e.g. relating to the ongoing use of trademarks and the ownership of assets). Until new arms' length agreements are in place, the Company will not be in compliance with Chapter 8 of the FCA and PRA's Senior Management Arrangements, Systems and Controls Handbook ("**SYSC**"), is at risk of poor service performance from the Co-operative Group and will be uncertain of its ability to achieve separation and to share separation costs with the Co-operative Group. Further, the Existing IT and existing MSA do not reflect the dynamics between the parties after separation (e.g. they treat CFSMS as a customer and the Company appoints CFSMS as its agent under both agreements). While this may have been appropriate when CFSMS was an internal service company for the whole of the former banking group, it is not appropriate now that the Company purchases services from the Co-operative Group independently of CFSMS. See the risk factors entitled "*It may not be possible to agree new arrangements between the Company and the Co-operative Group (including CFSMS and CISGIL) following the separation of the Company from the Co-operative Group. Even where arrangements are agreed, the new arrangements may be less favourable to the Company than the existing arrangements*"; "*The Company does not have any documented right to occupy several of its principal establishments and places of business. The Company's current occupation of some properties is in potential breach of the terms of the lease for that property*"; "*The Company will continue to rely on the Co-operative Group. The Co-operative Group may also continue to exert substantial influence over the Company*"; and "*The Company will continue to rely on the Co-operative brand*" for further information;

- the costs of the separation process remain uncertain and risk being greater than current forecasts. Owing to a lack of agreed scope, design and responsibility for effort, the Company is facing challenges in agreeing shared separation costs with the Co-operative Group. This increases liquidity and funding risk;

- there is a continuing mix of customer, employee and financial data (physical and electronic) with limited data partitions or access controls. Separating this is likely to be highly complex and be impacted by the lack of an information asset register that the Company will need to compile. See the risk factor entitled "*Failure to adequately maintain corporate records or to adequately maintain and protect customer and employee information could have a material adverse effect on the Company*" for further information;

- there is a risk of increased key person dependencies as part of the separation programme, with increased staff turnover due to the increased workload arising from separation;

- the separation process is encountering delays in respect of negotiations and planning, in part due to the Co-operative Group's complex governance arrangements, different working practices and the complexities resulting from the Company's regulated environment. Consultations on changes to the Co-operative Group's governance arrangements or adverse findings of any of the various enquiries and investigations underway which impact on the Co-operative Group may result in organisational disruption in operations or decision-making at the Co-operative Group, increasing the difficulties in

making progress with separation and the execution risk with respect to the agreements being negotiated to implement separation;

- the separation programme has multiple interdependencies with other programmes (e.g. the IT remediation plan and cost reduction programmes). These interdependency considerations increase the risk to separation completing in a timely or cost-effective manner. See the risk factors entitled "*The Company relies on the provision of certain services by the Co-operative Group, including IT and pensions services, and on the performance by the Co-operative Group of certain activities in order to transfer certain services currently provided by the Co-operative Group back to the Company*"; "*The Company is dependent on CFSMS to provide key assets and to on-supply certain services, data and assets supplied by third-party providers*"; "*It may not be possible to agree new arrangements between the Company and the Co-operative Group (including CFSMS and CISGIL) following the separation of the Company from the Co-operative Group. Even where arrangements are agreed, the new arrangements may be less favourable to the Company than the existing arrangements*" and "*Failure to adequately maintain corporate records or to adequately maintain and protect customer and employee information could have a material adverse effect on the Company*" for further information;

- there are increased pensions risks. See the risk factor entitled "*The contributions that the Company is required to make to its pension schemes may change over time. The Company may be obliged to make large one-off payments to its pension schemes, or pension schemes to which it is connected and/or associated, if certain events occur*" for further information;

- there may be reputational risks associated with a failure to execute separation and/or from the Company's continued association with the Co-operative Group. See the risk factors entitled "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co-operative values and ethics*" and "*There is a risk that the Company's ownership structure following the Liability Management Exercise and the Capital Raising may undermine the Company's reputation as being more focused on values and ethics than its competitors. Such a reputation has been a competitive advantage for the Company*" for further information; and

- there may be increased potential for conduct issues to arise owing to the extent of change resulting from the separation process.

The Company relies on the provision of certain services by the Co-operative Group, including IT and pensions services, and on the performance by the Co-operative Group of certain activities in order to transfer certain services currently provided by the Co-operative Group back to the Company

In addition to the IT and other services provided to the Company by CFSMS (see the risk factor entitled "*The Company is dependent on CFSMS to provide key assets and to on-supply certain services, data and assets supplied by third-party providers*" for further information), some IT and other professional services are provided to the Company by the Co-operative Group. The IT services provided by the Co-operative Group include core infrastructure services, colleague technology services, network services, service management services (including change management services), architecture direction, architecture design, supplier management, IT programme management and management operations (together, the "**IT Services**").

A significant majority of the IT Services are expected to return, over time, to the Company.

In the past, in addition to the IT Services, the Company relied on the Co-operative Group to provide certain services in respect of finance (including procurement), marketing, human resources, pensions, risk, corporate affairs, secretariat (governance), secretariat (legal), estates and investment property management functions, some of which were critical to maintaining the level of support for the on-going needs of the business and customers (together, the "**Professional Services**"). Since the Liability Management Exercise the Company has been in the process of transferring back many of the Professional Services and certain IT Services, and the associated staff, so reducing to a significant degree the level of reliance on the Co-operative Group. To date, the Company has transferred back or otherwise terminated all Professional Services other than the benefits, reward, payroll and Tier 1 Service Delivery Advice Line HR elements, procurement,

marketing, all of which are intended to have transferred back by September 2014, and pensions, estates (including second line oversight 'risk' functions) and investment property management and certain IT Services. The Company is at different stages of planning for the transfer back of those latter services.

The provision, and/or return (as appropriate), of the IT Services and the Professional Services is intended to be governed by the New IT Services Agreement and New MSA respectively, the terms of which are yet to be finalised (together, the "**New Service Agreements**"). Pending finalisation of the New Service Agreements, or if the New Service Agreements are not put in place, the provision and return of the IT Services and Professional Services are and will be governed by the Existing IT Services Agreement and Existing MSA respectively (together, the "**Existing Service Agreements**").

To the extent the Company relies on the Co-operative Group for the provision of IT Services and Professional Services under the Existing Service Agreements or, once finalised and entered into, the New Service Agreements, if the Co-operative Group fails to provide or procure those services or provide them in a timely manner or to agreed levels, such failure could have a material adverse effect on the Company's business, operating results, financial condition and prospects.

If the Co-operative Group and the Company fail to agree the detail of an exit plan, there be will be some uncertainty as to the extent of the Co-operative Group's obligations to transfer the IT Services or the Professional Services. In addition, if the Co-operative Group fails to perform activities necessary to transfer any of the IT Services or, to the extent not already transferred, Professional Services, back to the Company, or fails to complete those activities within the intended timeframe, the delay could give rise to increased costs to the Company, including increased VAT liability.

Any such delay could also give rise to increased costs in relation to assets that are currently shared by the Company and the Co-operative Group. This is because termination of the maintenance and/or development of shared assets under the New IT Services Agreement (once that agreement is finalised and entered into), is agreed not to be effective until the Company has either procured an alternative asset or separated in relation to that asset under the Transitional Services Agreement.

Currently, the data of the Company and the Co-operative Group are not fully segregated. Accordingly, under the current drafts of the New Services Agreements the parties are to agree a plan (or, if they cannot agree, refer to an expert for determining a plan) for the segregation of the Company's data from that of the Co-operative Group. Certain of the Company's data may be archived rather than segregated (either if the Company agrees that it may be archived or if certain conditions are met), subject to the caveat that Co-operative Group will segregate that data, at the Company's cost, if a regulator requires it to be segregated.

Currently, the Co-operative Group is not fully in compliance with the Company's IT security standards. Accordingly, under the current drafts of the New Service Agreements, the Co-operative Group is required to use its reasonable endeavours to comply with the Company's security standards, and is required to implement a programme of continuous improvement which programme must comply with "good industry practice". If a security failure should occur, this could cause a loss to the Company, for example regulatory fines, customer loss or reputational damage.

The Company and Co-operative Group are considering whether certain costs incurred by them in, among other things, transferring the IT Services and Professional Services back to the Company are to be shared between them. The parties have not yet agreed whether these costs should be shared, but have discussed the terms on which such sharing, if agreed, may occur. If in principle the parties do agree to share costs, the basis on which they would do so would be set out in the Separation Cost Agreement, the terms of which are to be finalised. The current draft of the Separation Cost Agreement envisages that costs that are eligible to be shared must be approved by both the Company and the Co-operative Group pursuant to specific business cases. If these procedures were to be implemented, the Company's desire to share certain costs relating to the transfer back of IT Services or Professional Services may therefore be frustrated by an inability to agree a business case for those costs. There is an expert determination procedure to mitigate this risk. If the terms of the Separation Cost Agreement cannot be agreed, the Company may be liable to increased costs of separation.

The Company is dependent on CFSMS to provide key assets and to on-supply certain services, data and assets supplied by third-party providers

A significant proportion of third-party services and assets (including core IT services and assets, such as the banking platform) used by the Company is procured by CFSMS not only for the benefit of the Company, but also for the benefit of other members of CBG. CFSMS also used to employ the majority of personnel used by the Company, although a significant proportion of the Company's total workforce has transferred to the Company since the Liability Management Exercise. Nevertheless, the Company remains dependent on CFSMS for the provision of those personnel who have not transferred to the Company since the Liability Management Exercise. CFSMS owns the majority of assets and contracts used by the Company. Some of those assets and contracts are used exclusively by the Company, while others are shared between the Company and other members of CBG.

CFSMS was established as a wholly owned subsidiary of CBG to facilitate economies of scale through the sharing of employees and the sourcing of third-party services and assets across CBG (which at the time included the Company). As such, the Company has procured certain assets and third-party services (including services provided by Steria Limited and SAS Software Limited, as well as its core banking platform) through CFSMS. The Company receives third-party services and assets with the support of a procurement service provided by the Co-operative Group, but the agreements under which those assets or third-party services are provided are entered into by CFSMS. As a result, the Company is relying on CFSMS to on-supply services and assets to it. With the exception of its agreement for the provision of transitional services to Royal London, CFSMS has little or no experience in providing outsourcing services to a third party on arm's length terms. CFSMS's obligations to the Company in relation to its provision of assets, contracts and personnel are currently governed by an agreement dated 16 February 2006 (the "**CFSMS-Bank 2006 Agreement**"). Under the CFSMS-Bank 2006 Agreement, the Company provides CFSMS with an indemnity for all liabilities, losses, damages, costs and expenses of any nature incurred as a result of CFSMS entering into and performing the agreement in respect of the assets, services and personnel provided to the Company. A new "**Transitional Services Agreement**" is currently being negotiated between the Company and CFSMS to replace the CFSMS-Bank 2006 Agreement but the negotiations are not yet complete. Until such time as the Transitional Services Agreement has been entered into, the Company will remain dependent on CFSMS for the provision of these third party contracts, assets and personnel under the terms of the CFSMS-Bank 2006 Agreement.

As stated above, a significant majority of the personnel engaged in the Company's business who had been employed by CFSMS and seconded to the Company have now been transferred to the Company. Since the Liability Management Exercise, all except approximately 60 of the personnel engaged in the Company's business who were employed by CFSMS have transferred to and are now employed by the Company. However a significant number of assets and contracts for services with third parties continue to be provided by CFSMS to the Company. The intention is to transfer a significant number of those assets and services to the Company but this will require co-operation from CFSMS. The parties are currently negotiating the terms of such transfers and discussions are ongoing in relation to the potential transfer of any assets and contracts that are exclusively used by the Company to the Company as soon as possible. The Company will continue to seek to discuss the transfer of assets that are used by both the Company and the other Co-operative Group entities (i.e. shared assets). However, there is a risk that the terms of such transfer cannot be agreed and that some or all of the shared assets and third party service contracts will remain with CFSMS, to be provided under the terms of the new Transitional Services Agreement (or under the terms of the CFSMS-Bank 2006 Agreement until such time as the new Transitional Services Agreement has been agreed). This may result in additional VAT charges. As a significant number of assets and third-party services required by the Company remain with or contracted to CFSMS, there is a risk that the Company may not be able to execute its remediation plans within the intended timeframe or at all – for example, it would be reliant upon the Co-operative Group's consent to use the assets required for remediation. As CFSMS owns the majority of assets used by the Company, if CFSMS lawfully refused to make available the relevant assets to the Company, this could potentially be a significant risk to the Company's business, operating results, financial condition and prospects.

The CFSMS-Bank 2006 Agreement was entered into at the time the Company was still part of the Co-operative Group. As such, it was not negotiated as an arm's length agreement and revised terms are being negotiated with the Co-operative Group under the proposed Transitional Services Agreement (see the risk factor entitled "*It may not be possible to agree new arrangements between the Company and the Co-operative Group (including CFSMS and CISGIL) following the separation of the Company from the Co-operative Group. Even where arrangements are agreed, the new arrangements may be less favourable to the Company than the existing arrangements*" for further information). As critical operational functions are provided to the Company by CFSMS, those arrangements are likely to be subject to the rules set out in SYSC 8. As the CFSMS-Bank 2006 Agreement was not negotiated on an arm's length basis, it does not comply with the requirements under SYSC 8 and to the extent replacement arrangements are not agreed with the Co-operative Group, there is a risk that the Company will not comply with its regulatory duties and, therefore, a risk of regulatory intervention.

Furthermore, as CFSMS holds a significant number of assets and on-supplies third-party services that are critical to the Company's business, there is a risk that, to the extent that CFSMS fails to make these available to the Company (and the parties fail to agree the terms to transfer them to the Company), the Company could be in breach of the regulatory threshold condition that requires the Company to have resources as are appropriate in relation to the regulated activities it carries on. As such, any failure by CFSMS to make such assets and services available to the Company may require the Company to obtain alternative sources of supply in order to meet this threshold condition and avoid regulatory intervention. This could, in turn, have significant financial consequences for the Company and have a significant adverse impact on the Company's business operating results, financial condition and prospects.

For so long as the Company relies on CFSMS for the provision of assets, third party services and personnel (whether under the terms of the CFSMS-Bank 2006 Agreement or the new Transitional Services Agreement), if CFSMS fails to provide or procure those assets, services or personnel or fails to provide them in a timely manner or to agreed levels, such failure could have a material adverse effect on the Company's business, operating results, financial condition and prospects.

It may not be possible to agree new arrangements between the Company and the Co-operative Group (including CFSMS and CISGIL) following the separation of the Company from the Co-operative Group. Even where arrangements are agreed, the new arrangements may be less favourable to the Company than the existing arrangements

The Company is dependent on the Co-operative Group for the provision of IT and other services and is dependent on CFSMS for the provision of the majority of its assets (including IT assets) and the on-supply of certain third-party services (see the risk factors entitled "*The Company relies on the provision of certain services by the Co-operative Group including IT and pensions services, and on the performance by the Co-operative Group of certain activities in order to transfer certain services currently provided by the Co-operative Group back to the Company*" and "*The Company is dependent on CFSMS to provide key assets and to on-supply certain services, data and assets supplied by third-party providers*" for further information). There are a number of agreements in place to govern these arrangements and most (if not all of these) are not on arm's length terms (the "**Existing Service Agreements**").

In light of the fact that, following completion of the Liability Management Exercise, the Company ceased to be part of the same group as the Co-operative Group and CFSMS, the Company, the Co-operative Group and CFSMS are currently renegotiating the terms of the Existing Service Agreements with a view to ensuring that the replacement arrangements are appropriate to reflect this fact and that certain assets and services required by the Company and supplied by the Co-operative Group and CFSMS are transferred to the Company.

As the terms of the replacement arrangements are still the subject of negotiation, there is a risk that the scope of, or terms upon, which the services are agreed to be provided to the Company may not be as favourable to the Company as the terms of the current arrangements or that the Company may not receive all the assets or services which it requires. In such circumstances, the Company will be dependent on sourcing such assets or services from elsewhere and there is no guarantee that the Company will be able to source such assets or services, to do so within a reasonable period of time, or to do so on favourable terms. Such failure could have

a material adverse effect on the Company's business, operating results, financial condition and prospects. Further, there is a risk that the agreements will not be concluded at all, including if there is organisational disruption in operations or decision-making at the Co-operative Group arising from the governance reviews.

Following completion of the Liability Management Exercise, the Company and the Co-operative Group are no longer in the same VAT group, which has resulted in monthly VAT charges of £174,000 being payable by the Company in respect of the assets that are still provided by CFSMS. If, and for so long as, the terms of the new agreements cannot be agreed and the transfer of assets and third-party services to the Company cannot be effected, the Existing Service Agreements will continue to apply and the Company will continue to incur these significant VAT costs. In addition, if, and for so long as, the terms of the Existing Service Agreements continue to apply, the Co-operative Group and CFSMS will (under the terms of the relevant agreements) continue to be able to terminate those agreements on relatively short notice with the consequence that, should they do so, the services provided under the Existing Service Agreements may cease before appropriate replacement arrangements have been found. Consequently, failure to reach agreement on the replacement arrangements could have a material adverse effect on the Company's business, operating results, financial condition and prospects.

As part of the negotiations relating to the separation of the Company from the Co-operative Group, the Company and the Co-operative Group also agreed terms relating to the surrender of group relief between the entities in the Company's tax group and entities in the Co-operative Group tax group. A deed which sets out the basis of the agreement by the Co-operative Group to take pro-active steps to allow it to maximise its claim for tax losses from the Company for the accounting periods to 31 December 2012 and 2013 was prepared. The deed also addresses the terms of the payment by the Co-operative Group to the Company for those tax losses. The 2013 Annual Accounts, which include a group relief debtor of £126.6 million, have been prepared on a basis consistent with the deed. The Company believes the terms reflected in the deed have been agreed but the deed has not been legally exchanged and hence there is a risk of the parties asserting that they are not contractually obliged to comply with its terms and that the group relief debtor on the Company's balance sheet may be reduced.

The group relief debtor has been calculated on the basis of the losses surrendered for 2012 and an estimate, provided by the Co-operative Group, of the tax losses that will be claimed by the Co-operative Group in 2013. If the Co-operative Group's capacity to claim tax losses from the Company is reduced as a result of revisions to its taxable profit calculations, then the ability of the Company to surrender losses will be impacted and the group relief debtor on the balance sheet will also reduce.

CISGIL and the Company have also been negotiating the terms of an agreement to document the terms of an existing referral arrangement between the parties, pursuant to which the Company markets certain general insurance products provided by CISGIL to its customers. This referral arrangement has been continuing on an undocumented basis for a number of years and the Company could be exposed to liability for mis-selling products sold under this arrangement. The draft referral agreement allocates mis-selling liability between the parties by way of a reciprocal indemnity. The draft referral agreement has been largely agreed in principle. However, it has not yet been signed. In the event that the agreement is not signed, the Company will not have the benefit of the mis-selling indemnity to protect itself in certain situations where it might otherwise incur mis-selling liability to customers notwithstanding that the claim had arisen as a result of CISGIL's acts or omissions.

The Company does not have any documented right to occupy several of its principal establishments and places of business. The Company's current occupation of some properties is in breach of the terms of the lease for that property

A number of the Company's principal establishments are in the control of the Co-operative Group and, historically, the Company has occupied these properties on an informal basis and it continues to do so.

The Company has been in negotiations with the Co-operative Group to formalise and secure the Company's rights of occupation by entering into new leases of the properties at CIS Building, Manchester and St Paul's

House, London with the Co-operative Group. There are currently approximately 1,750 individuals working in the CIS Building and 17 in St Paul's House. Neither of the new leases have completed yet. The lease for St Paul's House requires head landlord's consent to its grant. Consent has been applied for, but has not yet been obtained. To the extent appropriate consents from the head landlord are not obtained, the Company may be required to vacate that property on short notice. This would involve significant capital expenditure by the Company and it would likely cause some disruption to the Company's business. This could also mean that any capital expenditures already incurred by the Company on the fit-out works at St Paul's House are lost.

The Company has allowed a Co-operative food store to continue to trade from ground floor premises at its Balloon Street Property pursuant to the terms of an agreement for lease entered into in December 2013. The Company's lease of Balloon Street prohibits the occupation by a Co-operative food store without the landlord's consent. Consent from the Company's landlord in relation to Co-operative food stores occupation has been applied for and a settlement is being sought. If consent were not obtained, and the landlord sought to take enforcement action against the Company, there is a risk that the Company could be required to vacate the entire Balloon Street Property and that the landlord may also seek damages in relation to any breach.

The Company also had a 35-year lease over Delf House, Skelmersdale, which ended on 28 September 2013. There are currently approximately 750 individuals working in Delf House. The Company is currently in negotiation with the landlord, a council, over the terms of renewal of the lease. Terms have been agreed, in principle, for an initial new 5 year lease with options, to renew for a further 5 years after the fifth and tenth years.

If negotiations cannot be concluded with either landlord and the new leases do not complete, the Co-operative Group or council (as applicable) could seek to force the Company to vacate the properties. This would involve significant capital expenditure by the Company in the short term to relocate its personnel, equipment and operations to new premises, and it would likely cause some disruption to the Company's business.

Risk that the Company's use of a substantial network of ATMs in the Co-operative Group stores and outlets will be terminated

The Company has a substantial network of close to 2,000 ATMs in the Co-operative Group stores and outlets pursuant to an agreement with the Co-operative Group. This is circa 80 per cent. of the Company's overall ATM estate. However, the Co-operative Group has recently served notice in respect of that agreement, with the result that the ATMs will need to be removed from all Co-operative Group food stores and outlets by the end of 2015. Unless the Company and the Co-operative Group can negotiate a new agreement allowing the Company to retain its network of ATMs in the Co-operative Group stores and outlets, the removal of these ATMs could harm the Company's ATM business and lead to financial costs being incurred in the removal of those ATMs and increased interchange costs from the Company's customers using any replacement ATMs. Such a reduction in the Company's ATM network could also reduce the Company's negotiating power if the Company wishes to outsource the remaining branch-based ATMs to a third party. As the Co-operative Group has already served notice under the ATM agreement and the Co-operative Group has indicated it would prefer to enter into a new agreement with an alternative ATM provider, there is a high likelihood that one or more of these risks will crystallise. There are also approximately 400 ATMs in independent Co-operative outlets and there is also the risk that the agreements relating to these ATMs may also be terminated.

Risk that the Company's insurance cover may be inadequate, that it will be difficult for the Company to obtain insurance and that those insurance policies which the Company has in place might become void or voidable

The Company has a number of insurance policies in place with respect to its business, assets and liabilities. Any insurance that the Company may obtain may be subject to exclusions, limitations, minimum claim amounts and excess amounts and other terms that mean that the Company may have uninsured claims and losses. There is therefore a risk that the terms of the Company's insurance policies will not cover the Company's liabilities in all situations and that the Company may therefore have uninsured exposure. There is also a risk that the Company will not be able to obtain the insurance it needs or expects and in the quantum

that it requires, that it might not be able to predict the type of insurance cover it might need and / or that any insurance cover that the Company does have in place might become void or voidable.

For example, as part of the process of separating from the Co-operative Group, the Company is in the process of finalising the list of properties and contents. Until such time as the Company has a complete set of property assets and valuations, there is a risk that the insured values do not fully match the market values of the Company's assets and therefore do not comply with certain provisions in its property insurance policies. This risks those policies being voidable.

The Company may be subject to fines or customer attrition as a result of weaknesses in CISGIL point of sale system

The Company currently sells certain general insurance products provided by CISGIL, a Co-operative Group company. Sales are made face to face in the Company's branches utilising a point of sale system, provided by CISGIL, which was originally designed for use in a telephone sales channel, rather than face to face. There are certain shortcomings with the system that introduce risk to the Company. The system needs to be developed and there is a risk that the Company has to compensate customers if there are any failings. Furthermore if CISGIL cannot upgrade the system quickly, there is a risk that the Company may have to suspend the sale of CISGIL products which would reduce the Company's insurance related revenue.

The Company will continue to rely on the Co-operative Group. The Co-operative Group may also continue to exert substantial influence over the Company

The Co-operative Group currently owns 30 per cent. of the issued ordinary share capital of the Company through CBG. Following completion of the Capital Raising and assuming the Co-operative Group, through CBG, accepts its Open Offer Entitlement, the Co-operative Group's shareholding in the Company is likely to be reduced further.

To the extent it remains a significant shareholder of the Company (carrying at least 20 per cent. of voting rights), the Co-operative Group will continue to have the power, among other things, to affect or influence the Company's legal and capital structure and certain changes to its operations. The interests of the Cooperative Group could conflict with those of the Company or other shareholders, and this concentration of ownership may also have the effect of delaying, deferring or preventing the Company's ability to effect certain types of transactions that require approval by the Co-operative Group, including by special resolution for so long as it holds 25 per cent. or more of the Company's issued shares. In addition, the separation between the Company and the Co-operative Group provides a challenge to the Company's operating model.

In order to manage these risks, the Company entered into a Relationship Agreement with the Co-operative Group which regulates (in part) the relationship between and the degree of control that the Co-operative Group and its subsidiaries may exercise over the Company as long as the Co-operative Group owns 20 per cent. of the Company. In addition, as referred to in the Relationship Agreement, the Articles of Association of the Company grant the Co-operative Group the right to appoint up to two members to the Board depending on the size of its holding of Ordinary Shares.

In the event that the Co-operative Group's shareholding in the Company falls to below 20 per cent., the Relationship Agreement will terminate. This will have the effect that the Co-operative Group will no longer have the right to appoint members of the Board or to appoint a member to the Values and Ethics Committee. However, as these provisions are entrenched in the Articles of Association of the Company, in the event that the Co-operative Group's shareholding in the Company increases to over 20 per cent. again, the Co-operative Group's rights to appoint members of the Board and a member of the Values and Ethics Committee will be reinstated. Furthermore, certain provisions of the Relationship Agreement will continue to apply (notwithstanding its termination) in the event that the Co-operative Group's shareholding falls to less than 20 per cent. in the Company, including the requirements for: (a) the Co-operative Group to provide reasonable assistance to the Company to achieve a premium listing (although this is subject to the Company not seeking to remove or alter the entrenched rights of the Co-operative Group within the Company's Articles of Association); (b) the Co-operative Group to use the Company as its exclusive or principal

financial services provider for two years after terminaton; (c) the Co-operative Group not to operate, establish or acquire a competing business for three years after termination; (d) the Co-operative Group not to solicit employees of the Company for five years after termination; and (e) the parties to maintain confidentiality.

Under the Shareholder Rights Agreement, the Co-operative Group will in certain circumstances have the right alongside the Committed Shareholders, not to be exercised before 30 September 2014, to require the Company to assist in the launch of a secondary offering of Ordinary Shares, provided the exercising Shareholders have committed to sell Ordinary Shares valued at not less than £100 million.

In addition the Company continues to be dependent on the Co-operative Group and its subsidiaries for the provision of certain services, including IT (see the risk factors entitled "*The Company relies on the provision of certain services by the Co-operative Group, including IT and pensions services, and on the performance by the Co-operative Group of certain activities in order to transfer certain services currently provided by the Co-operative Group back to the Company*" and "*The Company is dependent on CFSMS to provide key assets and to on-supply certain services, data and assets supplied by third-party providers*" for further information). There can be no guarantee that these arrangements between the Co-operative Group and the Company will be sufficient for the Company's future needs (even if a new arrangement can be agreed) or that such provision of services will not be interrupted or cease altogether. There is also a risk that new contractual agreements will not be agreed. See the risk factor entitled "*It may not be possible to agree new arrangements between the Company and the Co-operative Group (including CFSMS and CISGIL) following the separation of the Company from the Co-operative Group. Even where arrangements are agreed the new arrangements may be less favourable to the Company than the existing arrangements*" for further information. If the contractual arrangements with the Co-operative Group are terminated, the staff providing the services may not transfer to the Company, and the Company may not find an alternative outsource provider or supplier for the services, on a timely basis, on equivalent terms without significant expense, or at all. The additional costs and expenses incurred in doing so may have a material adverse effect on the Company's cost base. This, in turn, could have a material adverse effect on the Company's business, operating results, financial condition and prospects.

The Company will continue to rely on the Co-operative brand

The Company is dependent on the strength of the Co-operative Bank brand (which it owns), the wider Co-operative brand (as used by the Co-operative Group) and its reputation with customers and potential customers of the Company. Whilst the Company seeks to manage material risks to the Cooperative Bank brand through careful monitoring, ultimately the Company is exposed to the risk that the Co-operative Group acts, fails to act or is speculated to act in a way such as to bring the Company brand into disrepute. This could include litigation, employee misconduct or the misconduct (including criminal activity) of anyone associated with the Co-operative brand (whether through the Cooperative Group, the Company or otherwise), operational failures, accidents, the outcome of regulatory investigations, press speculation and negative publicity, disclosure of confidential customer information, inadequate products and services, amongst other factors, and could negatively impact the Co-operative brand or the Co-operative Group's reputation. For example, adverse findings about the Co-operative Group arising out of investigations into past actions, or adverse commentary and organisational disruption to the Co-operative Group as a result of the Myners Report on the governance of the Co-operative Group (published 7 May 2014), could adversely affect the Cooperative brand. Should, as a result of matters relating to the Co-operative Group, the Company's brand, levels of customer satisfaction or the co-operative movement more generally be damaged, this would have a negative effect on the Company's business, operating results, financial condition and prospects and negatively impact the ability of the Company to achieve its stated strategy. See the risk factor entitled "*Reputational risk could cause harm to the Company, its business, operating results, financial condition and prospects and question the Company's commitment to co-operative values and ethics*" for further information.

The Company and the Co-operative Group have been negotiating a co-existence agreement in order to allocate trademarks into appropriate ownership, and to govern the use by each party of trademarks such as "Co-op" or "Co-operative" marks, to prevent any likelihood of confusion between the parties' use of such

trademarks and to avoid any disputes in the future (the "**Co-Existence Agreement**"). The Company currently owns the registrations for most of the trademarks that it uses (such as Co-operative Bank), but in the absence of such an agreement there could be greater scope for disagreements on the use of certain shared brands. Furthermore, there are certain trademarks or domain names that the parties are currently discussing the use of which are embedded in the Company's IT systems and used on existing marketing literature and signage. In the event that the terms of the Co-existence Agreement cannot be agreed there is a risk that the Company will be required to rapidly make changes to its IT systems, marketing literature and signage to remove these marks (which could have financial implications).

The Company has entrenched co-operative values and ethics into its Articles of Association. See the risk factor entitled "*There is a risk that the Company's ownership structure following the Liability Management Exercise and the Capital Raising may undermine the Company's reputation as being more focused on value and ethics than its competitors. Such a reputation has been a competitive advantage for the Company*" for further information. If the Shareholders of the Company decide to remove those entrenched provisions without the Co-operative Group's consent, the Company would be obliged, under the Agreed Co-existence Principles, agreed at the time of separation, to cease the conduct of any business under a brand that combines the words "Co-operative" or "Co-op" and "Bank".

There is a risk that the Secretary of State for Business, Innovation and Skills may, under section 76(1) of the Companies Act, direct the Company to change its registered name if, in his opinion, it gives so misleading an indication of the nature of its activities as to be likely to cause harm to the public. The FCA has the power to prevent the use of the "co-operative" name, or to take other action regarding the Company's branding, if the FCA considers this desirable to protect consumers, to promote competition in the interests of consumers or to protect the integrity of the UK financial system (note section 2.55L(2)(c) and (3), section 55N and the FCA's objectives in section 1C, 1D and 1E of FSMA).

The Company's accounting policies and methods are critical to how it reports its financial condition and results of operations. They require the Company to make estimates about matters that are uncertain

Accounting policies and methods are fundamental to how the Company records and reports its financial condition and results of operations. The Company must exercise judgement in selecting and applying many of these accounting policies and methods so that they comply with IFRS.

In the Company's financial statements, the basis of preparation and accounting policies disclosures have identified certain accounting policies in respect of which significant judgement is required in determining appropriate assumptions and estimates when valuing assets, liabilities, commitments, provisions and contingencies.

These critical judgements and estimates relate to, *inter alia*, the assumptions used in the determination of loan impairment provisions, conduct risk and legal provisions, the treatment of assets held by CFSMS, intangible and tangible assets impairments, deferred tax, pension schemes and the Liability Management Exercise.

A variety of factors could affect the ultimate value that is obtained either when earning income, recognising an expense, recovering an asset or reducing a liability. The Company has established policies and control procedures that are intended to ensure that these judgements (and the associated assumptions and estimates) are well controlled and applied consistently. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The Company cannot guarantee that it will not be required to make changes in accounting estimates or restate prior period financial statements in the future and any such changes or restatements could be material in nature.

The Company has recently completed a tender process with respect to its auditors and Ernst and Young LLP has been selected by the Board as its auditor going forward. The appointment of Ernst and Young LLP will be recommended by the Board to the AGM in May 2014. The change in auditors could result in a difference in interpretation of accounting policies and practices.

The processes for consolidating the Company's financial results are manual in nature and involve significant spreadsheet overlays. The processes are reliant on checks and reconciliations to ensure accuracy of the results reported, and are resource intensive

The Company's financial reporting process is complex, reflecting reliance on legacy systems which have not been integrated following the merger of the Company and Britannia. The Company relies on manual processes to consolidate the Company's financial results, and there is a significant use of spreadsheets, as opposed to automated consolidation processes. The manual nature of the processes increases the risk of accounting errors.

The Company's statutory results and management accounts are drawn from five different ledgers. Spreadsheets are used to consolidate information from the five ledgers and to perform consolidation adjustments (e.g. remove intercompany balances and eliminate the cost of investment in subsidiaries). This process is further complicated through fair value adjustments (which arise from the accounting treatment of the Company's merger with Britannia) and further manual adjustments (usually in relation to key judgements and estimates). Similarly, the production of the monthly management accounts requires the use of spreadsheets and templates to produce the consolidated Company results.

Given the manual and complex nature of these processes, the Company has implemented controls and checks to help ensure the accuracy of the financial results. These include reconciliations between ledgers and operating systems and further detailed account reconciliations performed by the financial control team. They also include the production and review of Board performance reports, which detail the composition of each balance sheet item in the statutory balance sheet.

Since 2012, a project has been ongoing to improve the monthly results process. The Company intends to have completed implementation of these changes by the end of 2015. As part of this project, processes and teams have been relocated and there is a risk of lost knowledge and expertise in the current spreadsheet based processes. Additional regulatory requirements, including FINREP and COREP will further strain these processes. These improvements and automations may take longer or prove to be more expensive than currently anticipated.

Provisions for liabilities in the Company's accounts may not be adequate

The Company is required to make provisions for liabilities in its accounts. The Company's provisions may not be enough as they are the Company's best estimates. Its contingent liabilities (not on balance sheet) may be underestimated or there may be contingent liabilities which the company is currently unaware of. Provisions are recognised for legal or constructive obligations arising from past events, if it is probable (i.e. more likely than not) that there will be outflows of resources and the amounts can be reliably estimated. Contingent liabilities are possible obligations whose existence will be confirmed only by uncertain future events or present obligations where the transfer of economic resources is uncertain and cannot reasonably be measured. Contingent liabilities are not recognised on the balance sheet, but are disclosed unless the outflow of resources is remote.

Where provisions have already been taken in published financial statements or results announcements, these have been recognised, in accordance with IAS 37 "*Provisions, Contingent Liabilities and Contingent Assets*", as the best estimate of the expenditure required to settle the obligation as at the reporting date. Such estimates are inherently uncertain and it is possible that the eventual outcomes may differ materially from current estimates, resulting in future increases or decreases to the required provisions (as has, for example, been the case in relation to the provisions that the Company has made in relation to PPI redress payments), or actual losses that exceed or fall short of the provisions taken. Examples of contingent liabilities in relation to which this risk might apply include the following:

- *Conduct and legal risks*

  Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media and politicians, there is a risk that certain aspects of the Company's current or historic business, including, amongst other things, mortgages and relationship banking, may be determined by the FCA and other regulatory bodies or the courts as not being

conducted in accordance with applicable laws or regulations, or fair and reasonable treatment, in their opinion. In particular, there is currently a significant regulatory focus on the sale practices and reward structures that financial institutions have used when selling financial products.

There is a risk that there may be regulatory or other investigations and legal or regulatory action against the Company in relation to conduct and other issues that the Company is not presently aware of or in relation to which the Company's assumptions change or do not reflect the eventual outcome. Potential risks include investigations and actions against the Company resulting from alleged mis-selling of financial products or the ongoing servicing of those financial products and investigations, actions or claims relating to breaches of the Consumer Credit Act or other relevant statutes.

In relation to the Consumer Credit Act, provisions have been recognised to deal with Consumer Credit Act related breaches. As part of the process of identification of breaches, detailed and technical legal analysis has been carried out as to whether breaches of the technical requirements of the Consumer Credit Act have in fact occurred, the nature of those breaches and the consequences which follow (which differ according to the precise nature of the breach). Such legal analysis by its nature involves judgment and assessment of the facts in those particular circumstances. In the event that such legal analysis and judgments are determined to be wrong, the Company could be exposed to material additional liability and provisions taken to date could be inadequate.

Further, the Company is already the subject of multiple regulatory and other investigations, including the Treasury Select Committee review, the independent Kelly Review, the enforcement investigations announced by the PRA and FCA on 6 January 2014 and the independent HM Treasury investigation into events at the Company and the circumstances surrounding them. The Company is also engaged in various other legal proceedings which arise in the ordinary course of business.

A provision has been raised relating to additional costs arising from defects in certain of the Company's historic mortgage documentation. There is a risk that such provision may prove inadequate, including that the actual costs of remediation and redress, and any additional costs of enforcing affected mortgages, may be more than currently estimated, or that the assessment of the impact of such defects may prove to be incorrect or incomplete.

In connection with the Company's mortgage securitisation and covered bond transactions, the Company makes various representations and warranties relating to the mortgage loans, including in relation to ownership, compliance with legislation and organisation procedures. If the representations and warranties are breached subject to any applicable materiality determination, or if any actual breaches identified are determined to be material the Company may be required to repurchase the affected mortgage loans or in some circumstances pay compensation to the securitisation vehicle. There is a risk that a number of the underlying matters giving rise to conduct and legal provisions have given rise to breaches by such representations and warranties. Accordingly, there is a risk that the Company may be required to pay compensation or to repurchase affected mortgage loans in amounts that may reduce the Company's liquidity.

The Company is unable to estimate the extent to which this matter will impact it or how further development may have a material adverse impact on the Company's net assets, operating results or cash flows in any particular period. See the risk factor entitled "*The Company's business is subject to inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail deposits becomes limited and/or becomes more expensive, and this may have an adverse effect on the Company's business, profitability and its ability to meet its liabilities as they fall due*" for further information. The nature of any future disputes and legal, regulatory or other investigations or proceedings into conduct or other matters cannot be predicted in advance. Furthermore, the outcome of any ongoing disputes and legal, regulatory or other investigations or proceedings is difficult to predict; see risk factors entitled "*The Company is exposed to a number of conduct risks*", "*The Company is under intense regulatory scrutiny and expects that environment to continue. The Company is also the subject of multiple regulatory and other investigations and enquiries into events at the Company and circumstances surrounding them and may also be subject to other legal and/or regulatory proceedings*" and "*The Company is currently involved in litigation and may in the future*

become involved in further litigation. The outcome of any legal proceedings is difficult to predict" for further information.

- *Pensions*

  There is uncertainty over the amount that the Company will have to pay while it continues to participate in Pace and in the event that it exits Pace. In respect of the Britannia Scheme, the Company will need to manage the liabilities that could arise on separation from the Co-operative Group. See the risk factor entitled "*The contributions that the Company is required to make to its pension schemes may change over time. The Company may be obliged to make large one-off payments to its pension schemes, or pension schemes to which it is connected and/or associated if certain events occur"* for further information.

- *Indemnification and Tax on separation*

  Until separation of the Company from the Co-operative Group is complete, and the new arrangements referred to in the Transitional Services Agreement have been entered into, the Company will continue to be responsible for indemnifying CFSMS under the CFSMS-Bank 2006 Agreement. It is anticipated that the Company will become the owner of the assets currently held by CFSMS for the provision of services exclusively to the Company – it is expected that this will be achieved in a VAT-efficient manner, but if this cannot be done, there is a potential VAT cost of £26 million on the transfer of the Company-exclusive assets to the Company.

  The Directors have reviewed and reconsidered the accounting treatment of the intangible asset in development and all other assets held on the balance sheet of CFSMS which were used solely by the Company. The Directors have concluded that the Company was substantially exposed to the risks and rewards of the assets referred to above and after considering the funding of the assets and the fact that CFSMS lacks other assets to absorb losses, the appropriate accounting treatment would be to hold these assets on the balance sheet of the Company. The Company has applied this approach to the accounting treatment of the Company-exclusive assets. However, if, and to the extent that, the Company changes or has to change the approach it has applied to the tax treatment of the Company-exclusive assets, there may be an additional tax charge. There will continue to be VAT charges incurred in respect of any assets that are supplied to the Company under the CFSMS-Bank 2006 Agreement or the Transitional Services Agreement (as applicable). There will continue to be VAT charges incurred in respect of any assets that are supplied to the Company under the CFSMS-Bank 2006 Agreement or the TSA (as applicable). In addition, provisions have not been taken where no obligation (as defined in IAS 37 "*Provisions, Contingent Liabilities and Contingent Assets*") has been established, whether associated with a known or potential future litigation or regulatory matter. Accordingly, an adverse decision in any such matters could result in significant losses to the Company which have not been provided for. Such losses would have an adverse impact on the Company's business, operating results, financial condition and prospects.

Changes in the Company's accounting policies or in accounting standards could materially affect how it reports its financial condition and operating results

From time to time, the International Accounting Standards Board (the "**IASB**") and/or the EU change the international financial reporting standards issued by the IASB, as adopted by the European Commission for use in the EU ("**IFRS**"), that govern the preparation of the Company's financial statements. These changes can be difficult to predict and could materially impact how the Company records and reports its financial condition and results of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in restating prior period financial statements.

The pension costs in respect of the Britannia Scheme are also accounted for on a defined contribution basis. There is a risk that, in future periods, the Company will have to account for the Britannia Scheme on a defined benefit basis and, as such, could have to recognise significant additional liabilities in respect of the Britannia Scheme in its accounts.

For example, changes to International Financial Reporting Standard 9 (Financial Instruments: Recognition and Measurement) ("**IFRS 9**"), which are due to become effective in relation to accounting periods beginning on or after 1 January 2018, address phase 1 of the IASB's project to replace International Accounting Standard 39, Financial Instruments: Recognition and Measurement. The changes will require the Company to classify its financial assets either at amortised cost or at fair value and the available for sale category for financial assets currently used by the Company will cease to be available. In addition, where the Company opts to fair value its financial liabilities under IFRS 9, the movement in fair value due to own credit risk will be directly recognised in other comprehensive income unless this results in an accounting mismatch. Currently, other than derivatives, which are required, to be carried at fair value, the Company only fair values its liabilities on customer accounts, including capital bonds. The capital bonds are fixed term customer accounts with returns based on movements in an index, such as FTSE-100, over the life of the bonds. The Company uses swaps to create economic hedges against all of its capital bonds and so has elected to carry them at fair value through income and expense in order to prevent an accounting mismatch. The IASB is currently proposing amendments to the classification and measurement requirements of Phase 1 of IFRS 9.

In March 2013, the IASB issued an exposure draft on proposals for the impairment of financial instruments. The proposals recognised expected credit losses earlier than the current incurred loss model. The proposals will form Phase 2 of IFRS 9.

The IASB may make other changes to financial accounting and reporting standards that govern the preparation of the Company's financial statements, which the Company may adopt, or which the Company may adopt prior to the date on which such changes become mandatory if determined to be appropriate by the Company, or which the Company may be required to adopt. Any such change in the Company's accounting policies or accounting standards could materially affect its reported financial condition and results of operations.

The burden on the Company of the Financial Services Compensation Scheme, which imposes significant levies on the Company, may increase in future periods

FSMA established the Financial Services Compensation Scheme ("**FSCS**"), which pays compensation to eligible customers of authorised financial services firms which are unable, or are likely to be unable, to pay claims against them. An institution's FSCS levy is linked to its share of the UK deposit market, and, therefore, its FSCS levy may have a material impact on its profits. As at the date of the Circular, a number of claims against the FSCS have been triggered. Claims on the FSCS are funded by loans from HM Treasury, and until such loans are repaid, increased levies on UK deposit-taking institutions fund interest payments on such loans. As a result of the various claims under the FSCS, the Company, in common with all regulated UK deposit takers, has since 2008 been subject to significantly increased FSCS levies. The regulated UK deposit takers are being required to fund, by way of a further increase in the FSCS levy, capital repayments to HM Treasury of such loans. There can also be no assurance that there will be no actions taken under the Banking Act that may lead to future claims against the FSCS, and concomitant increased FSCS levies payable by the Company (and other regulated UK deposit takers), which may have a material adverse effect on its operating results.

Based on its share of protected deposits, the Company pays levies to the FSCS to enable the scheme to meet claims against it. In 2013, the Company paid £13.5 million in respect of the 2012/13 levy and a further £11.0 million in respect of the first capital payment. The amount provided for in the Company's accounts to meet its obligations to the FSCS, in respect of the 2013/14 and 2014/15 levy periods, was £39.6 million as at 31 December 2013. While it is anticipated that the substantial majority of claims will be repaid wholly from recoveries from the institutions concerned, there is the risk of a shortfall, such that the FSCS may place additional levies on all FSCS participants, which levies may be in significant amounts that may have a material impact on the Company's profits. For example, in March 2012, the FSCS and HM Treasury agreed the refinancing of £20.4 billion in loans made to the FSCS by HM Treasury to fund the compensation payments made by the FSCS to customers whose savings were put at risk by bank failures in 2008 and 2009. As a result, the FSCS was required to pay a significantly increased amount of interest which it will recover through additional levies on the financial services industry. Following recoveries since March 2012 and the first capital repayment, the FSCS currently has outstanding loans of approximately £16.6 billion. The

amount provided for in the Company's accounts to meet its obligations to the FSCS, in respect of the 2013/14 and 2014/15 levy periods, including a provision for capital levy of £12.1 million, was £39.6 million as at 31 December 2013.

As noted above, in common with other financial institutions which are subject to the FSCS, the Company also has a potential exposure to future FSCS levies resulting from the failure of other financial institutions and consequential claims which arise against the FSCS as a result of such failure. The quantification and timing of such losses, if any, cannot be determined and, therefore, although the Company's share could be significant (reflecting the fact that the share is calculated by reference to the level of each institution's protected deposits and, for the scheme year 2012/2013, the Company's share of such deposits was 3 per cent.), the Company cannot yet make any provision in respect of such levies.

Historically, compensation scheme levies similar to the FSCS have tended to increase over time (especially during and in the aftermath of periods of economic crisis), and there can also be no assurance that there will not be any further claims against the FSCS and concomitant increased FSCS levies payable by the Company. Any such increases in the Company's costs and liabilities related to the levy may have a material adverse effect on the operating results of the Company. In July 2012, the FCA published a consultation paper as part of its FSCS Funding Model Review ("**FFMR**"). The FFMR will concentrate on issues such as the composition of the nine funding classes, the levy thresholds applicable to each and their tariff bases. However, the methodology for determining levies per institution will be driven primarily by revisions to the EU Deposit Guarantee Scheme Directive ("**DGSD**"). The European Commission published a legislative proposal in July 2010. The main changes proposed included a tighter definition of deposits, a requirement that a Deposit Guarantee Scheme (as such term is used in the DGSD) pay customers within a week and that banks must be able to provide information at any time, on the aggregated deposits of a depositor, known as the single customer view. On 12 June 2013, the European Council announced that the negotiations on revisions to the DGSD were on hold, pending further development on the RRD.

As a result of the structural reorganisation and reform of the UK financial regulatory authorities, the FCA and PRA now have oversight over the FSCS (although it continues to be an independent regulatory body). It is possible that the future policy of the FSCS and future levies on the Company may differ from those at present, and such reforms could result in the Company incurring additional costs and liabilities, which may adversely affect its business, operating results, financial condition and prospects.

In past years the Government has provided significant support to UK financial institutions, including the Funding for Lending Scheme which commenced on 1 August 2012 and to which an extension was announced on 24 April 2013. Any significant reduction or withdrawal of the Funding for Lending Scheme could increase competition for other sources of funding which could adversely impact the Company

In past years, the Government has provided significant support to UK financial institutions, including through the Special Liquidity Scheme, which is the liquidity scheme introduced by the Bank of England on 21 April 2008 for certain financial institutions to improve the liquidity position of the banking system by allowing banks and building societies to swap their high-quality mortgage-backed and other securities for UK treasury bills for up to three years, and the Credit Guarantee Scheme, which was introduced in October 2008 and under which the Government guaranteed eligible bank and building society debt securities for a limited period.

On 1 August 2012, the Funding for Lending Scheme became operational. The aim is to boost the incentive for banks and building societies to lend to UK households and non-financial companies. The Funding for Lending Scheme is designed to reduce funding costs for participating institutions so that they can make loans cheaper and more easily available. Access to the Funding for Lending Scheme is directly linked to how much each institution lends to the real economy. Those that increase lending are able to borrow more and at a lower cost than those that scale back their loans. Under the original Funding for Lending Scheme, participating financial institutions were, for a period of 18 months to the end of January 2014, able to borrow funds with a maturity of up to four years. On 24 April 2013, the scheme was extended for a further 12 months, with drawings now permitted until the end of January 2015 and the funding under the scheme now running until January 2019. The Company accessed the Funding for Lending Scheme in the first half of 2013, drawing

£900 million of UK treasury bills. The UK treasury bills remain available to the Company until March 2017. There have been further changes to the scheme that seek to target specific areas of the economy and reduce the impact on household lending.

The availability of Government support for UK financial institutions, to the extent that it provides access to cheaper and more attractive funding than other sources, reduces the need for those institutions to fund themselves in the retail or wholesale markets. Any significant reduction or withdrawal of Government support will increase funding costs for those institutions which have previously utilised that support. In addition, other financial institutions that have relied significantly on Government support to meet their funding needs will also need to find alternative sources of funding when that support is reduced or withdrawn and, in such a scenario, the Company expects to face increased competition for funding, particularly retail funding, on which it is reliant in the future. This competition could further increase its funding costs and thereby adversely impact its operating results and financial condition.

The extension to the Funding for Lending Scheme, announced in April 2013, has skewed the incentive towards lending to SMEs, by weighting net lending to that sector by a factor of 10 in 2013 and 5 in 2014. This will benefit eligible institutions which are seeking to reduce the residential mortgage element of their balance sheets, but which are still providing loans to SMEs. As the Company is seeking to reduce its exposure to commercial real estate lending, but does conduct some lending with SMEs, there is a risk that its competitive position will be damaged through other institutions having greater access to new Funding for Lending Scheme funds that the Company does not enjoy, the result being that the Company might not be able economically to match the pricing of those competitors in the mortgage market.

The Company's business and financial performance have been and may continue to be affected by general economic conditions in the UK, and adverse developments in the UK or global financial markets could cause the Company's earnings and profitability to decline

As with its competitors, the Company is directly and indirectly subject to inherent risks arising from general economic conditions in the UK and other economies and the state of the global financial markets both generally and as they specifically affect financial institutions. Since mid-2008, the global economy and the global financial system, and the Eurozone in particular, have experienced a period of significant turbulence and uncertainty. The severe dislocation of the financial markets around the world that began in August 2007 and significantly worsened in mid-2008 triggered widespread problems at many commercial banks, investment banks and other financial and related institutions in the UK and around the world. The dislocation severely impacted general levels of liquidity, the availability of credit and the terms on which credit is available. This crisis in the financial markets led the Government and other governments to inject liquidity into the financial system and take other forms of action relating to financial institutions, including bank recapitalisations and the provision of government guarantees for certain types of funding, aimed at both supporting the sector and providing confidence to the market. There can be no guarantee of such support in the future, and such support is likely to be on more punitive terms for financial institutions than in the past.

These market dislocations were also accompanied by recessionary conditions and trends in the UK and many economies around the world. The widespread deterioration in these economies adversely affected, among other things; consumer confidence, levels of unemployment, the state of the housing market, the commercial real estate sector; bond markets, equity markets, counterparty risk, inflation, the availability and cost of credit, transaction volumes in wholesale and retail markets, the liquidity of the global financial markets and market interest rates, which in turn had, and continues to have, in a number of respects, a material adverse effect on the Company's business, operating results, financial condition and prospects.

Although there have been periods where market conditions have generally improved, developments in 2011 and 2012, particularly in the Eurozone, have demonstrated that there continues to be significant uncertainty. See the risk factor entitled "*The Company's business and financial performance would be adversely affected by a break-up of the single European currency*" for further information.

The sovereign debt crisis in Europe led to an increase in the cost of funding. The initial impact of this increase was felt in the wholesale markets, and there was a consequential increase in the cost of retail funding, with greater competition in a savings market which is growing only slowly by historical standards.

A number of policy interventions, including most recently the Bank of England's Funding for Lending Scheme, have helped to ease these funding pressures. However, if there were to be further escalations in the European sovereign debt crisis, the cost of funding could increase again.

There remain continued challenges and uncertainty for the UK economy, including the combined economic prospects of the Eurozone, which presents a risk of a slowdown in economic activity in the UK's principal export markets, the impact of any future government austerity measures, and the continued squeeze on household incomes.

These pressures on households may, if combined with an increase in interest rates, lead to an increase in arrears in the Company's residential lending portfolios, including Optimum, and an associated increase in retail impairment provisions.

In preparing its business plan, the Company has assumed that the UK's economic recovery will become embedded in 2014 and to continue will improve in future years. The Company has assumed that base rate rises will only occur; when the economy is in a stable position, will be done gradually, and that is now expected to be closer to 3 per cent. than the previous long-term average of 5 per cent. The Company is currently anticipating base rate rises to start occurring in early 2015; a low interest rate environment shall continue to exert downward pressure on net interest income across the financial sector, but would support affordability of the Company's mortgages by its customers. The Company has experienced a decline in its net interest margin since the market dislocations commenced in August 2007 from 259 bps for the year ended 31 December 2007, to 109 bps for the 12 months ended 31 December 2013. Were the Company's assumptions to be incorrect, there is a risk that this would impact the Company's business, operating results, financial condition and prospects.

The UK housing market, which the Company is exposed to, had been muted since late 2009, with transaction levels below historic norms.

Whilst there have recently been improvements in UK GDP and the commercial property market, macroeconomic risk remains. Should a reversal of the improvements occur, this could have a potential impact on impairments; for further information see the risk factor entitled "*Worsening economic and market conditions could result in increased commercial property loan losses beyond what the Company has already provided for, which would adversely impact the Company's financial and operational performance*" for further information.

The continued effect of margin compression and exposure to both retail and commercial loan impairment charges, resulting from the impact of general economic conditions, means that the results of the Company's operations and financial position may continue to be adversely impacted by such factors, and there remains the possibility of further downward pressure on its operating results and financial condition, prospects and growth depending on a number of external influences, such as the consequences of a more austere economic environment.

Risks relating to the planned referendum on Scottish independence

The Company faces risks associated with the planned referendum on Scottish independence, currently scheduled to take place in September 2014, and potential uncertainty preceding and post the referendum. The Company has three branches and two commercial centres in Scotland which account for 3 per cent. and 6 per cent. of the Company's retail and commercial customer bases, respectively. It is unclear what impact independence would have on the rest of the United Kingdom. The potential impact of independence on security for the loans is contentious. The potential impact of independence on monetary and financial regulation policy and currency may have an adverse effect on the Company's business, operating results, financial condition and prospects. While the Company is monitoring and assessing the potential impact on its business of a vote in favour of Scottish independence, the situation remains uncertain.

The Company's business and financial performance would be adversely affected by a break-up of the single European currency

In recent years, there has been significant volatility in financial markets around the world. The financial turbulence in 2008 and its after-effects on the wider economy have led to generally more difficult earnings conditions for the financial sector and, at the time, resulted in the failures of a number of financial institutions in the United States, the UK and elsewhere in Europe and unprecedented action by governmental authorities, regulators and central banks around the world. A number of countries in Europe, such as the GIIPS countries, together with Cyprus, have been particularly affected by the difficult financial and economic conditions since 2008 and are struggling with large sovereign debts and/or public budget deficits. These factors, together with weak economies and disruption in the capital markets, necessitated a range of international rescue packages and other assistance, including for Greece and Ireland in 2010, Portugal in 2011, Greece and Spain in 2012 and Cyprus in March 2013. The perceived risk of default on the sovereign debt of certain of the GIIPS countries intensified in the latter part of 2011 and into 2012, particularly in relation to Greece. This raised concerns about the contagion effect such a default would have on other EU economies, as well as the ongoing viability of the euro currency and the Economic and Monetary Union ("**EMU**").

Reflecting these and other concerns, in January 2012, one of the major international credit rating agencies lowered its long-term ratings in respect of nine European sovereigns, further increasing market uncertainty. Furthermore, the effectiveness of the actions aimed at stabilising European economies and reducing debt burdens is not assured and the possibility remains that the euro could be abandoned as a currency by countries that have already adopted its use or, in an extreme scenario, abandonment of the euro could result in the dissolution of the EMU. This would lead to the re-introduction of individual currencies in one or more EMU member states. The effects on the European and global economies of the potential dissolution of the EMU, exit of one or more EU member states from the EMU and the redenomination of financial instruments from euro to a different currency, are impossible to predict fully.

However, if any such events were to occur they would likely:

- result in significant market dislocation;
- heighten counterparty risk; and
- affect adversely the management of market risk, including asset and liability management due, in part, to redenomination of financial assets and liabilities.

If any such events were to occur, the Company would be immediately exposed to certain potential losses on its portfolio of treasury assets and to redenomination risks as one or more individual countries introduced new currencies. However, as the Company is a UK-focused retail and commercial operation, it has no sovereign exposure to the GIIPS countries, but does have sovereign exposures to other Eurozone governments. As at 31 December 2013, the Company had a £110.2 million gross exposure to the financial institutions in European countries. It held no other material non-UK sovereign debt.

The Company anticipates that the occurrence of any of the events described above would be likely to adversely impact the cost and availability of wholesale funding, thereby increasing competition for retail funds and adversely impacting the Company's net interest margin.

The Company's earnings and net interest margins have been adversely affected by a number of factors, including a prolonged period of low Bank of England base rates and competition for retail funds, and may continue to be adversely affected for so long as one or more of these factors persist. In addition, regulatory capital shortfall and other recent events impacting the Company may have an adverse effect on the Company's net interest margin

The Company's net interest margin and, consequentially, earnings are affected by the pricing on the lending products it offers to its customers and the cost of funding. The Company's net interest margin has been squeezed by a number of factors which have negatively impacted on the pricing of its lending products and the cost of its funds.

The very low level of the Bank of England base rate since March 2009 has contributed to a decline in the Company's net interest margin, as funding costs rose relative to the base rate. The Bank of England base rate has remained at 0.5 per cent. since March 2009, having fallen from 5.75 per cent. in July 2007 through eight consecutive cuts of between 0.25 per cent. and 1.0 per cent. In the 30 years preceding July 2007, the lowest level of the base rate was 3.5 per cent. The Company's earnings and net interest margins have been adversely affected by a number of factors, including a prolonged period of low Bank of England base rates and competition for retail funds, and may continue to be adversely affected for so long as one or more of these factors persist. In addition, the regulatory capital shortfall and other recent events impacting the Company may have an adverse effect on the Company's net interest margin.

Competition for the highest quality mortgages is intense and is likely to continue, putting downward pressure on returns available for the lowest risk-weighted mortgage assets. The regulatory capital shortfall has made it more difficult for the Company to access funding for such mortgages and, therefore, to compete for such mortgages.

At the same time, price comparison websites have become more popular and widely used, allowing customers to more easily compare products and make buying decisions based on price. Whilst the Company aims to provide fair pricing to its customers, there is a risk that there will always be a number of other providers offering better pricing that will attract customers who may otherwise have joined or stayed with the Company. In consequence, there is a risk that industry pricing will be forced lower, impacting on the Company's ability to deliver its strategic income targets and impacting on its financial performance.

For a number of years, the retail savings market has been under pressure from historically low interest rates and competition from banks seeking to lower their loan-to-deposit ratios and to reduce their reliance on wholesale funding. Notwithstanding the Funding for Lending Scheme (which has reduced competition for retail deposits by providing financial institutions with cheap funding), the net result of these pressures has been an increase in the relative price for retail savings, adversely impacting the Company's ability to manage its net interest margin. The regulatory capital downgrade and other recent events impacting the Company have also increased the costs of funding as the Company has sought to manage its deposits offering to mitigate against the risk of customers leaving the Company.

Worsening economic and market conditions and/or increasing interest rates and/or a fall in house prices could result in increased residential mortgage and unsecured loan losses which would adversely impact the Company's financial and operational performance

The performance of the Company's core retail lending portfolios (which excluded Optimum, a closed book of intermediary and acquired mortgage book assets) has been stable over the past three financial years, with levels of arrears that are below industry averages published by the Council of Mortgage Lenders (the "**CML**"). The number of the Company's customers greater than 2.5 per cent. in arrears is 0.3 per cent. (excluding Optimum) at 31 December 2013 (CML average was 1.29 per cent. as of 31 December 2013). However, despite some deleveraging, the personal sector in the UK remains heavily indebted and vulnerable to increases in unemployment, rising interest rates and/or falling house prices.

Increased unemployment could lead to borrowers who lose their jobs being unable to service the loan payments in a timely fashion which would result in higher levels of arrears, in both the Company's secured residential mortgage loan and unsecured consumer loan portfolios which, in turn, would lead to an increase in the Company's impairment charges in respect of these portfolios. Increased unemployment could also result in less demand for the Company's products.

Rising interest rates would put pressure on existing and new borrowers whose loans are linked to the base rate or the Company's variable rates and who may have become accustomed to the current low interest rate environment. A significant portion of the Company's outstanding residential mortgage loan products are potentially subject to changes in interest rates. In particular, Optimum, being a portfolio of predominantly interest-only intermediary and mortgage book assets (as at 31 December 2013, £6,886.6 billion) may be particularly sensitive to changes in interest rates as they impact affordability and therefore customer affordability. In addition, borrowers with a mortgage loan that is subject to a variable rate of interest or where the interest rate adjusts following an initial fixed rate or low introductory rate, are exposed to increased

monthly payments as and when their mortgage interest rate adjusts upward (or, in the case of a mortgage loan with an initial fixed rate or low introductory rate, at the end of the relevant fixed or introductory period). In an increasing interest rate environment, borrowers seeking to avoid these increased monthly payments by refinancing their mortgage loans may no longer be able to find available replacement loans at comparably low interest rates and this could lead to an increase in arrears in the Company's retail lending portfolios, as well as an increase in the Company's retail loan impairment charges. The majority of the unsecured loan portfolio is on fixed customer rates.

A number of loans are also linked to LIBOR and such loans would be impacted by an increase in LIBOR, whether or not there is an increase in underlying interest rates. The Core Business has approximately 734 customers with aggregate balances of £57 million on a LIBOR-linked mortgage (out of a total of approximately 175,000 customers).

According to the seasonally adjusted Halifax House Price Index, average house prices in the UK peaked in Q3 2007 at almost £200,000 before falling steadily until Q2 2009 to £158,000. Average house prices have then remained delicately balanced and in the three quarters to Q4 2013 have recovered to £174,000. If UK house prices were to fall generally or in particular regions to which the Company has significant exposure in response to renewed economic pressures and/or the actions of lenders seeking to realise the values of impaired assets, this would be likely to result in an increase in the Company's retail loan impairment charges as the value of the security underlying its mortgage loans was eroded. In addition, a key assumption in the judgement of estimated future credit losses is the Company's estimate of future house price index movements. Optimum, which had an average loan-to-value of 72 per cent. as at 31 December 2013, is particularly exposed to movements in house prices. If Optimum's future house price index movements were to differ from management's expectations with a deterioration of 5 per cent., the impact on credit losses would be £7.5 million.

As a result of recent government initiatives, there has been an increased interest in buy-to-let loans, with buy-to-let lenders advancing 160,900 buy-to-let loans in 2013 resulting in £20.7 billion of mortgages according to data published by the CML. Whilst the Company intends to constrain volumes of new buy-to-let mortgages as a proportion of total new lending, as at 31 December 2013, the Company had £1.032 billion buy-to-let loans in its Core Business and £2.042 billion in its Non-core Business. As at 31 December 2013, 88 per cent. of the Company's retail buy-to-let loans were interest-only. These borrowers have been supported through the financial crisis by a combination of low interest rates, stable house prices and rising rents as first-time buyers have struggled to raise the required deposit to allow them to purchase their own homes. Whilst, as at 31 December 2013, the percentage of buy-to-let loans with greater than 2.5 per cent. in arrears was low, if interest rates were to rise and/or the economy were to weaken and place pressure on employment, incomes and/or house prices, the credit performance of the Company's buy-to-let mortgage book (together with the Company's retail mortgage book), may deteriorate, which in turn could adversely impact the Company's financial and operational performance. The buy to let market has shown clear sensitivity to house price movements in the past, although gross lending has been increasing over the past four years against the backdrop of steady house prices.

Worsening economic and market conditions could result in increased commercial property loan losses beyond what the Company has already provided for, which would adversely impact the Company's financial and operational performance

The Company's portfolio of loans secured on commercial property amounted to £6,581.4 billion at 31 December 2013. The underlying credit quality of these loans has been negatively impacted by continued poor economic conditions. The Company has segregated much of the Company's commercial property loans into its non-core division, CoAM. These commercial loans had already suffered a significant degree of impairment prior to being placed into run-off.

However, the conditions which continue to adversely impact the commercial property market include:

- a resumption in the fall of commercial property valuations, as witnessed in recent years, in part as a result of a general focus by banks across Europe on reducing their exposures to higher risk assets through portfolio sales and individual asset disposals;

- lower availability of debt and equity finance to support restructurings;
- uncertainties about the capital treatment of commercial real estate lending, with a trend towards higher regulatory capital requirements for commercial real estate lending;
- several high-profile tenant failures in recent years; and
- a continuation of the market trend for shorter lease life and of tenants exercising breaks.

All these factors reduce the certainty of cash flows and exacerbate shifts in collateral values and difficulties in refinancing. Reflecting these factors, it is possible that there may be further declines in collateral values in the next few years, particularly in secondary office and retail properties, with some recovery thereafter with the result that further impairments in connection with the Company's remaining commercial loan property portfolio may occur.

The Company has significant holdings of investment securities and negative changes in the fair value of these securities could have a material adverse effect on the Company's comprehensive income, financial condition and prospects

As at 31 December 2013, the Company's portfolio of available for sale investment securities had a fair value of £2.7 billion. The Company's investment securities are, where appropriate, fair valued on each balance sheet date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. As a wide range of valuation techniques is available, it may be inappropriate to compare the Company's fair value information to that of independent market or other financial institutions. Changes to assumptions and different methodologies can have significant impacts, particularly on fair values which are based on unobservable inputs.

In addition, on the merger of the Company with Britannia in 2009, Britannia's net assets were restated to fair value. The majority of these fair value adjustment unwinds are expected to be through the income statement over the lives of the associated assets and liabilities. Although over time the impact is broadly neutral, the impact in any one year depends on the assumptions made about expected future arrears, interest rates, redemption rates and maturities. The timing of fair value adjustment unwinds may have a material adverse effect on the Company's operating results, financial condition and prospects.

Any changes in fair value of available for sale investment securities during the relevant period are recorded in other comprehensive income, except for impairment losses and foreign exchange gains or losses which are recognised in the income statement. Gains and losses arising on the sale of available for sale investment securities are also recognised in the income statement, including any cumulative fair value gain or loss previously recognised in other comprehensive income which is reclassified to the income statement. Any changes in fair value of investment securities designated at fair value through income or expense during the relevant period are recognised in the income statement. In the financial year ended 31 December 2013, the Company recorded other comprehensive income from available for sale investments (net of amounts reclassified to the income statement) of £32.7 million and the Company also recognised net impairment gains on available for sale investment securities of £18.5 million. The impairment gains related to a structured investment vehicle held by the Company. In the same financial year, the Company recorded fair value movements through the income statement from investment securities designated at fair value through income or expense of £35.3 million.

Although the Company has recorded other comprehensive income, in respect of its available for sale investment portfolio in recent years, it has in previous years experienced significant fair valuation losses on securities included in the portfolio. Accordingly, there can be no assurance that fair valuations of its investment securities in future periods will not result in other comprehensive losses or impairments which could be material. In addition, the value that the Company ultimately realises for its investment securities may be lower than their current fair value, resulting in losses being recorded in its income statement, which losses could be material. Any of these factors could have a material adverse effect on the Company's operating results, financial condition or prospects.

The Company has a regulated branch in Guernsey and a regulated subsidiary in the Isle of Man, each of which are subject to local regulatory requirements that may impact on their business or profitability and thus on the business or profitability of the Company

The Company's relevant regulated branch in Guernsey and subsidiary in the Isle of Man are also subject to the local regulatory regime and the potential for regulatory intervention in Guernsey and the Isle of Man respectively.

The principal risk associated with regulated branches is that the local regulators may require the branch to hold liquidity locally. The local regulators also have oversight of the branch's operations and may have powers to require changes to those operations.

Regulated subsidiaries are subject to the full scope of regulation in the jurisdiction in which they are established, including locally imposed capital requirements and liquidity requirements, as well as conduct of business and other operational requirements. The local regulator may impose requirements on the subsidiary which will affect that subsidiary's ability to generate a return for the Company, including requirements to hold both further capital and liquidity. The consequence of these requirements is that they will impact the Company's liquidity and consolidated capital requirements. For example, the Company's Isle of Man subsidiary has been required to hold additional collateral against its existing lending to the Company following the announcement of the Company's Recapitalisation Plan.

In August 2013, the Company announced its intention to close the Guernsey branch and has been taking all the necessary steps to enable the repayment of all depositor balances. For deposit balances that remain unclaimed, for a period of 10 years an unclaimed deposit trust has been set up in Guernsey and settled with deposits to a value of approximately £2 million. The Company wrote to the Guernsey Financial Services Commission (GFSC) to advise it will surrender its banking licence with effect from 30 April 2014 and the GFSC confirmed acceptance of the licence surrender with effect from that date. Mortgage lending is not regulated on the island and lending in respect of Guernsey properties will continue to be administered by the Company in the UK, albeit restricted to existing customers only. A third-party advocate is to be appointed to manage local administration of these accounts in Guernsey (e.g. liaising with the land registry), whilst underwriting will continue to be managed through the Company's operation in the UK.

In line with its wider strategy of simplifying the business, the Company announced in January 2014 the decision to commence the gradual wind-down of the business of Britannia International Limited ("**BIL**"). Under the current proposals, it is envisaged that BIL will be wound down throughout the course of 2014 and cease all operations during H1 2015.

The Company is exposed to a number of tax risks including risk of changes in tax legislation and its interpretation and to increases in the rate of corporate and other taxes

The Company's activities are conducted principally in the UK and it is, therefore, subject to a range of UK taxes at various rates. Future actions by the government to change tax rates or to impose additional taxes could reduce the Company's profitability. Additional or revised tax legislation or changes to its interpretation might also affect the Company's financial condition in the future. In addition, the Company is subject to tax audits and enquiries by HMRC which could result in additional tax charges including interest and penalties relating to past periods of up to six years being made. Any such charges could be material, which might also affect the Company's financial condition in the future.

There is risk that the Company could suffer losses due to additional tax charges (including interest and penalties), other financial costs or reputational damage due to: failure to comply with, or correctly assess the application of, relevant tax laws; failure to deal with tax authorities in a timely, transparent and effective manner (including in relation to historic transactions); incorrect calculation of tax estimates for reported and forecasted tax numbers; or provision of incorrect tax advice. Such charges, or conducting any challenge to a relevant tax authority, could lead to adverse publicity, reputational damage and costs materially exceeding current provisions, in each case to an extent which could have an adverse effect on the Company's operations, financial conditions and prospects.

"

ANNEX

DEFINITIONS

"2012 Annual Accounts"	the financial statements of the Company for the financial year ended 31 December 2012
"2013 Annual Accounts"	the annual report and accounts of the Company for the financial year ended 31 December 2013, issued on 11 April 2014
"2014 Commitment"	the contractual commitment by CBG to commit £333 million of CET 1 capital by the end of 2014 as part of the Recapitalisation Plan
"2014 Commitment Agreement"	the agreement between the Company and CBG which is further described in the risk factor entitled *"The ability of CBG and/or the Co-operative Group to fund its 2014 capital commitment is dependent on certain actions, some of which are partially outside the control of the Co-operative Group"*
"Agreed Co-existence Principles"	the co-existence principles agreed between the Company and the Co-operative Group to be expressed in the Co-existence Agreement
"Accountancy Scheme"	the FRC's accountancy scheme
"AGM"	the annual general meeting of the Company for the year 2014
"Articles of Association"	the articles of association of the Company adopted on 15 November 2013
"Authorities"	HM Treasury, the Bank of England, the FCA and/or the PRA
"Balloon Street Property"	the property located at 1 Balloon Street, Manchester M60 4EP, United Kingdom
"Banking Act"	the Banking Act 2009
"Banking Reform Act"	the Financial Services (Banking Reform) Act 2013
"Bank of England's Red Book"	the Bank of England's Sterling Monetary Framework
"Basel Committee"	means the Bank for International Settlements' Basel Committee on Banking Supervision
"Basel III"	the comprehensive set of reform measures issued by the Basel Committee, to strengthen the regulation, supervision and risk management of the banking sector, including "Basel III: A global regulatory framework for more resilient banks and the banking system, December 2010 (as amended)" and "Basel III: International framework for liquidity risk management, standards and monitoring, December 2010"
"BIL"	Britannia International Limited
"BIPRU"	the FCA's and PRA's Prudential Sourcebook for Banks, Building Societies and Investment Firms
"Board"	the board of directors from time to time of the Company (or a duly appointed committee of the Board)
"Bonus Issue"	the issue of Bonus Shares to Smaller Shareholders as described in

more detail in the RNS

"Britannia" Britannia Building Society

"Britannia Scheme" the Britannia pension scheme as further described in the risk factor entitled "*The contributions that the Company is required to make to its pension schemes may change over time. The Company may be obliged to make large one-off payments to its pension schemes, or pension schemes to which it is connected and/or associated, if certain events occur*"

"BRRD" the EU Bank Recovery and Resolution Directive, the text of which was published on 28 April 2014 (PE-CONS 14/14)

"Business Day" a day other than a Saturday or Sunday or public holiday in England and Wales

"Capital Issue Date" the date of completion of the Capital Raising as determined by the Company

"Capital Raising" the Placing, the Open Offer and the Bonus Issue

"CBG" Co-operative Banking Group Limited

"CCA" or **"Consumer Credit Act"** Consumer Credit Act 1974, as amended

"CEO" or **"Chief Executive Officer"** the chief executive officer of the Company from time to time

"CFSMS" CFS Management Services Limited

"CFSMS-Bank 2006 Agreement" the agreement dated 16 February 2006 in relation to the provision of assets and personnel to the Company by CFSMS

"Chairman" the chairman of the Board from time to time

"Chief Financial Officer" the chief financial officer of the Company from time to time

"Chief Risk Officer" the chief risk officer of the Company from time to time

"Circular Date" the date on which this Circular is posted to Qualifying Shareholders

"CIS Building" the CIS Building on Miller Street, Manchester M60 6AL, United Kingdom

"CISGIL" CIS General Insurance Limited

"CML" the Council of Mortgage Lenders

"CoAM" Co-operative Asset Management, a division of the Company which manages assets

"Co-Existence Agreement" the co-existence agreement being negotiated by the Company and the Co-operative Group as further described in the risk factor entitled "*The Company will continue to rely on the Co-operative brand*"

"Committed Shareholders" Silver Point, Perry Capital, Invesco Asset Management Limited and York Capital Management Europe (UK) Advisors, LLP, each of whom have delivered an Irrevocable Undertaking Letter to the

	Company and UBS on or before the date of the Circular
"Common Equity Tier 1 Capital" or **"CET 1"**	a form of regulatory capital, having a specific meaning in prevailing prudential and capital adequacy laws and regulations applicable in England
"Companies Act"	the Companies Act 2006, including any statutory modification or reenactment thereof
"Company"	The Co-operative Bank p.l.c., a company incorporated in England and Wales (registered number 00990937), whose registered office is at P.O. Box 101, 1 Balloon Street, Manchester M60 4EP
"Co-operative Group"	the Co-operative Group Limited or the Co-operative Group Limited and its subsidiary undertakings, as the context requires
"Co-operative Life Insurance and Asset Management"	Royal London (CIS) Limited (formerly known as Co-operative Insurance Society Limited) and Royal Asset Management (CIS) Limited (formerly known as The Co-operative Asset Management Limited)
"Core Assets"	the asset classes of the Core Business of the Company
"Core Business"	the core business activity of the Company, which is consistent with the strategy and risk appetite of the Company. This includes the retail, core corporate and business banking and treasury and other divisions
"COREP"	the EU-wide supervisory reporting framework for common reporting under CRR
"CPP"	Card Protection Plan Limited
"**CRD**"	Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC
"CRD IV"	the EU's implementation of Basel III via the CRD and the CRR
"Credit Guarantee Scheme"	HM Treasury's credit guarantee scheme introduced in October 2008 (and closed to new issuance on 28 February 2010) for the purpose of assisting the funding of the UK banking sector and supporting the stability of the financial system
"CRR"	Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance
"Current Account Switching Service"	the current account switching service overseen by the UK Payments Council
"Customer"	has the meaning set out in the regulatory rules of the U.S. Commodities Futures and Trading Commission as in force from time to time
"Dated Notes"	the lower tier 2 bonds which were the subject of the Scheme, as described in the Prospectus
"Delf House"	the property located at Delf House, Southway, Skelmersdale,

	Lancashire WN8 6NY, United Kingdom
"Deputy Chief Executive Officer"	the deputy chief executive officer of the Company from time to time
"DGSD"	Directive 94/19/EC (the EU Deposit Guarantee Scheme Directive)
"Director"	a director of the Company from time to time
"disclosure"	Information made available in the Prospectus, the 2013 Annual Accounts and any other publicly available document
"Discount Window Facility"	a bilateral facility offered by the Bank of England designed to address short-term liquidity shocks
"D-SIBs"	a domestically systemically important bank as so deemed by the Financial Stability Board or such other institution or body responsible for the prudential supervision of financial institutions
"DWF"	the Bank of England's Discount Window Facility
"EEA"	European Economic Area
"EMU"	the Economic and Monetary Union of the EU
"Enlarged Share Capital"	the issued ordinary share capital of the Company immediately following the Capital Issue Date, being the Existing Ordinary Shares, the New Ordinary Shares and the Bonus Shares
"EU"	the European Union
"Euroclear UK"	Euroclear UK and Ireland Limited, the operator of CREST
"Eurozone"	those Member States which have adopted the euro
"Excluded Territories"	Australia, Canada, Hong Kong, Japan, New Zealand, South Africa, Switzerland and the United States and any other jurisdiction where the extension or availability of the Placing and Open Offer would breach any applicable law or regulation, and "**Excluded Territory**" shall mean any of them
"Excluded Territories Shareholders"	Shareholders with a registered address, or who are resident or located, in an Excluded Territory on the Circular Date or the Record Date, as the context requires
"Existing IT Services Agreement"	the agreement, dated 5 July 2012 (as amended and restated from time to time), in relation to the provision by the Co-operative Group of certain IT services to the Company and other members of CBG
"Existing Ordinary Shares"	the 250,000,000 Ordinary Shares in issue as at the Record Date
"FCA"	Financial Conduct Authority
"FFMR"	the FCA's FSCS Funding Model Review
"Fitch"	Fitch Ratings Limited
"FINREP"	the EU-wide supervisory reporting framework for Financial Reporting under CRR
"FPC"	Financial Policy Committee
"FRC"	the Financial Reporting Council
"FSCS"	the Financial Services Compensation Scheme

"FSMA"	the Financial Services and Markets Act 2000, as amended
"Funding for Lending Scheme"	the Bank of England and HM Treasury Scheme launched on 31 July 2012 to encourage banks and building societies to increase their lending to UK households and non-financial companies
"GDP"	gross domestic product
"GENPRU"	the FCA's and PRA's General Prudential Sourcebook for Banks, Building Societies, Insurers and Investment Firms
"General Meeting"	the general meeting of the Company scheduled to take place on 27 May 2014 at 9.00 a.m. at 10 Upper Bank Street, Canary Wharf, London E14 5JJ in connection with the Capital Raising
"GIIPS countries"	Greece, Italy, Ireland, Portugal and Spain
"Government"	the government of the United Kingdom
"**Group Placees**"	means the persons who conditionally agree to acquire Existing Ordinary Shares "cum" applicable Open Offer Entitlements from CBG pursuant to the Group Placing and who irrevocably and unconditionally agree to apply and subscribe for the maximum number of Open Offer Shares pursuant to their respective Open Offer Entitlements acquired pursuant to the Group Placing
"Group Placing"	the placing of Existing Ordinary Shares held by CBG on a cum entitlement basis with institutional investors (including Shareholders) as described in paragraph 3 of Part 1 of this Circular
"Group Placing Shares"	the Existing Ordinary Shares that UBS, as agent for CBG has placed pursuant to the Group Placing
"Group Shares"	the 54,058,442 Ordinary Shares subscribed for by CBG to which the 2014 Commitment Agreement relates
"G-SIBs"	globally systemically important banks within the meaning of Basel Committee on Bank Supervision or as so deemed by the Financial Stability Board or such other institution or body responsible for the prudential supervision of financial institutions
"Halifax House Price Index"	the monthly house price series issued by Lloyds Banking Group
"HMRC"	HM Revenue & Customs
"HMRC's Valuation Office"	the Valuation Office Agency, an executive agency of HMRC
"HM Treasury"	the Government's economic and finance ministry
"Holders"	holders of Dated Notes from time to time
"HR Director"	human resources director of the Company from time to time
"HSBC"	HSBC Bank plc, public limited company organised under the laws of England and Wales, registered with Companies House under number 00014259
"IAS 19"	International Accounting Standard 19
"IASB"	the International Accounting Standards Board.
"ICG"	individual capital guidance, being the PRA's guidance as to the regulatory capital it expects the Company to hold

"ICO"	Information Commissioners Office
"IFRS"	the international financial reporting standards issued by the IASB, as adopted by the European Commission for use in the EU
"IFRS 9"	International Financial Reporting Standard 9 (Financial Instruments: Recognition and Measurement)
"Immigration Bill"	The Immigration Bill 2013-2014
"Insurance Proceeds"	proceeds of the sale by Co-operative Group of Co-operative Life Insurance and Asset Management and the proposed sale of CISGIL
"Investor Presentation"	the investor presentation given to investors on 11 April 2014 and prepared in conjunction with the announcement of the 2013 Annual Accounts, as subsequently revised on 28 April 2014
"IPO"	initial public offering
"ISIN"	International Securities Identification Number
"IT Services"	IT services provided by the Co-operative Group as further described in the risk factor entitled "*The Company relies on the provision of certain services by the Co-operative Group, including IT and pensions services, and on the performance by the Co-operative Group of certain activities in order to transfer certain services currently provided by the Co-operative Group back to the Company"*
"**Kelly Review**"	the independent review, chaired by Sir Christopher Kelly, into the events that led to the requirements for the Company's plans to address US $1.5 billion capital shortfall, the decision to merge the Company with Britannia in 2009 and the proposed acquisition of the Verde Business
"Liability Management Exercise"	the liability management exercise of the Company and the Co-operative Group to raise £1.2 billion of capital in 2013, announced on 13 November 2013 and completed on 20 December 2013 consisting of the transfer of certain preference shares and the extinguishment of multiple subordinated liabilities, followed by the recognition of a single tranche of subordinated debt, undertaken as part of the Recapitalisation Plan
"LIBOR"	London Interbank Offered Rate – the interest rate participating banks offer to other banks for loans on the London market
"Liikanen Group"	the group established in November 2011 comprising high-level experts on structural aspects of the EU banking sector
"LCR"	at any time has the meaning given to the term LCR or Liquidity Coverage Ratio (or any equivalent term) in CRD IV
"Listing Rules"	the listing rules of the FCA relating to admission to the Official List made in accordance with section 73A(2) of FSMA
"MAS"	Mortgage Agency Services
"MCOB"	FCA's Mortgage Code of Conduct Sourcebook
"Member State"	a member state of the EU
"Money Laundering Regulations"	the Money Laundering Regulations 2007 as amended from time to

	time
"Moody's"	Moody's Investors Service Limited
"Myners Report"	the review of the governance of the Co-operative Group conducted by Lord Paul Myners which commenced in December 2013
"New IT Services Agreement"	the proposed draft amendment and restatement of the Existing IT Services Agreement contemplated by the Recapitalisation Plan
"New MSA"	the new professional services master services agreement, consistent with the Existing MSA, that is intended to be entered into between the Company and the Co-operative Group
"New Ordinary Shares"	the new Ordinary Shares to be issued by the Company pursuant to the Placing and Open Offer
"Non-core Assets"	the asset classes of the Non-core Business of the Company
"Non-core Business"	non-core business lines include activities not consistent with the current strategy of the Company, which are targeted for run down or exit. These non-core lines contain the majority of the impairment risk for the Company, and predominantly include the corporate non-core, Optimum (the closed book of intermediary and acquired loan book assets) and Illius (the residential property company) businesses which originated from the non-member Britannia business prior to merger
"Official List"	the Official List maintained by the Financial Conduct Authority
"OFT"	Office of Fair Trading
"Open Offer"	the conditional invitation to Qualifying Shareholders to apply for New Ordinary Shares on the terms and conditions set out in the Circular and, in the case of Qualifying Non-CREST Shareholders only, also the Application Form
"Open Offer Shares"	the New Ordinary Shares offered to Qualifying Shareholders pursuant to the Open Offer
"Optimum"	the Optimum closed book mortgage portfolio, as further described in the risk factor entitled "*The inability of the Company to deleverage its Non-core Assets in a controlled and capital efficient manner may have a negative impact on the Company's business, operating results, financial condition and prospects, its regulatory capital position and its ability to comply with its regulatory capital requirements. Any greater than expected costs or delays in deleveraging the Non-core Assets may divert funding from and adversely impact the growth of the Core Business*"
"Ordinary Share"	an ordinary share of £0.05 each in the capital of the Company
"Overseas Shareholders"	Qualifying Shareholders who have registered addresses outside the United Kingdom
"Pace"	The Co-operative Pension Scheme
"Parliamentary Commission on Banking Standards"	the joint select committee appointed by the UK parliament to consider and report on, amongst other things, professional standards and culture of the UK banking sector; lessons to be learnt about corporate governance; transparency and conflicts of interest, and

	the implications for regulation and for Government policy on banking standards
"Payment Card Industry Data Security Standard"	the payment card industry data security standard as issued by the Payment Card Industry Security Standards Council, as amended from time to time
"Payment Card Industry Security Standards Council"	a council formed on 7 September 2006 for the purpose of issuing and managing the Payment Card Industry Data Security Standard
"Payment Systems Regulator"	the payment systems regulator created by the FCA on 1 April 2014
"Pension Protection Fund"	the statutory protection fund established under the provisions of the Pensions Act 2004
"Pensions Regulator"	the UK regulator of work-based pension schemes, as established under the Pensions Act 2004
"Perry Capital"	Perry Capital UK LLP
"Pillar 1 Requirements"	the minimum amount of capital resources that the Company is required to maintain at all times under GENPRU 2.1.40R and 2.1.41R
"Placees"	the persons procured by UBS pursuant to the Placing and Open Offer Agreement who conditionally agree to subscribe for Placing Shares not taken up under the Open Offer by Qualifying Shareholders (other than the Co-operative Group, the Committed Shareholders and Group Placees), on the terms of the Placing Letter
"Placing"	the conditional placing by UBS, as agent for and on behalf of the Company, of Placing Shares at the issue price on the terms and subject to the conditions in the Placing and Open Offer Agreement and the Placing Letter
"Placing and Open Offer Agreement"	the agreement between the Company and UBS with respect to the Placing and Open Offer dated 9 May 2014
"Placing Letter"	a letter sent by UBS to, and executed by, Placees, evidencing such Placees' commitments to subscribe for Placing Shares on such terms and conditions as set out therein and at the issue price and on the basis that the obligations of the Placees to subscribe for such Placing Shares shall be conditional on the relevant Placing Shares not being subscribed for by Qualifying Shareholders (other than the Co-operative Group, the Committed Shareholders and Group Placees) pursuant to the Open Offer
"Platform"	the Company's brand of residential mortgage loans sold through mortgage intermediaries
"PPI"	payment protection insurance
"PRA"	Prudential Regulation Authority
"Professional Services"	the services that Company previously relied on Co-operative Group to provide, as further detailed in the risk factor entitled "*The Company relies on the provision of certain services by the Co-operative Group, including IT and pensions services, and on the performance by the Co-operative Group of certain activities in order to transfer certain services currently provided by the Co-*

operative Group back to the Company"

"Project Unity"	the project whereby between 2011 and 2013 the Company transferred a number of functions to the Co-operative Group and entered into arrangements pursuant to which the Co-operative Group would provide certain services to the Company
"Prospectus"	the prospectus dated 4 November 2013 of the Company in relation to the issue of 11 per cent. subordinated notes due 2023 as supplemented on 4 December 2013
"Prospectus Directive"	Directive 2003/71/EC
"Purchase Agreement"	the purchase agreement dated 4 November 2013 between the Company and certain holders of Dated Notes listed in such agreement
"Qualifying CREST Shareholder"	Qualifying Shareholders holding Ordinary Shares in uncertificated form
"Qualifying Non-CREST Shareholders"	Qualifying Shareholders holding Ordinary Shares in certificated form
"Qualifying Shareholders"	holders of Existing Ordinary Shares on the shareholder register of the Company on the Record Date (except for, subject to limited exceptions, Excluded Territories Shareholders)
"Recapitalisation Plan"	the recapitalisation plan originally announced on 17 June 2013 by the Company and the Co-operative Group to strengthen the Company's capital base
"Receiving Agent"	Computershare Investor Services PLC
"Record Date"	6.00 p.m. on 8 May 2014
"Registrar"	Computershare Investor Services PLC
"Regulation S"	Regulation S of the United States Security Act 1933, as amended
"Relationship Agreement"	the agreement between the Company, the Co-operative Group and CBG, dated 4 November 2013, which regulates the basis for the ongoing relationship between the parties thereto
"Relevant Member State"	each Member State of the EEA which has implemented the Prospectus Directive
"Relevant Situations"	interests arising other than in relation to transactions and arrangements with the Company which conflicts or potentially conflicts with the interest of the Company that each Director has disclosed to the Board
"Resolutions"	the resolutions to be proposed at the General Meeting as set out in Part 8 of this Circular
"Risk Committee"	means the risk committee of the Company
"RNS"	announcement of the capital raising of the Company dated 9 May 2014
"RMF"	the Company's risk management framework
"Royal London"	Royal London Mutual Insurance Society Limited

"RRD"	the proposed Recovery Resolution Directive, being the Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010
"Rule 144A"	Rule 144A of the United States Securities Act 1933, as amended
"S&P"	Standard & Poor's Credit Market Services Europe Limited
"Scheme"	the scheme of arrangement under Part 26 of the Companies Act in respect of the Company and certain of its creditors, approved by the Companies Court and registered at Companies House on 18 December 2013
"Scheme Meeting"	the meeting at which the Scheme was approved by certain of the creditors' of the Company entitled to vote in respect of the Scheme
"Securities Act"	United States Securities Act 1933, as amended
"Senior Independent Director"	a senior independent director of the Company from time to time
"Senior Managers" or the **"Senior Management"**	those persons listed as senior management in paragraph 8 of Part 7 of this Circular
"Separation Cost Agreement"	the agreement which may be entered into by the Company and the Co-operative Group Limited, detailed further in paragraph 13.5 of Part 7 of this Circular
"Shareholder"	a holder of an Ordinary Share
"Shareholder Rights Agreement"	the agreement between the Co-operative Group, CBG, the Committed Investors and the Company dated 9 May 2014, as described in paragraph 13.9 of Part 7 of this Circular
"Silver Point"	SP Coop Investment, Ltd. (Cayman)
"Single Resolution Mechanism"	the EU framework for recovery and resolution of Eurozone banks, adopted on 15 April 2014
"SME"	small and medium-sized enterprises
"Special Liquidity Scheme"	the liquidity scheme introduced by the Bank of England on 21 April 2008 for certain financial institutions
"St Paul's House"	the Property at 8-12 Warwick lane, London EC4M 7BP, United Kingdom
"subsidiary"	a subsidiary as defined by section 1159 of the Companies Act
"SYSC"	the FCA's and PRA's Sourcebook for Senior Management Arrangements, Systems and Controls
"Third Party Transfer"	the transfer by CBG, at the request of the Company, of all, or some of its Group Shares to a third party as directed by the Company, or to the Company for nil consideration
"Transitional Services Agreement"	the agreement that Company and CFSMS are negotiating to replace

	the CFSMS-Bank 2006 Agreement with appropriate revised arrangements, further detailed at paragraph 13.6 of Part 7 of this Circular
"Treasury Select Committee"	the Treasury Committee inquiry into the Verde Transaction
"UBS"	UBS Limited, a private company organised under the laws of England and Wales (registered under number 02035362)
"UK" or **"United Kingdom"**	the United Kingdom of Great Britain and Northern Ireland
"Undertaking to Pay"	the legally binding and irrevocable undertaking to pay, dated 4 November 2013, entered into by CBG in favour of the Company under the 2014 Commitment Agreement
"US" or **"United States"**	the United States of America, its territories and possessions, any state of the United States and the District of Columbia
"Variation and Director Appointment Deed"	the deed summarised at paragraph 13.8 of Part 7 of this Circular
"Values and Ethics Committee"	means the values and ethics committee of the Company
"VAT"	(a) any tax imposed in compliance with the council directive of 28 November 2006 on the common system of value added tax (EC Directive 2006/112) (including, in relation to the United Kingdom, value-added tax imposed by VATA); and (b) any other tax of a similar nature, whether imposed in a member state of the European Union in substitution for, or levied in addition to, such tax referred to in (a), or elsewhere
"VATA"	in the United Kingdom, the Value Added Tax Act 1994 and legislation and regulations supplemental thereto and, elsewhere, legislation and regulations of a similar nature
"Verde Business"	Lloyds TSB branches which formed the basis of a proposed acquisition by the Company
"Verde Transaction"	the proposed acquisition by the company of the Verde Business