# PILLAR 3:
# RISK MANAGEMENT DISCLOSURES

AIB Group

31 December 2008

## Background and context

### *Background*

This document represents the 'Pillar 3' disclosures for AIB Group as at 31 December 2008, as required by directives 2006/48/EC and 2006/49/EC, known as the Capital Requirements Directive ("CRD") relating to the taking up and pursuit of the business of credit institutions.

The CRD which was transposed into Irish law at the end of 2006 introduced some significant amendments to the capital adequacy framework. Its goal is to provide a greater link between the risk a bank faces and the capital it requires, and it does this in a number of ways. In terms of minimum capital requirements ('Pillar 1') it brings greater granularity in risk weightings under the standardised approach for credit risk, and introduces an explicit capital requirement for operational risk.

The CRD also introduces two additional 'pillars'. Under Pillar 2 ('supervisory review') banks may estimate their own internal capital requirements through an Internal Capital Adequacy Assessment Process ("ICAAP"), which is subject to supervisory review and evaluation. Pillar 3 ('market discipline') involves the disclosure of a suite of qualitative and quantitative risk management information to the market.

The CRD came into force from 1 January 2007 but contained a provision allowing banks to remain on the existing capital adequacy framework until 1 January 2008. AIB chose to avail of this option.

### *Basis of disclosures*

Allied Irish Banks, p.l.c ("AIB" or the "Parent Company") and its subsidiaries (collectively "AIB Group" or "Group") prepares consolidated financial statements ("consolidated accounts") under International Financial Reporting Standards ("IFRS").

Allied Irish Banks, p.l.c is a credit institution authorised by the Irish Financial Services Regulatory Authority ("the Financial Regulator"). Both the Parent Company and the Group are required to file regulatory returns with the Financial Regulator for the purpose of assessing, *inter alia*, their capital adequacy and balance sheets.

All subsidiaries are consolidated for both financial statement presentation and regulatory reporting and accordingly for AIB Group the regulatory returns and Financial Statements are similar other than presentation.

The Pillar 3 disclosures have been prepared for Allied Irish Banks, p.l.c. and its subsidiaries on a Group consolidated basis. These disclosures cover both the Pillar 3 qualitative and quantitative disclosure requirements.

The Pillar 3 disclosures have been prepared to explain the basis on which the Group has prepared and disclosed capital requirements and information about the management of certain risks and for no other purpose. They do not constitute any form of financial statement and should not be relied upon exclusively in making any judgement on the Group. They should be read in conjunction with the other information made public by AIB and available on the AIB website, including the Annual Financial Report.

### *Frequency*

These disclosures will be made on an annual basis as of the financial year-end date of 31 December.

### *Reporting conventions*

This is the first report prepared in accordance with Pillar 3. Therefore the inclusion of comparative information has been limited to previously reported capital adequacy disclosures. In future reporting periods, comparative data will be included in the quantitative disclosures, where relevant.

### *Media and location*

The report will be published on AIB's website (www.aibgroup.com), alongside the Annual Financial Report.

### *Verification*

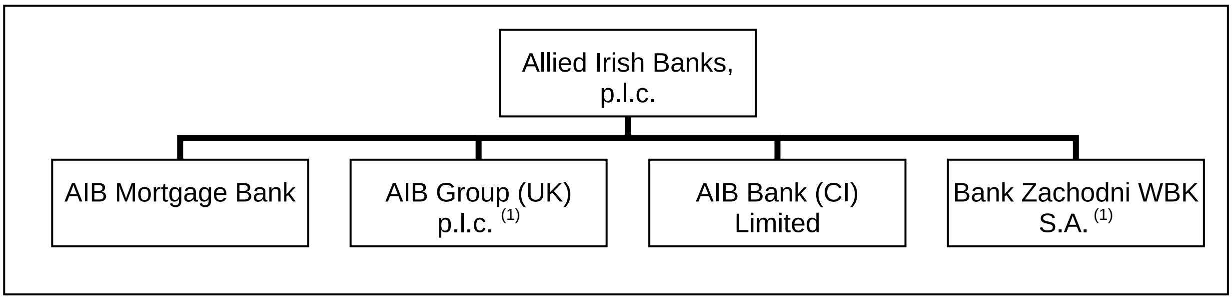
The Pillar 3 disclosures have been subject to internal review procedures consistent with those undertaken for unaudited information published in the Annual Financial Report and have not been audited by the Group's external auditors. Disclosures are externally audited only to the extent that the information is required to be audited under an accounting or listing requirement.

# 1. Overview

## Basis of consolidation for accounting and prudential purposes

Allied Irish Banks, p.l.c. is the parent company in AIB Group and is a European Economic Area institution regulated by the Irish Financial Services Regulatory Authority ("the Financial Regulator"). AIB Group prepares consolidated financial statements under International Financial Reporting Standards ("IFRS") for statutory reporting purposes ("the Consolidated Accounts"). Additionally, AIB Group is required to prepare regulatory returns ("the Regulatory Returns") for the purpose of assessing its capital adequacy and monitoring its balance sheet. All subsidiaries are consolidated for both Group statutory and regulatory purposes. Details of significant subsidiary (a) capital requirements and (b) risk weighted assets are set out in Appendix 2.

**Organisational structure of licensed banks within AIB Group**




(1) For the purposes of illustration, intermediate parent companies of AIB Group (UK) p.l.c. and Bank Zachodni WBK S.A. have been omitted from this diagram.

## Transfer of capital between parent company and its subsidiaries

Allied Irish Banks, p.l.c. is the parent company of a number of licensed subsidiary banks and investment firms which are subject to individual capital adequacy requirements. Each of these licensed subsidiaries is subject to minimum capital requirements imposed by their individual regulators and has maintained those ratios above the minimum requirements during the period.

Accordingly, in order to maintain capital and/or liquidity ratios at or above the levels set down by their regulators, the licensed subsidiaries would be unable to remit capital to the parent when to do so would result in such ratios being breached. Apart from this requirement, there is no restriction on the prompt transfer of own funds or the repayment of liabilities between the subsidiary companies and the parent.

## Irish government guarantee and recapitalisation

### <u>Government guarantee</u>

### Legislative basis

Under the Credit Institutions (Financial Support) Act 2008 (the 'Act'), the Minister for Finance has the power to provide financial support, including guarantees, to specified credit institutions and their subsidiaries.

The Credit Institutions (Financial Support) Scheme 2008 (Statutory Instrument No. 411 of 2008) (the 'Scheme'), having been approved by both Houses of the Oireachtas (i.e. the Irish Parliament) on 17 October 2008, was made by the Minister for Finance on 20 October 2008.

The Act, the Scheme and associated Ministerial orders provide the statutory basis for the guarantee for credit institutions announced by the Minister for Finance on 30 September 2008 and 9 October 2008.

The Scheme has been approved by the European Commission as being compatible with EC Treaty State aid rules.

## Nature of the statutory guarantee

The covered liabilities of participating covered institutions are guaranteed under the laws of Ireland by the Minister for Finance, for the period 30 September 2008 to 29 September 2010 inclusive.

In the event of any default of a covered institution in respect of a covered liability, the Minister for Finance will pay to the relevant creditor, on demand, an amount equal to the unpaid covered liabilities.

Banks which are covered institutions may only be removed from the guarantee in specified, exceptional, circumstances such as when they are acquired or merged with another bank which is not covered by the Scheme, or where they are in material breach of their obligations under the Scheme.

Should a covered institution be removed from the Scheme, all of its fixed term covered liabilities outstanding at that time will continue to have the full benefit of the guarantee to 29 September 2010 or their maturity, whichever is the earlier. All covered liabilities, including on-demand deposits, will be protected by notice of at least 90 days prior to any covered institution being removed from the Scheme.

No call can be made under the guarantee after 29 September 2010.

The guarantee does not affect any other rights or claims of creditors.

## Covered institutions

Allied Irish Banks, p.l.c., AIB Mortgage Bank, AIB Group (UK) p.l.c., AIB Bank (CI) Limited and Allied Irish Banks North America Inc. are covered institutions for the purpose of the Scheme, standing specified under the Credit Institutions (Financial Support) (Specification of Institutions) Order 2008 (Statutory Instrument No. 416 of 2008).The extent to which the liabilities of these institutions are covered liabilities is set out in the Scheme.

## Covered liabilities

The following liabilities are covered by the Scheme ('covered liabilities'):

- all retail and corporate deposits (to the extent not covered by existing deposit protection schemes in Ireland or any other jurisdiction);
- interbank deposits;
- senior unsecured debt;
- covered bonds (including asset covered securities); and
- dated subordinated debt (lower tier 2)

excluding any intra-group borrowing and any debt due to the European Central Bank arising from Eurosystem monetary operations.

## Charge and indemnity

The covered institutions will pay a quarterly charge to the Exchequer for the guarantee. The aggregate amount of the charge is based on the increased debt servicing costs that the State bears as a result of providing the guarantee. Current estimates are that over the two years of the Scheme the charge to the covered institutions for the guarantee will yield € 1 billion. Each covered institution's share of the annual charge is calculated by reference to its risk profile and a guarantee charging model specified by the Minister.

By joining the Scheme, a covered institution will also agree to indemnify the Minister in respect of any payments made, or costs incurred, by the Minister in respect of the guarantee relating to that covered institution.

A covered institution is not required to indemnify the Minister in respect of any payments made by the Minister under a guarantee given to any other covered institution that is not a member of its corporate group.

## Board representation

The Minister may nominate up to two non-executive directors to the Board of a covered institution.

## Commercial conduct and reporting requirements

Conditions will be imposed on covered institutions that regulate the commercial conduct of their business, having regard to capital ratios, market share and balance sheet growth, in order to minimise any potential competitive distortion that may arise and to avoid any abuse of the guarantee or any use in a manner irreconcilable with the purpose of the guarantee. These conditions are set out in the Scheme.

Covered institutions will be subject to particular reporting requirements to enable the Financial Regulator and the Minister for Finance to monitor compliance with the Scheme and the achievement of the purposes of the Act.

## Further information

The Act, the Scheme and associated Ministerial Orders are available on the website of the Department of Finance.

## Government recapitalisation

On 11 February 2009, the Minister for Finance of Ireland announced a recapitalisation package under which the Irish government will provide € 3.5 billion core tier 1 capital to Allied Irish Banks, p.l.c. In return, the Minister will receive preference shares with a fixed dividend of 8% per annum payable in cash or ordinary shares in lieu. These preference shares can be repurchased at par up to the fifth anniversary of the issue and at 125% of face value thereafter. The Minister can appoint 25% of the directors of AIB Group. While the Scheme continues, this includes the two directors nominated by the Minister under the Scheme. The preference shares also carry voting rights to 25% of total ordinary voting rights on two issues in respect of change of control and of AIB board appointments.

Warrants attached to the preference shares carry an option to purchase up to 25% of the ordinary share capital of Allied Irish Banks, p.l.c. The strike price of the first 15% of these warrants to be exercised will be € 0.975.The strike price for the balance of the warrants will be € 0.375. If the Group redeems up to € 1.5 billion of the new preference shares from privately sourced core tier 1 capital prior to 31 December 2009, then the € 0.375 warrants will be reduced pro rata to that redemption.

As outlined in its business plan submitted to the Financial Regulator, the Group has stated its commitment to increase lending capacity to small and medium sized enterprises by 10% and to provide an additional 30% capacity for lending to first time house buyers in 2009. Compliance with this commitment will be monitored by the Financial Regulator. The Group has also committed, under the Mortgage Arrears Code of Practice, not to commence court proceedings for repossession of principal private residences until after 12 months of arrears appearing, where the customer continues to cooperate reasonably and honestly with the Group.

## Further developments

On 20 April 2009, following due diligence and stress test scenarios carried out in cooperation with the Minister for Finance, AIB and the Minister for Finance have formed a view that to strengthen the Group's capital position a total amount of € 5.0 billion new core tier 1 capital is appropriate. As a consequence, in addition to the proposed € 3.5 billion injection by the Government, the Group aims to increase core tier 1 capital by a further € 1.5 billion before the end of 2009 through various sources including disposals of assets.

The Group believes that the Government has taken a positive step in its decision to create a National Asset Management Agency ("NAMA") and AIB has signalled its intention to participate in this initiative and to work closely with the authorities to achieve its implementation.

## Approval for ordinary dividends

A covered institution shall comply with rules governing the declaration and payment of dividends made by the Minister for Finance after consultation with the Governor of the Central Bank and Financial Services Authority. These rules will take into account the objective of achieving or maintaining the capital ratios, as the regulatory authority may direct. No new dividends shall be declared or paid by a covered institution before such rules are made.

No final dividend will be paid in respect of the year ended 31 December 2008.

## Solo consolidation

In the preparation of its financial statements under IFRS, the balance sheet of Allied Irish Banks, p.l.c. includes all activities of the reporting entity including its foreign branches. Transactions between branches of Allied Irish Banks, p.l.c. are excluded in presenting the balance sheet at each reporting date.

The Financial Regulator has adopted the national discretion under Article 70 of the CRD concerning the ability of institutions to include certain subsidiaries in their individual regulatory return. This treatment, termed 'solo consolidation', in effect treats such subsidiaries as if they were branches of the parent rather than separate entities in their own right. There are certain criteria that must be met before the Financial Regulator will approve the inclusion of non-authorised subsidiaries in the 'solo consolidation'. Allied Irish Banks, p.l.c. has received approval to prepare its regulatory return on a solo consolidation basis.

In accordance with the discretion provided for in Article 72 of the CRD and except for the information presented in Appendix 2, AIB Group presents its Pillar 3 information on an AIB Group consolidated basis.

# 2. Risk management - framework

Risk taking is inherent in the provision of financial services and the Group assumes a variety of risks in undertaking its business activities. Risk is defined as any event that could: damage the core earnings capacity of the Group; increase earnings or cash-flow volatility; reduce capital; threaten business reputation or viability; and/or breach regulatory or legal obligations.

AIB has adopted an Enterprise Risk Management approach to identifying, assessing and managing risks. The key elements of the Enterprise Risk Management framework are:

2.1 Risk philosophy;
2.2 Risk appetite;
2.3 Risk governance and risk management organisation;
2.4 Risk identification and assessment process;
2.5 Risk strategy; and
2.6 Stress and scenario testing.

## 2.1 Risk philosophy

The Board and senior management set the 'tone at the top'. This establishes the culture, philosophy and behaviour of the Group towards risk and governance, and provides the basis for the engagement of risk governance processes at enterprise, divisional and functional levels. The Board has adopted a broad set of risk taking principles reflecting the Group's risk philosophy and culture, and articulating the high-level standards against which risk taking decisions are made. The three key principles are:

- AIB is in the business of taking risk in a controlled manner to enhance shareholder value.
- All risks and related returns are owned by the relevant business units.
- The risk governance functions perform independent oversight of the management of risk by the business units and provide assurance to the Board.

## 2.2 Risk appetite

The Group's risk appetite framework seeks to encourage appropriate risk taking to ensure that risks are aligned to business strategy and objectives. The Group determines its risk appetite in a number of ways. Firstly, it considers its external stakeholders (including equity and debt holders, and relevant regulatory authorities) and their requirements, and expresses this in the form of a top-down risk appetite statement. This statement provides explicit Board guidance on risk appetite including, but not limited to, target capital levels, target debt ratings and thresholds on earnings volatility.

Secondly, risk appetite is captured through the planning process, whereby the Group considers how much and what type of risk it needs in order to deliver the Group's business objectives and strategy. Lastly, risk appetite is determined by reference to the risk profile that emerges from the various risk assessment processes used by the Group for individual risk types. This can be considered 'bottom up' appetite.

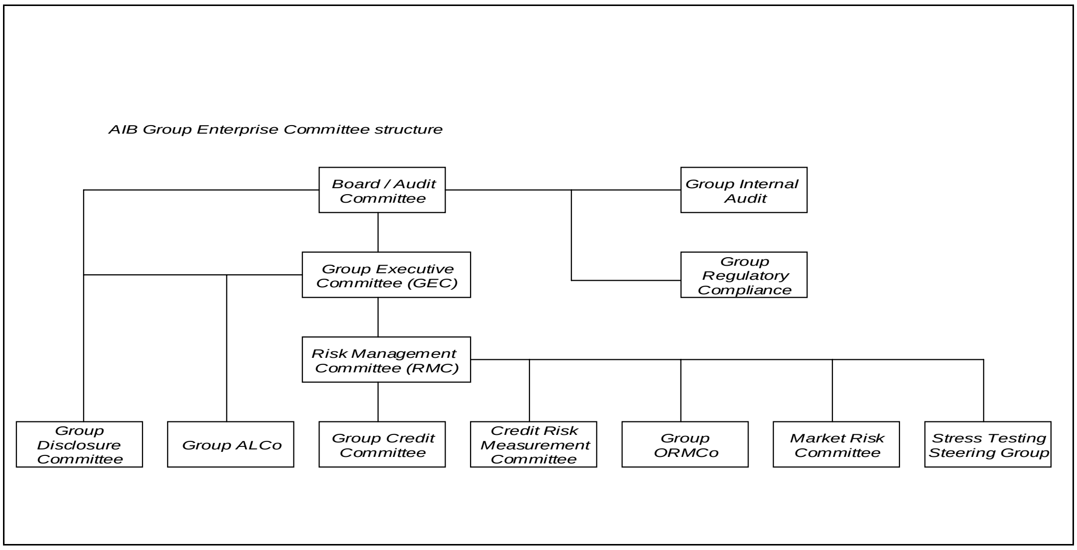
Risk appetite is evidenced in a range of Board approved limits and delegated authorities and in actions taken on the basis of a comparison of bottom-up risk profile with top-down risk appetite. The Group's risk appetite is continually reassessed to ensure ongoing alignment to business strategy and objectives.

## 2.3 Risk governance and risk management organisation

The Board and senior management have ultimate responsibility for the governance of all risk taking activity in the Group. AIB uses a 'three lines of defence' framework in the delineation of accountabilities for risk governance.

Under the three lines of defence model, primary responsibility for risk management lies with line management. Line management is supported by three Group and Divisional functions with a risk governance role. These are the enterprise-wide Risk, Regulatory Compliance and Finance functions. Together these act as the second line of defence. The third and final line of defence is the Group Internal Audit function which provides independent assurance to the Audit Committee of the Board on all risk-taking activity.

While the Board has ultimate responsibility for all risk-taking activity within AIB, it has delegated some risk governance responsibilities to a number of committees or key officers. The diagram below summarises the Enterprise Committee structure of the Group.




The Board is responsible for the leadership, direction and control of the Group and is accountable to shareholders for financial performance.

The Audit Committee's roles and responsibilities include reviewing the Group's annual and interim financial statements, the scope of the audit, the findings, conclusions and recommendations of the internal and external Auditors reports on compliance and the effectiveness of internal controls.

The Group Executive Committee ("GEC") is the senior executive committee of the Group. The GEC manages the strategic business risks of AIB and sets the business strategy of the enterprise within which the risk management function operates. The Risk Management Committee ("RMC") is the highest executive forum for risk governance within the Group. It is responsible for identifying, analysing and monitoring risk exposures, adopting best practice policies and standards, and reviewing risk management activities at an enterprise level. The RMC acts as the parent body of a number of other risk and control committees, namely the Group Credit Committee, the Credit Risk Measurement Committee, the Group Operational Risk Management Committee ("Group ORMCo"), the Market Risk Committee and the Stress Testing Steering Group.

The Group Asset and Liability Management Committee ("Group ALCo") is responsible for all activities in AIB relating to capital planning and management, funding and liquidity management, structural asset and liability management and the Internal Capital Adequacy Assessment Process ("ICAAP").

The Group Disclosure Committee is responsible for ensuring the compliance of the Group's external disclosures with legal and regulatory requirements, including relevant provisions of the Sarbanes Oxley Act.

*The role of Risk Management and the Group Chief Risk Officer*

The Group Chief Risk Officer ("Group CRO") has independent oversight of the Group's enterprise-wide risk management activities. The Group CRO is a member of the Group Executive Committee and reports to the Group Chief Executive, with a dotted line to the chairman of the Audit Committee. The Group CRO's responsibilities include:

a) developing and maintaining the Enterprise Risk Management framework;
b) providing independent reporting to the Board on risk issues, including the risk appetite and risk profile of the Group; and
c) providing independent assurance to the CEO and Board that material risks are identified and managed by line management and that the Group is in compliance with enterprise risk policies, processes and limits.

In addition to the enterprise-wide Risk function, each of the four operating divisions, and Operations and Technology have dedicated risk management functions, with divisional CROs reporting directly to the Group CRO.

*The role of Finance and the Group Finance Director*
Finance and the Group Finance Director have responsibility for all of the financial processes of the Group. These include financial and capital planning, financial and management accounting, financial and regulatory disclosures and balance sheet management. Risks embedded in these processes remain the responsibility of the Group Finance Director, as does responsibility for compliance with tax legislation as well as external financial and regulatory reporting requirements.

*Regulatory Compliance*
Regulatory Compliance is an enterprise-wide function which operates independently of the business. The function is responsible for identifying compliance obligations arising from ‘conduct of business’ (customer-facing) regulations in each of the Group’s operating markets. There are Regulatory Compliance teams in each division who work closely with management in assessing compliance risks and provide advice and guidance on addressing these risks. Risk-based monitoring of compliance by the business with regulatory obligations is undertaken. The outputs of this monitoring are independently reported by Regulatory Compliance to the Group Audit Committee.

The Regulatory Compliance function also promotes the embedding of an ethical framework within AIB’s businesses to ensure that the Group operates with honesty, fairness and integrity.

*Group Internal Audit*
Group Internal Audit (“GIA”) is an independent evaluation and appraisal function reporting to the Board through the Audit Committee.

GIA acts as the third line of defence in the Group’s risk governance organisation and provides assurance to the Audit Committee on the adequacy, effectiveness and sustainability of the governance, risk management and control processes throughout the Group, including the activities carried out by other control functions. The results of GIA audits are reported quarterly to the Audit Committee, which monitors both resolution of audit issues and progress in the delivery of the audit plan.

## 2.4 Risk identification and assessment process

Risk is identified and assessed in the Group through a combination of top-down and bottom-up risk assessment processes. Top-down processes focus on broad risk types and common risk drivers rather than specific individual risk events, and adopt a forward-looking view of perceived threats over the planning horizon. The key top-down risk assessment process is the Enterprise Risk Assessment, which is undertaken on a six monthly basis. This looks at the material risks facing the Group, as identified by divisional and functional risk review processes, overlaid with an analysis at Group level of emerging threats, industry trends and external incidents.

The Enterprise Risk Assessment is the most significant input into the Material Risk Assessment undertaken for the purpose of the Internal Capital Adequacy Assessment Process under Pillar 2 of the CRD.

Bottom-up risk assessment processes are more granular, focusing on risk events that have been identified through specific qualitative or quantitative measurement tools. A key qualitative tool is self-assessment, which is used in the assessment of operational and regulatory compliance risk. Quantitative tools include the use of internal grading models to estimate the Probability of Default (“PD”), Loss Given Default (“LGD”) and Exposure at Default (“EAD”) of credit exposures, and Value at Risk (“VaR”) in the context of the Group’s trading portfolios.

Top-down and bottom-up views of risk come together through a process of upward reporting of, and management response to, identified and emerging risks. This ensures that the Group’s view of risk remains sensitive to emerging trends and common themes.

## 2.5 Risk strategy

The Group's risk strategy is informed by its risk appetite and the risk profile which emerges from the risk assessment process. To the extent that mismatches are identified between risk appetite and the actual risks being taken, action to address such gaps is undertaken. This may involve risk reduction or increased risk mitigation in cases where risk profile exceeds risk appetite, or a selective and gradual increase in risk taking where risk profile is significantly below risk appetite. Risk strategy is enhanced through the Group's continued improvement of its risk measurement methodologies to support a more quantitative representation of its overall risk profile.

## 2.6 Stress and scenario testing

The Group uses stress testing and scenario analysis to supplement its risk assessment processes and to meet its regulatory requirements. The objective of stress testing and scenario analysis is to assess the Group's exposure to extreme, but plausible, events. The Stress Testing Steering Group is a senior committee tasked by the Risk Management Committee with the (i) approval of stress scenarios, (ii) oversight of the conduct of the analysis and (iii) review of, and decision making on foot of, the results. Regulatory requirements for banking supervision include specific stress tests under Pillars 1 and 2 of the CRD. Under Pillar 1, the Group applies a severe stress to its existing portfolios. Under Pillar 2, the Group stresses its Financial and Capital Plan. In addition, the Central Bank and Financial Services Authority requests stress tests from time to time as part of its Financial Stability Assessment and Reporting.

## 2.7 Ongoing assessment

AIB continually reassesses its risk management framework to ensure the outputs are aligned with the strategies of the firm and appropriate for managing the risks inherent in its market environment. This is particularly relevant in today's environment and against the background of significant losses sustained in our credit portfolio. All elements of our framework are currently being reviewed to ensure they are fit for purpose and relevant for today's challenging risk environment.

# 3. Risk management - individual risk categories

This section provides details of the Group's exposure to and risk management of the following individual risk categories which have been identified through the Group's risk assessment process:

3.1 Credit risk;
3.2 Market risk;
3.3 Interest rate risk in the banking book;
3.4 Structural foreign exchange risk;
3.5 Liquidity risk;
3.6 Operational risk; and
3.7 Regulatory compliance risk.

Further information is available in the Group Annual Financial Report, which is also available on the Group website (www.aibgroup.com).

## 3.1 Credit risk

Credit risk is defined as the risk that a customer or counterparty will be unable or unwilling to meet a commitment that it has entered into and that the Group is unable to recover the full amount that it is owed through the realisation of any security interests. The most significant credit risks arise from lending activities to customers and banks, trading portfolio, available for sale and held to maturity financial investments, derivatives and 'off-balance sheet' guarantees and commitments. The credit risks arising from balances at central banks, treasury bills and items in course of collection are deemed to be negligible based on their maturity and counterparty status.

*Credit risk on derivatives*
The credit risk on derivative contracts is the risk that the Group's counterparty in the contract defaults prior to maturity at a time when AIB has a claim on the counterparty under the contract. AIB would then have to replace the contract at the current market rate, which may result in a loss. Derivatives are used by AIB to meet customer needs, to reduce interest rate risk, currency risk and in some cases, credit risk, and also for proprietary trading purposes. Risks associated with derivatives are managed from a credit, market and operational perspective. The credit exposure is treated in the same way as other types of credit exposure and is included in customer limits. The total credit exposure consists partly of current replacement cost and partly of potential future exposure. The potential future exposure is an estimation, which reflects possible changes in market values during the remaining life of the individual contract. The Group uses a simulation tool to estimate possible changes in future market values and computes the credit exposure to a high level of statistical significance.

*Country risk*
Credit risk is also influenced by country risk, where country risk is defined as the risk that circumstances arise in which customers and other counterparties within a given country may be unable or precluded from fulfilling their obligations to the Group due to economic or political circumstances.

Country risk is managed by setting appropriate maximum risk limits to reflect each country's overall credit worthiness. These are informed by independent credit information from international sources and supported by periodic visits to relevant countries. Risks and limits are monitored on an ongoing basis.

*Settlement risk*
Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. The settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated when effected via assured payment systems, or on a delivery-versus-payment basis. Each counterparty is assessed in the credit process and clearing agents, correspondent banks and custodians are selected with a view to minimising settlement risk. The most significant portion of the Group's settlement risk exposure arises from foreign exchange transactions. Daily settlement limits are established for each

counterparty to cover the aggregate of all settlement risk arising from foreign exchange transactions on a single day.

*Credit concentration risk*
Credit concentration risk arises where any single exposure or group of exposures, based on common risk characteristics, has the potential to produce losses large enough relative to the Group's capital, total assets, earnings or overall risk level to threaten its health or ability to maintain its core operations. Credit concentration risk is identified, monitored and managed by single name counterparty, product, industry sector, geography and within appropriate policy parameters.

***Risk identification and assessment***
Credit risk is identified, assessed and measured through the use of credit rating and scoring tools for each borrower or transaction. The methodology used produces a quantitative estimate of PD for the borrower. This assessment is carried out at the level of the individual borrower or transaction and at sub-portfolio, portfolio, business unit and/or divisional level where relevant.

In the retail consumer and small and medium sized entity ("SME") book, which is characterised by a large number of customers with small individual exposures, risk assessment is largely informed through statistically-based scoring techniques. Both application scoring for new customers and behavioural scoring for existing customers are used to assess and measure risk as well as to facilitate the management of these portfolios. In the commercial, corporate and interbank books, the rating systems utilise a combination of objective information, essentially financial data, and subjective assessments of non-financial risk factors such as management quality and competitive position. The combination of expert lender judgement and statistical methodologies varies according to the size and nature of the portfolio together with the availability of relevant default experience.

The ratings influence the management of individual loans. Special attention is paid to lower quality rated loans and, when appropriate, loans are transferred to special units to help avoid default or, when in default, to minimise loss.

Credit concentration risk is identified and assessed at single name counterparty level and at portfolio level. The Board approved Group Large Exposure Policy ("GLEP") sets the maximum limit by grade for exposures to individual counterparties or group of connected counterparties. Portfolio concentrations are identified and monitored by exposure and grade using internal sector codes. Such measures facilitate the measurement of concentrations by balance sheet size and risk profile relative to other portfolios within the Group and in turn facilitate appropriate management action discussion and decision making.

*Role of stress and scenario analysis in the assessment of credit risk*
The Group conducts periodic stress tests on specific portfolios to assess the impact of credit concentrations and to assist the identification of any additional concentration in its loan books. These tests are carried out as required by senior management.

Additional stress tests are carried out to assist capital planning under the CRD. Stress tests undertaken on the Group's credit portfolios form a significant part of the Group's Pillar 1 and Pillar 2 stress tests as described in Section 2.6.

***Risk management and mitigation***
A framework of delegated authorities underscores the Group's management of credit risk. Credit grading, scoring and monitoring systems facilitate the early identification and management of any deterioration in loan quality. The credit management system is underpinned by an independent system of credit review.

Delegated authority is a key credit risk management tool. The Board determines the credit authority for the Group Credit Committee ("GCC") and divisional Credit Committees, together with the authorities of the Group Chief Executive and the Group Chief Credit Officer. The GCC considers and approves credit exposures which are in excess of divisional credit authorities. Delegated authorities below these levels have been clearly defined and are explicitly linked to levels of seniority within the Group.

Key credit policies are approved by the Board. Divisional management approves divisional credit policy within the parameters of relevant Group level policies. The divisional risk management function is an integral part of the approval process of divisional policies. Material divisional policies are referred to the Risk Management Committee and/or to the Board, where relevant, for approval.

The GLEP sets out a framework for the management of single-name credit concentrations. Any exceptions to limits are highlighted and reported to the RMC.

Levels of concentrations by geography, sector and product are effectively set through the divisional and Group planning process.

*Credit risk mitigation*

The most significant and widely used credit risk mitigation tool available to the Group, particularly around underwriting and credit review, is its own robust internal credit risk control framework. In terms of individual exposures, while the perceived strength of the borrower's repayment capacity is the primary factor in granting the loan, security in the form of collateral or guarantees is generally required as a secondary source of repayment in the event of the borrower's default. Very occasionally, credit derivatives are purchased to hedge credit risk. Current levels are minimal and their use is subject to the normal credit approval process.

In the case of large exposures, it is sometimes necessary to reduce initial deal size through appropriate sell-down and syndication strategies. There are established guidelines in place relating to the execution of such strategies.

*Provisioning for impairment*

The identification of loans for assessment as impaired is driven by the Group's rating systems. The Group provides for impairment in a prompt and consistent way across the credit portfolios. The rating models provide a systematic discipline in the identification of loans as impaired and in triggering a need for provisioning on a timely basis.

Loans are identified for assessment as impaired if they are past due for typically ninety days or more or exhibit, through lender assessment, an inability to meet their obligations to the Group.

Within its provisioning methodology, the Group uses two types of provisions: (a) Specific; and (b) Incurred but not reported ("IBNR") – i.e. collective provisions for earning loans. Specific provisions arise when the recovery of a specific loan or group of loans is significantly in doubt. The amount of the specific provision will reflect the financial position of the borrower and the net realisable value of any security held for the loan or group of loans. In practice, the specific provision is the difference between the present value of expected future cash flows for the impaired loan(s) and the carrying value. IBNR provisions are maintained to cover loans which are impaired at the balance sheet date, and while not specifically identified, are known from experience to be present in any portfolio of loans. IBNR impairment provisions can only be raised for incurred losses and are not allowed for losses that are expected to happen as a result of likely future events. IBNR provisions are determined by reference to previous loss experience in loan portfolios and to the credit environment at balance sheet date. Whilst provisioning is an ongoing process, all divisions formally review provision adequacy on a quarterly basis and determine the overall provision requirement. These provisions are, in turn, reviewed and approved on a quarterly basis at Group level.

***Risk monitoring and reporting***

Credit managers receive sufficient account and customer information on a daily basis to pro-actively manage the Group's credit risk exposures at transaction and relationship level.

Credit risk at a portfolio level is monitored regularly and reported on a monthly basis, to senior management and the Board.

Monthly reporting typically includes, but is not limited to, information on advances, concentrations, provisions and grade profiles and trends. A more detailed credit review is prepared for the Board on a quarterly basis.

Single name counterparty concentrations are monitored at transaction level. Large exposures are reported monthly to senior management and quarterly to the Board. Portfolio concentrations are monitored and reported monthly at divisional and Group level.

More detailed reports are prepared quarterly at Group level, which outline trends by exposure and grade for key concentrations.

In addition to the regular suite of reports, the Board also receives periodic ad hoc reports on specific aspects of credit risk.

*Credit performance measurement framework*
The Group continues to refine its methodology for measuring the risk adjusted profitability of its credit business. Economic Value Added ("EVA") is one of the primary measures of performance. EVA represents the value added having deducted all costs, including expected loss and a charge for the economic capital required to support the facility. The most important inputs into the determination of the expected loss and the economic capital are the PD, the LGD and the EAD.

The grades produced by the rating models are translated into a PD, which is a key parameter when measuring risk. LGD is measured taking into account, *inter alia*, the security held by the Group. EAD for many products is equal to the outstanding exposure but for some products, such as credit lines and derivative contracts, the EAD may be higher than the outstanding exposure.

## 3.2 Market risk

Market risk is defined as the risk to the Group's earnings and shareholder value resulting from adverse movements in the level or volatility of market prices of debt instruments, equities, currencies and derivatives.

The market risk associated with the Group's trading activities is predominantly the result of the facilitation of client business and running proprietary positions in debt instruments, foreign exchange contracts, equities, and the related derivatives of these products. In addition, the Group assumes market risk as a result of its Group-wide balance sheet and capital management responsibilities. The management of the Group's market risk activities is predominantly centralised in the Capital Markets division, specifically within Global Treasury, as the only business unit mandated to conduct proprietary trading with the wholesale markets. The Group's brokerage businesses are mandated to take moderate market risk.

The Group has not sought regulatory approval for use of its market risk models for regulatory capital purposes.

Further information is available in the Group Annual Financial Report, which is available on the Group website (www.aibgroup.com).

***Risk identification and assessment***
Independent risk functions exist within each trading business and are tasked with capturing all material sources of market risk within the trading portfolios. In addition to the standard risk factors, credit spreads, liquidity issues, non-linearity and risk concentrations are also considered. There is a formal process in place for all new products in the trading portfolio.

In quantifying the portfolio's market risk profile, the Group's risk measurement systems are configured to address all material risk factors, including price dynamics, volatilities and correlation behaviour. The Group's core risk measurement methodology is based on a variance co-variance application of the industry standard Value at Risk ("VaR") technique that incorporates the portfolio diversification effect within each standard risk factor (interest rate, foreign exchange, equity, as applicable).The resulting VaR figures, calculated at the close of business each day, are an estimate of the probable maximum loss in fair value over a one month holding period that would arise from a 'worst case' movement in market rates. This 'worst case' is derived from an observation of historical prices over a period of three years, assessed at a 99% statistical confidence level. Instruments with significant embedded or explicit option characteristics receive special attention, including Monte Carlo simulation and a full analysis of option sensitivities.

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. Furthermore, the use of confidence intervals does not convey any information about the potential loss when the confidence level is exceeded. The Group recognises these limitations and supplements its use of VaR with a variety of other techniques, including sensitivity analysis, interest rate gaps by time period, and daily open foreign exchange and equity positions. Furthermore, stress-testing and scenario analysis are employed on an ongoing basis to gauge the Group's vulnerability to loss under stressed market conditions.

***Risk management and mitigation***
In managing and overseeing market risk, the Group makes a distinction between its trading and non-trading activities. Trading occurs when front line management exercises its discretion, subject to

allocated market risk limits, to increase, hold, hedge or exit the market risk inherent in a given position. All such trading positions, including equity market making, are subject to the rigour of the market risk management framework and are overseen by the Market Risk Committee, irrespective of the accounting or regulatory treatment.

The Group refers to all other positions that are structural in nature as 'non-trading'; i.e. market risks inherent in the structure of the Group's balance sheet that are non-proprietary in nature, for example interest free current account balances. The Group ALCo is responsible for the oversight of these activities and the appropriate strategies for measuring and hedging these risks. From a regulatory perspective, these positions are always recorded in the banking book.

The majority of Global Treasury managed positions also meet the criteria for inclusion in the regulatory-defined 'banking book' and any changes in fair value are accounted for in reserves. The balance of the risk positions within Global Treasury's portfolio (including all derivative activity, other than those in hedge accounting relationships) and all equity market-making transactions meet the criteria for inclusion in the regulatory-defined 'trading-book' and are accounted for at fair value through the income statement.

Market risk management in the Group has a number of inter-related components. As a management process, it is actively administered on the basis of clearly delegated authorities that reflect the appropriate segregation of duty, fit for purpose trading environments with enabling technology, and competent personnel with relevant skill and experience. It should be noted that credit risk issues inherent in the market risk portfolios are subject to the credit risk framework that is described in the previous section.

A comprehensive suite of policies and standards clarifies roles and responsibilities, and provides for effective risk assessment, measurement, monitoring and review of trading positions. Market risk management aligns with trading business strategy through the articulation of an annual risk strategy and appetite statement. Risk appetite is defined as the level and nature of risk the trading businesses are willing to accept in pursuit of value.

Market risk appetite addresses the question of how much and what type of market risk is acceptable to the Group and is consistent with its overall business strategy.

Market risk is managed both in terms of its potential economic and accounting impacts:

a) Economic perspective: the Group uses VaR limits to control the impact of market risk activities on tier 1 capital (the Group employs a matrix of such limits across the trading businesses); and
b) Accounting perspective: the Group uses Earnings at Risk ("EAR") limits to control the income statement impact of capital erosion by defining the maximum tolerance for losses in a given reporting period. 'Stop loss' mechanisms at the trader level form part of this process.

***Risk monitoring and reporting***

Quantitative and qualitative information is used at all levels of the organisation, up to and including the Board, to identify, assess and respond to market risk. The actual format and frequency of risk disclosure depends on the audience and purpose which ranges from transaction-level control and activity reporting to enterprise-level risk profiles. For example, front office and risk functions receive the full range of daily control and activity, valuation, sensitivity and risk measurement reports, while the Board receives a monthly market risk commentary and summary risk profile.

## 3.3 Interest rate risk in the banking book

Interest rate risk in the banking book ("IRRBB") is defined as the Group's sensitivity to earnings volatility in its non-trading activity arising from movements in interest rates. It reflects a combination of non-trading treasury activity and interest rate risk arising in the Group's retail, commercial and corporate operations. AIB's treasury activity includes its money market business and management of internal funds flows with the Group's businesses. These treasury transactions are also captured under the market risk VaR assessment measure. Non-trading interest rate risk in retail, commercial and corporate banking activities can arise from a variety of sources, including where those assets and liabilities and off-balance sheet instruments have different repricing dates.

***Risk identification and assessment***
Banking book interest rate risk is calculated in each business unit on the basis of establishing the repricing behaviour of each asset, liability and off-balance sheet product. For some products the actual interest repricing characteristics differ from the contractual repricing arrangements. In these cases the repricing maturity is determined by the market interest rates that most closely fit the behaviour of the product interest rate. For non-interest bearing current accounts, the repricing maturity is determined by the stability of the portfolio. The assumptions behind these repricing maturities and the stability levels of portfolios are reviewed annually by the relevant divisional asset and liability committees.

The risks from these exposures are managed through a series of VaR, basis point sensitivity and earnings at risk measures. Banking book positions as they are transferred / held in the Group's Global Treasury are also captured under the Group's market risk framework.

***Risk management and mitigation***
As a core risk management principle, the Group requires that all material interest rate risk is transferred to Global Treasury. This transferred banking book risk is managed as part of Global Treasury's overall interest rate risk position. The Group manages structural interest rate risk volatility by maintaining a portfolio of instruments with interest rates fixed for several years. The size and maturity of this portfolio is determined by characteristics of the interest-free or fixed-rate liabilities or assets and, in the case of equity, an assumed average maturity. Group ALCo assesses the effectiveness of hedging through the stability of the earnings achieved on notional reinvestment of net interest rate insensitive liabilities.

***Risk monitoring and reporting***
Group ALCo monitors the Group's banking book interest rate risk and has oversight responsibility for non-treasury banking book risk. Treasury banking book risk is overseen by the Market Risk Committee. Group ALCo meets on a monthly basis and receives standing reports on the Group's asset and liability risk profile. It monitors positions against these limits on a monthly basis. The Board reviews and approves relevant policies and limits.

## 3.4 Structural foreign exchange risk

Structural foreign exchange rate risk arises from the Group's non-trading net asset position in foreign currencies. This arises from the Group's net investments in its sterling, US dollar, Polish zloty and Bulgarian lev -based subsidiaries and associates.

***Risk identification and assessment***
The Group prepares its consolidated balance sheet in euro. Accordingly, the consolidated balance sheet is affected by movements in the exchange rates between these currencies and the euro.

The currency profile of the Group's capital may not necessarily match that of its assets and risk-weighted assets and capital ratios may be subject to exposure from exchange rate movements. These positions are not actively hedged, although some mitigation of euro/sterling and euro/zloty positions arises from the Group's capital structure.

The Group also has a structural exposure to foreign exchange risk arising from its share of earnings from overseas subsidiaries and associates. Group ALCo sets the framework for and reviews the management of these activities. Open positions are reported as differences between expected earnings in the current year and the value of hedges in place.

***Risk management and mitigation***
The Group's structural foreign exchange hedging activity is overseen by the Hedging Committee, a sub-committee of the Group ALCo. The objective of the Group's hedging policy is to manage the Group's foreign currency earnings within tolerance levels based on the budget for the forthcoming year, making use of other natural hedges within the Group's balance sheet where these are available. The Hedging Committee also assesses effectiveness of FX hedging by monitoring the effective exchange rate achieved for currency earnings.

***Risk monitoring and reporting***
Group ALCo monitors the Group's structural foreign exchange risks. It meets on a monthly basis and receives standing reports on the Group's asset and liability risk profile including structural foreign exchange risk. The Board reviews and approves relevant policies and limits.

## 3.5 Liquidity risk

The objective of liquidity management is to ensure that, at all times, the Group holds sufficient funds to meet its contracted and contingent commitments to customers and counterparties, at an economic price. Throughout the difficult market conditions of 2008, the Group's liquidity management process has proved itself to be robust in maintaining its liquidity position.

***Risk identification and assessment***
Liquidity risk is assessed by modelling the net cash outflows of the Group over a series of maturity bands. Behavioural assumptions are applied to those liabilities whose contractual repayment dates are not reflective of their inherent stability. These net cash outflows are compared against the Group's stock of liquid assets to consider, within each maturity band, the adequacy of the Group's liquidity position.

***Risk management and mitigation***
The objective of the Group's liquidity management policy is to ensure that the Group can at all times meet its obligations as they fall due at an economic price. The Group pursues this objective in a number of ways. Firstly, through the active management of its liability maturity profile, it ensures a balanced spread of repayment obligations with a key focus on 0-7 day and 8-31 day time periods. Monitoring ratios apply to periods in excess of 31 days. Secondly, the Group maintains a stock of high quality liquid assets to meet its obligations as they fall due. Discounts are applied to these assets based upon their cash-equivalence and price sensitivity. The Group's stock of liquid assets is maintained at a level considered sufficient to meet the withdrawal of deposits or calls on commitments in both normal and abnormal trading conditions. In all cases, net outflows are monitored on a daily basis and the required minimum stock of liquid assets can be increased if these outflows exceed predetermined target levels. Finally, the Group maintains a diversified funding base across all segments of the markets in which it operates.

The Group's retail franchise and accompanying retail deposit base in Ireland, the UK and Poland provides the Group with a stable and predictable source of funds. Although a significant element of these retail deposits are contractually repayable on demand or at short notice, the Group's customer base and geographic spread generally mitigates against this risk.

The Group monitors and manages the funding support provided by its deposit base to its loan book through a series of measures including its externally reported customer loan/deposit ratio. More refined measures are utilised internally which recognise the capacity to generate contingent liquidity out of the Group's loan book, the structure of the Group's wholesale term funding and the stability of its customer deposit base. The Group, in reducing its market funding dependency levels, has successfully reduced its external reported loan/deposit ratio from 157% at 31 December 2007 to 140% at 31 December 2008.

Global Treasury, through its Wholesale Treasury operations manages, on a global basis, the liquidity and funding requirements of the Group. Euro, sterling, US dollar and Polish zloty represent the most important currencies to the Group from a funding and liquidity perspective. Global Treasury is active in the wholesale funding markets including the interbank and commercial deposit market. This is supplemented by commercial paper, certificate of deposit, medium term note and covered bond programmes which serve to further diversify the Group's sources of funding. Market conditions in 2008 have resulted in a contraction of wholesale market appetite on the part of participants for liquidity risk. This has manifested itself through a shortening of duration in wholesale funding available, leading to a contraction in the term funding profile of AIB and many institutions.

During 2008, AIB increased its qualifying liquid asset and contingent funding capacity, through the structuring of loan portfolios into central bank eligible assets.

In September 2008, the Irish Government guaranteed the covered liabilities of seven Irish credit institutions, including AIB. This guarantee covers all retail, commercial, institutional and interbank deposits until the end of September 2010. To date AIB has successfully issued € 2 billion of

AAA rated senior debt under this framework and has maintained its strong franchise resources base in difficult market conditions.

The Group's debt ratings are as follows: Moody's long-term "Aa3" and short-term "P -1"; Fitch long-term "A -" and "F1+" short term; Standard and Poors long-term single "A" and "A -1" short-term (under issuance terms of Irish Government Guarantee A1+).

The Group's liquidity management policy is designed to provide the Group with sufficient liquidity to meet its current requirements. In addition, it operates a funding strategy designed to anticipate additional funding requirements based upon projected balance sheet movements. The Group undertakes liquidity stress testing and contingency planning to deal with unforeseen events. The Group regularly undertakes liquidity stress tests, which reflect increasing levels of severity applied to its liquidity position. These stress tests include both firm specific and systemic risks. These scenario events are reviewed in the context of the Group's liquidity contingency plan, which details corrective actions options under various levels of stress events. The purpose of these actions is to ensure continued stability of the Group's liquidity position, within the Group's pre-defined risk tolerance levels.

The Group's approach to liquidity management complies with the Financial Regulator's revised 'Requirements for the Management of Liquidity Risk', introduced in July 2007 and all of the Group's regulatory ratio requirements for liquidity were met throughout 2008.

***Risk monitoring and reporting***

The liquidity position of AIB is measured and monitored daily within Global Treasury. The daily liquidity report shows the Group's principal operating currencies of euro, sterling, US dollar and Polish zloty. Group ALCo and the Board receive monthly reports on the liquidity and funding position of the Group.

## 3.6 Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It includes legal risk, but excludes strategic and reputational risk. In essence, operational risk is a broad canvas of individual risk types which includes information technology and business continuity risk, internal and external fraud risk and fiduciary and legal risk.

Further information is available in the Group Annual Financial Report, which is available on the Group website (www.aibgroup.com).

***Risk identification and assessment***

Risk and Control Self-Assessment ('self-assessment') is a core process in the identification and assessment of operational risk across the enterprise. The process serves to ensure that key operational risks are proactively identified, evaluated, monitored and reported, and that appropriate action is taken.

Self-assessments are completed at business unit level and are regularly reviewed and updated. Assurance processes are in place at divisional and enterprise level to ensure the completeness and robustness of each business unit's self-assessment, and that appropriate attention is given to more significant risks.

***Risk management and mitigation***

Each business area is primarily responsible for managing its own operational risks. An overarching Group Operational Risk Management ("ORM") policy is in place, which has established an effective and consistent approach to Operational Risk Management across the enterprise. The Group ORM policy is also supported by a range of specific policies addressing issues such as new product and initiative approval, information security, and business continuity management.

An important element of the Group's operational risk management framework is the ongoing monitoring through self-assessment of risks, control deficiencies and weaknesses, the tracking of incidents and loss events and the use of a structured 'lessons learned' process to ensure that, once identified, control deficiencies are communicated and remedied across the Group. The role of Group ORMCo is to review and coordinate operational risk management activities across the Group including setting policy and promoting best practice disciplines.

The Group takes an end-to-end approach to internal controls in order to make sure that all components, taken together, deliver the control objectives of key risk management processes.

In addition, an insurance programme is in place, including a self insured retention, to cover a number of risk events which would fall under the operational risk umbrella. These include financial lines policies (comprehensive crime/computer crime; professional indemnity/civil liability; employment practices liability; directors and officers liability) and a suite of general insurance policies to cover such things as property and business interruption, terrorism, combined liability and personal accident.

***Risk monitoring and reporting***

The primary objective of the operational risk management reporting and control process within the Group is to provide timely, pertinent operational risk information to the appropriate management level so as to enable appropriate corrective action to be taken and to resolve material incidents which have already occurred. A secondary objective is to provide a trend analysis on operational risk and incident data for the Group. The reporting of operational incidents, trend data, key risk indicators and outstanding audit issues at Group ORMCo supports these two objectives. In addition, the Board, Group Audit Committee and the RMC receive summary information on significant operational incidents on a regular basis.

## 3.7 Regulatory compliance risk

Regulatory compliance risk is defined as the risk of regulatory sanctions, material financial loss or loss to reputation which the Group may suffer as a result of failure to comply with all applicable laws, regulations, rules, standards and codes of conduct applicable to its activities.

***Risk identification and assessment***

The scope of the Regulatory Compliance function relates to 'conduct of business' compliance obligations, including anti-money laundering and regulation on privacy and data protection. The identification, interpretation and communication roles relating to other legal and regulatory obligations have been assigned to functions with specialist knowledge in those areas. For example, employment law is assigned to Human Resources, taxation law to Group Taxation and prudential regulation to the Finance and Risk functions.

Regulatory Compliance undertakes a six-monthly assessment of the key compliance risks at divisional and enterprise level. The significance of compliance risks, their potential impact on the business and the effectiveness of management controls to mitigate these risks are assessed. These reviews of compliance risks take a forward-looking view of the compliance risks facing the Group. They anticipate upstream risks in the form of new regulations, increased regulatory scrutiny and the increasing demands of stakeholders over the next three years.

The divisional risks are discussed and agreed at divisional management boards. These are collated and processed by Regulatory Compliance into an overall enterprise-wide review of compliance risks. This is reviewed at Risk Management Committee and ultimately the Group Audit Committee. The Regulatory Compliance function supports and validates this approach by operating a risk framework model that is used in collaboration with business units to identify, assess and manage key compliance risks at business unit level. These risks are incorporated in the operational risk self-assessment risk templates ("SARTs") for the relevant business units.

***Risk management and mitigation***

The Board, operating through the Audit Committee, has approved the Group's compliance policy and the mandate for the regulatory compliance function. The Audit Committee reviews the Group's key compliance risks on a six monthly basis to assess the extent to which AIB is managing its compliance risks effectively. At least once a year the Audit Committee will review the Group's Compliance Policy and its ongoing implementation to assess the extent to which the Group is managing its compliance risks effectively.

Management is responsible for ensuring that the Group complies with its regulatory responsibilities. Group Executive Committee's responsibilities in respect of compliance include the establishment and maintenance of the framework for internal controls and the control environment in which compliance policy operates thereby ensuring that Regulatory Compliance is suitably independent from business activities and that it is adequately resourced. The Regulatory Compliance function is specifically responsible for:

a) independently identifying, assessing and monitoring compliance risks faced by the Group;

b) advising and reporting to the Risk Management Committee, divisional boards and the Board (through the Audit Committee) on the effectiveness of the processes established to ensure compliance with laws and regulations within its scope;
c) providing advice and guidance to management and staff on compliance risks within its scope and appropriate policies and procedures to mitigate these risks; and
d) providing a monitoring capability for “non-conduct of business” compliance risks in the areas of taxation law, company law, employment law, environmental law, and health and safety law on a risk prioritised basis.

Regulatory Compliance is an enterprise-wide function headed by the Group General Manager Regulatory and Operational Risk who reports to the Group Chief Risk Officer and independently to the Chairman of the Audit Committee. The primary role of the Regulatory Compliance function is to provide direction and advice to enable management to discharge its responsibility for managing the Group’s compliance risks.

Regulatory Compliance is also mandated to conduct investigations of possible breaches of compliance policy and to appoint outside legal counsel or other specialist external resources to perform this task if appropriate.

The principal compliance risk mitigants are risk identification, assessment, measurement and the establishment of suitable controls at business level. In addition, the Group has insurance policies that cover a number of risk events which fall under the regulatory compliance umbrella.

***Risk monitoring and reporting***

Regulatory Compliance undertakes risk-based monitoring of compliance with relevant policies, procedures and regulatory obligations. Monitoring can be undertaken by either dedicated compliance monitoring teams, front line quality assurance functions at the direction of the compliance function, or in the case of the Capital Markets Division, by business unit compliance officers.

Risk prioritised annual compliance monitoring plans are prepared based on the risk assessment process. Monitoring is undertaken both on a business unit and a process basis. The annual monitoring plan is reviewed regularly, and updated to reflect changes in the risk profile from emerging risks, changes in risk assessments and new regulatory 'hotspots'. Issues emerging from compliance monitoring are escalated for management attention, and action plans and implementation dates are agreed. The implementation of these action plans is monitored by Regulatory Compliance.

# 4. Capital and capital management

The policy of the Group is to maintain adequate capital resources at all times, having regard to the nature and scale of its business and the risk inherent in its operations. It does this through an Internal Capital Adequacy Assessment Process (“ICAAP”). The overarching principle of the ICAAP is the explicit linkage between capital and risk; the adequacy of the Group’s capital is assessed on the basis of the risks it is exposed to. This requires a clear assessment of the material risk profile of the Group, and a consideration of the extent to which identified risks, both individually and in aggregate, require capital to support them. In addition, the level of capital held by the Group is influenced by its target debt rating and minimum regulatory requirements.

The Board reviews and approves the Group’s capital plan on an annual basis. The capital planning process is fully integrated into the Group and divisional planning process. The capital plan considers the amount and type of capital the Group requires to support its business strategy and comply with regulatory requirements. It takes into consideration the results of stress tests, and considers strategies for hedging, releasing and raising capital in order to arrive at and maintain the Group’s desired capital profile. Stress testing, in the context of capital planning, is a technique used to evaluate the potential effect on an institution’s capital adequacy of a specific event or movement of a set of economic variables, and focuses on exceptional but plausible events. This means that an institution’s capital requirement can increase significantly during an economic stress despite a decrease in nominal exposures.

AIB uses five different measures of capital or capital requirements in decision making:- (a) Minimum regulatory capital requirements (Pillar 1); (b) Internal capital requirement (Pillar 2); (c) Target capital; (d) Actual capital; and (e) Capital floor.

## Minimum regulatory capital requirement (Pillar 1)

As regards regulatory capital resources and capital adequacy, the Group is subject to the requirements of the Financial Regulator. The Financial Regulator’s rules closely follow the provisions of the CRD, and apply a risk asset ratio framework to the measurement of capital adequacy.

The adequacy of the Group’s capital is assessed by comparing available regulatory capital resources with capital requirements expressed as risk weighted assets. AIB must maintain a minimum total capital to risk weighted assets (“RWA”) ratio of 8% and a minimum tier 1 capital (to risk weighted assets) ratio of 4%.

While the capital requirements for credit risk depend to a significant degree on the credit worthiness of the obligor, the CRD permits the use of different approaches to the calculation of RWA; the Standardised Approach and the Internal Ratings Based Approach (see Section 5). AIB Group uses a mix of Standardised and Internal Ratings Based Approaches for calculating capital requirements for credit risk.

The capital requirement for market risk and operational risk is calculated according to the Standardised Approach.

The Group has not at this stage sought approval for use of its market risk models for the purpose of calculating minimum regulatory capital requirements for market risk.

The table below summarises the total exposures, based on Exposure at Default (“EAD”), the gross risk weighted assets and the minimum capital requirements at 31 December 2008.

**Table 1: Capital adequacy information - Total exposures (EAD), risk weighted assets and minimum capital requirement**

**31 December 2008**

| | Total exposures € m | Risk weighted assets € m | Minimum capital requirement € m |
|---|---|---|---|
| Standardised approach | 58,643 | 51,413 | 4,113 |
| IRB approach | 137,751 | 73,189 | 5,855 |
| Market risk | N/A | 2,043 | 163 |
| Operational risk – Standardised approach | N/A | 7,250 | 580 |
| **Total** | **196,394** | **133,895** | **10,711** |

**Table 1a: Market risk minimum capital requirement**

**31 December 2008**

| Market risk | Minimum capital requirement € m |
|---|---|
| Interest rate PRR[(1)] | 96 |
| Equity rate PRR[(1)] | 8 |
| Foreign exchange PRR[(1)] | 22 |
| Investment firms | 37 |
| **Total** | **163** |

[(1)] PRR: Position risk requirement

## Internal capital requirement (Pillar 2)

AIB Group defines its internal capital as the tier 1 capital required to protect it against severe unexpected losses that might put the solvency of AIB Group at risk. The internal capital requirement is determined by summing:

The minimum Pillar 1 regulatory requirement for credit risk and operational risk (calculated as 4% of RWA); the economic capital calculation for market risk (VaR based); and the capital calculation for any other material risks that are deemed to warrant a specific capital requirement.

### *Target capital*

For the year ended 31 December 2008 the Group managed and measured its own performance to a target Group tier 1 ratio at or above 7% (minimum policy ratio of 6.5%). For the year ended 31 December 2009 the Group manages and measures its own performance to a target Group tier 1 ratio at or above 8% (minimum policy ratio of 7.5%).

### *Actual capital*

This is the actual capital held for AIB Group, which at 31 December 2008 was € 14,050 million. Table 2 sets out the components and calculation of the Group's tier 1 and total capital ratios under the CRD at 31 December 2008 and 31 December 2007.

### *Capital floor*

Under the Foundation IRB Approach, AIB is subject to capital floors as determined by the Financial Regulator.

The floors apply to both consolidated and individual subsidiary calculations, and are based on a percentage of the capital requirements that would have been as calculated under the pre-CRD capital adequacy framework.

## Table 2: Capital adequacy information – components of capital base

| | 31 December 2008<br>€ m | 31 December 2007<br>€ m |
|---|---|---|
| **Tier 1** | | |
| Paid up ordinary share capital | **294** | 294 |
| Eligible reserves | **8,569** | 8,566 |
| Equity minority interests in subsidiaries | **354** | 361 |
| Supervisory deductions from core tier 1 capital | **(1,490)** | (1,176) |
| **Core tier 1 capital** | **7,727** | 8,045 |
| Non-equity minority interests in subsidiaries | **990** | 990 |
| Non-cumulative preference shares | **-** | 169 |
| Non-cumulative perpetual preferred securities | **864** | 972 |
| Reserve capital instruments | **497** | 497 |
| Supervisory deductions from tier 1 capital | **(172)** | (286) |
| **Total tier 1 capital** | **9,906** | 10,387 |
| **Tier 2** | | |
| Eligible reserves | **232** | 212 |
| IBNR provisions (Standardised portfolio) | **536** | 101 |
| Subordinated perpetual loan capital | **692** | 813 |
| Subordinated term loan capital | **2,970** | 2,651 |
| Supervisory deductions from tier 2 capital | **(172)** | (286) |
| **Total tier 2 capital** | **4,258** | 3,491 |
| Gross capital | **14,164** | 13,878 |
| Supervisory deductions | **(114)** | (143) |
| **Total capital** | **14,050** | **13,735** |
| **Risk weighted assets** | | |
| Credit risk | **124,602** | 121,785 |
| Market risk | **2,043** | 5,796 |
| Operational risk | **7,250** | 6,510 |
| **Total risk weighted assets** | **133,895** | **134,091** |
| **Capital ratios** | | |
| Core tier 1 | **5.8%** | 6.0% |
| Tier 1 | **7.4%** | 7.7% |
| Total | **10.5%** | 10.2% |

The Group's Basel II capital ratios are based on Pillar 1 ('minimum capital requirements') under the CRD. Under Pillar 2 ('supervisory review') banks may estimate their own capital requirements through an Internal Capital Adequacy Assessment Process ("ICAAP") which is subject to supervisory review and evaluation. The ICAAP evaluation is currently in progress.

Summary information on the main components of own funds items, and their terms and conditions as applicable, is set out in Appendix 1.

The Group's capital ratios remained strong during 2008 with a core tier 1 ratio of 5.8%, a tier 1 ratio of 7.4% and a total capital ratio of 10.5% at 31 December 2008.

Core tier 1 capital decreased by € 318 million reflecting the negative impact of exchange rate movements of € 639 million and increased supervisory deductions arising from the acquisition of Bulgarian American Credit Bank ("BACB"), offset by net retentions for capital adequacy purposes of € 460 million. The US$250 million non-cumulative preference shares were repaid in July 2008 and this, together with negative exchange rate movements of € 121 million on the sterling perpetual preferred securities, brought tier 1 capital to € 9,906 million.

Tier 2 capital increased by € 767 million, reflecting the issue of subordinated term loan capital € 885 million and additional qualifying credit provisions of € 435 million offset by the redemption of subordinated term loan capital of € 200 million and negative exchange rate movements of € 487 million.

Total risk weighted assets declined marginally during 2008. Credit risk weighted assets increased by €2.8 billion primarily reflecting the downgrading of exposures due to the decline in economic conditions; new business increases and the transfer from trading portfolio financial assets to financial investments available for sale. This was offset by the negative impact of exchange rate movements of € 6.7 billion. The decrease in market risk weighted assets of € 3.8 billion arose primarily due to the transfer of financial assets as discussed above and the redesignation of certain transactions. The increase in operational risk weighted assets reflects the natural increase in capital requirements arising from an increase in business activity rather than any underlying specific increase in operational risks.

# 5. Credit risk

The Group's main source of income arises from granting credit. Accordingly this exposes it to its most significant risk, namely credit risk. As described in Section 3.1, Credit Risk is the risk that a customer or counterparty will be unable or unwilling to meet a commitment that it has entered into and that the Group is unable to recover the full amount that it is owed through the realisation of any security interests. The most significant credit risks in AIB Group arise from traditional lending activities to customers and banks. Credit risk also arises through the use of derivatives, off-balance sheet guarantees and commitments and through the Group's trading and 'available for sale' portfolios of financial instruments. Capital requirements are based on the perceived level of riskiness of individual credit exposures.

The Capital Requirements Directive ("CRD") provides two approaches for the calculation of minimum regulatory capital requirements for credit risk;

a) The Standardised Approach; and
b) Internal Ratings Based Approach ("IRB Approach"), which can be sub divided into
   i. Foundation Internal Ratings Based Approach ("Foundation IRB Approach");
   ii. Advanced Internal Ratings Based Approach ("Advanced IRB Approach"); and
   iii. Retail Internal Ratings Based Approach ("Retail IRB Approach").

Under the Standardised Approach, risk weightings for rated counterparties are determined on the basis of the external credit rating assigned to the counterparty. For non-rated counterparties and certain other types of exposure, regulatory-determined standardised risk weightings are used.

The IRB Approach allows banks, subject to regulatory approval, to use their own estimates of certain risk components to derive regulatory capital requirements for credit risk across different asset classes. The relevant risk components are probability of default ("PD"), loss given default ("LGD") and exposure at default ("EAD"). For non-retail exposures, there are two IRB approaches. Under the Foundation IRB Approach banks use their own estimate of PD, and regulatory estimates of LGD and EAD. Under the Advanced IRB Approach, banks use their own estimates of all three risk components. For retail exposures, there is only one IRB approach – this uses internal estimates of all three risk components.

Both Standardised and Foundation IRB exposures are assigned to exposures classes, in accordance with Articles 79 and 86 of the CRD.

As at 31 December 2008, the Group uses a combination of Standardised and IRB Approaches for assessing its capital requirements for credit risk. It has received regulatory approval to use the Foundation IRB Approach for certain sovereign, bank and corporate exposures, and uses the Retail IRB Approach for certain residential mortgage exposures (henceforth, for ease of reference within this document, this combination of Foundation and Retail IRB approval will be referred to as approval to use a Foundation IRB Approach).

As at 31 December 2008, 41.3% of the Group's credit risk capital requirement has been calculated on the basis of the Standardised Approach, with the remainder calculated using the Foundation IRB Approach. Details of the approvals for Foundation IRB are set out in Section 7. Capital requirements for portfolios where the Group is migrating to Foundation IRB over a timeframe agreed with the Financial Regulator are currently calculated using the Standardised Approach.

The Group's exposures under both Standardised and Foundation IRB approaches are set out in Sections 6 and 7. Additional commentary on specific credit risks arising from certain transactions including derivative transactions, repurchase agreements and securitisations are set out in Sections 10 and 11 of this document.

The following definitions apply to the tables throughout this document:

a) The Group reports exposure values as Exposure at Default ("EAD").
b) Total gross exposure is before Credit Risk Mitigation ("CRM"), Credit Conversion Factors ("CCFs") and offsets;
c) Total exposure is after CRM, CCFs and after specific offsets;
d) Items belonging to high risk categories include, subject to the discretion of competent authorities, exposures associated with particularly high risks such as investments in venture capital firms and private equity investments;

e) Collective Investment Undertakings ("CIU") include:
   i. undertakings where the sole object is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk-spreading; and
   ii. units which are, at the request of the holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a CIU to ensure that the stock exchange value of its units does not vary significantly from their net asset value shall be regarded as equivalent to such repurchase or redemption.

f) "Other items" refers to other assets including land and buildings, plant and machinery, other fixtures and fittings, tools and equipment, payments on account and tangible assets in the course of construction.

The capital requirements for exposures calculated under the Standardised Approach and Foundation IRB Approach and the related exposure values are set out in the following table.

**Table 3: Total exposures (EAD) by exposure class and related minimum capital requirements**

**31 December 2008**

| Exposure class | Total exposures € m | Minimum capital requirement € m |
|---|---|---|
| **Standardised exposure class** | | |
| Central governments and central banks | 133 | - |
| Regional governments or local authorities | 31 | 1 |
| Administrative bodies and non-commercial undertakings | 34 | 3 |
| Institutions[(1)] | 504 | 33 |
| Corporates | 18,526 | 1,411 |
| Retail | 10,405 | 625 |
| Secured on real estate property | 24,127 | 1,693 |
| Past due items[(2)] | 1,232 | 138 |
| Items belonging to regulatory high risk categories | 174 | 21 |
| Collective investment undertakings | 12 | 1 |
| Other items | 3,465 | 187 |
| **Total for Standardised Approach** | **58,643** | **4,113** |
| **Foundation IRB exposure class** | | |
| Central governments and central banks | 16,816 | 11 |
| Institutions[(1)] | 19,865 | 244 |
| Corporates | 70,611 | 5,170 |
| Retail | 22,773 | 276 |
| Securitisation positions | 7,679 | 154 |
| Non-credit obligation assets | 7 | - |
| **Total for Foundation IRB Approach** | **137,751** | **5,855** |
| **Total for Credit Risk** | **196,394** | **9,968** |

[(1)] Institution exposure class predominantly relates to banks

[(2)] The Basel standardised asset class past due items only includes exposures that are (a) standardised; (b) greater than 90 days past due or defaulted; and (c) impaired. A profile of contractually past due (but not impaired) facilities, for both the Standardised and Foundation IRB Approaches, is contained in table 14, set out in Section 9.

# 6. Credit Risk – Standardised Approach

Exposures rated under Standardised Approach amounted to € 58,643 million, with a capital requirement of € 4,113 million as at 31 December 2008. This amounts to 41.3% of the total capital requirement for credit risk. The following tables analyse the credit risk exposures under the Standardised Approach by sector on the following bases:

a) Geographic (table 4);
b) Industry (table 5); and
c) Residual maturity (table 6).

AIB Group monitors geographic breakdown based on the country of the borrower and the guarantor of ultimate risk.

## Use of external credit ratings

AIB uses Standard and Poor's Rating Services, Moody's Investors Service and Fitch Ratings as its nominated External Credit Assessment Institutions ("ECAIs") for a small part of its credit risk corporate asset class exposures under the Standardised Approach (see also Section 11).

Exposures to which credit ratings are assigned are mapped to risk weights using mapping guidelines issued by the Financial Regulator. These guidelines are identical to those issued by the Committee of European Banking Supervisors ("CEBS"). The externally rated credit risk exposures are not material and represent 2.4% of standardised exposures and 0.7% of the total (Standardised Approach and Foundation IRB Approach) credit risk exposures. Another small portion has been rated using credit quality assessment steps. These relate to exposures where a preferential risk weight is applied to the exposures when there is no rating agency but other criteria are met to categorise into a risk band other than unrated.

Of the total exposures after credit risk mitigation amounting to € 58,643 million, € 1,424 million are rated by ECAIs, and € 299 million is rated using credit quality assessment steps. These are set out in tables 7 and 8 below.

### Table 4: Geographic distribution of credit exposures (EAD) – Standardised Approach

**31 December 2008**

| Exposure class / Geography | Central governments and central banks € m | Regional governments or local authorities € m | Administrative bodies and non-commercial undertakings € m | Institutions € m | Corporates € m | Retail € m | Secured on real estate property[1] € m | Past due items € m | Items belonging to regulatory high risk categories € m | Collective investment undertakings € m | Other items € m | Total € m |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Republic of Ireland | 99 | - | 20 | 8 | 6,106 | 6,860 | 5,920 | 365 | 63 | - | 2,009 | **21,450** |
| United Kingdom | 34 | - | 11 | 6 | 8,570 | 1,274 | 11,790 | 742 | 6 | - | 680 | **23,113** |
| Poland | - | 31 | 3 | 484 | 2,712 | 2,183 | 4,606 | 110 | 22 | 12 | 761 | **10,924** |
| United States of America | - | - | - | - | 1,087 | - | 1,144 | 15 | 83 | - | 4 | **2,333** |
| Rest of the world | - | - | - | 6 | 51 | 88 | 667 | - | - | - | 11 | **823** |
| **Total exposures** | **133** | **31** | **34** | **504** | **18,526** | **10,405** | **24,127** | **1,232** | **174** | **12** | **3,465** | **58,643** |
| **Total gross exposures** | **133** | **56** | **34** | **646** | **21,472** | **16,047** | **25,717** | **1,659** | **198** | **12** | **3,501** | **69,475** |
| **Average exposures over the period[2]** | **407** | **15** | **62** | **653** | **21,676** | **12,174** | **28,230** | **972** | **132** | **10** | **3,276** | **67,607** |

[1] The total exposures (EAD) in the secured on real estate property exposure class includes a significant portion of property portfolios in AIB Bank UK, Capital Markets and CEE divisions, as well as residential mortgages in AIB Bank UK and CEE divisions.

[2] Included in the calculation of average exposures for the period are exposures that were included under the Standardised Approach at the beginning of 2008 but which received Foundation IRB approval during 2008. The average exposures for the period may therefore be reflective of movements to Foundation IRB of models approved during the year.

### Table 5: Industry distribution of credit exposures (EAD) – Standardised Approach

31 December 2008

| Exposure class / Sector code | Central governments and central banks € m | Regional governments or local authorities € m | Administrative bodies and non-commercial undertakings € m | Institutions € m | Corporates € m | Retail € m | Secured on real estate property[1] € m | Past due items € m | Items belonging to regulatory high risk categories € m | Collective investment undertakings € m | Other items € m | Total € m |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Agriculture | - | - | - | - | 872 | 953 | 1 | 24 | 1 | - | - | **1,851** |
| Construction | - | - | - | - | 272 | 545 | 2,375 | 117 | - | - | - | **3,309** |
| Distribution | - | - | - | - | 2,825 | 1,057 | 92 | 82 | 5 | - | 3 | **4,064** |
| Energy | - | - | - | - | 227 | 30 | - | 8 | 8 | - | - | **273** |
| Financial | - | - | - | - | 2,402 | 154 | 30 | 14 | 22 | 12 | 277 | **2,911** |
| Home loans | - | - | - | - | 9 | 468 | 5,120 | 70 | - | - | - | **5,667** |
| Manufacturing | - | - | - | - | 2,027 | 447 | 5 | 56 | 47 | - | 1 | **2,583** |
| Other loans - personal | - | - | - | - | 2,022 | 5,003 | 19 | 214 | 4 | - | 1 | **7,263** |
| Other services | - | - | - | - | 6,711 | 887 | 45 | 88 | 83 | - | 28 | **7,842** |
| Property | - | - | - | - | 127 | 482 | 16,440 | 542 | - | - | - | **17,591** |
| Transport & communication | - | - | - | - | 873 | 353 | - | 17 | 4 | - | 3 | **1,250** |
| Bank, sovereign & public sector | 133 | 31 | 34 | 504 | - | - | - | - | - | - | - | **702** |
| Other | - | - | - | - | 159 | 26 | - | - | - | | 3,152 | **3,337** |
| **Total exposures** | **133** | **31** | **34** | **504** | **18,526** | **10,405** | **24,127** | **1,232** | **174** | **12** | **3,465** | **58,643** |

[1] The total exposures (EAD) in the secured on real estate property exposure class includes a significant portion of property portfolios in AIB Bank UK, Capital Markets and CEE divisions, as well as residential mortgages in AIB Bank UK and CEE divisions.

## Table 6: Residual maturity of credit exposures (EAD) – Standardised Approach

**31 December 2008**

| Exposure class / Residual maturity | Central governments and central banks € m | Regional governments or local authorities € m | Administrative bodies and non-commercial undertakings € m | Institutions € m | Corporates € m | Retail € m | Secured on real estate property[1] € m | Past due items € m | Items belonging to regulatory high risk categories € m | Collective investment undertakings € m | Other items € m | Total € m |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| On demand | - | 6 | - | 14 | 529 | 62 | 414 | 88 | 7 | - | - | **1,120** |
| 0 < 3 months | 99 | 1 | - | 5 | 1,566 | 798 | 3,000 | 238 | - | - | 2 | **5,709** |
| 3 < 6 months | - | - | - | - | 756 | 530 | 1,522 | 41 | - | | 44 | **2,893** |
| 6 months < 1 year | 1 | 7 | - | 6 | 3,138 | 2,187 | 2,270 | 229 | 56 | - | 212 | **8,106** |
| 1 < 3 years | - | 10 | 24 | 479 | 3,497 | 1,813 | 5,115 | 67 | 6 | - | 67 | **11,078** |
| 3 < 5 years | 33 | 5 | 6 | - | 3,022 | 2,499 | 4,145 | 383 | 50 | 9 | 34 | **10,186** |
| 5 < 10 years | - | 2 | 4 | - | 2,533 | 1,159 | 2,205 | 57 | 54 | 3 | - | **6,017** |
| 10 years + | - | - | - | - | 3,485 | 1,357 | 5,456 | 129 | 1 | - | - | **10,428** |
| No maturity | - | - | - | - | - | - | - | - | - | - | 3,106 | **3,106** |
| **Total exposures** | **133** | **31** | **34** | **504** | **18,526** | **10,405** | **24,127** | **1,232** | **174** | **12** | **3,465** | **58,643** |

[1] The total exposures (EAD) in the secured on real estate property exposure class includes a significant portion of property portfolios in AIB Bank UK, Capital Markets and CEE divisions, as well as residential mortgages in AIB Bank UK and CEE divisions.

**Table 7: Total Exposure (EAD) value (after CRM) split by credit quality – Standardised Approach**

**31 December 2008**

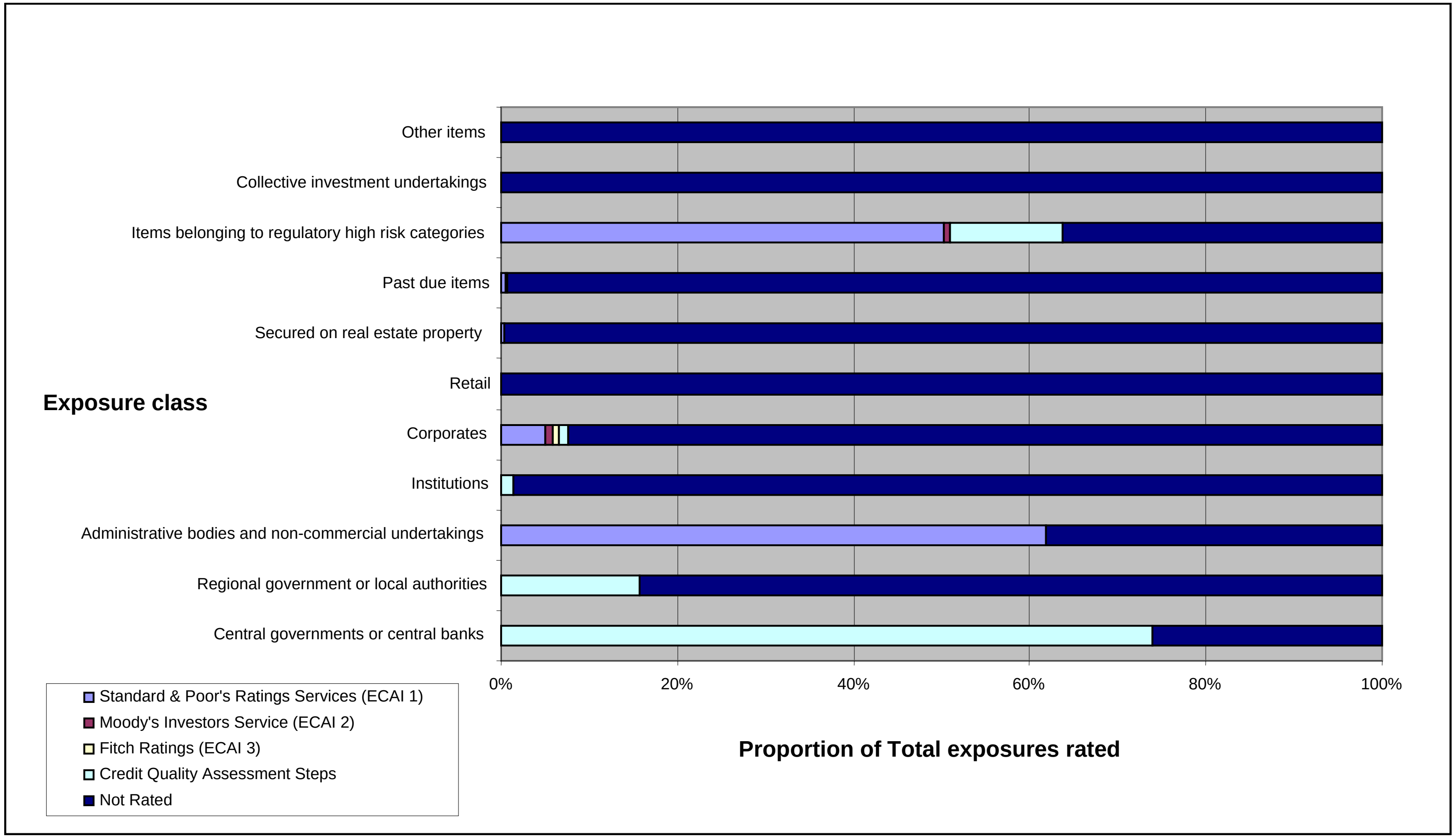
| Credit quality assessment steps[1] | Central governments and central banks | Regional governments or local authorities | Administrative bodies and non-commercial undertakings | Institutions | Corporates[2] | Retail | Secured on real estate property | Past due items | Items belonging to regulatory high risk categories | Collective investment undertakings | Other items | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** |
| Step 1 | 98 | - | 21 | 7 | 722 | - | 47 | - | - | - | - | **895** |
| Step 2 | - | 5 | - | - | 509 | - | 7 | - | - | - | - | **521** |
| Step 3 | - | - | - | - | 142 | - | 17 | - | - | - | - | **159** |
| Step 4 | - | - | - | - | 27 | - | 1 | - | - | - | - | **28** |
| Step 5 | - | - | - | - | - | - | - | 2 | 99 | - | - | **101** |
| Step 6 | - | - | - | - | - | - | 1 | 6 | 12 | - | - | **19** |
| ***Total rated*** | ***98*** | ***5*** | ***21*** | ***7*** | ***1,400*** | ***-*** | ***73*** | ***8*** | ***111*** | ***-*** | ***-*** | ***1,723*** |
| Unrated | 35 | 26 | 13 | 497 | 17,126 | 10,405 | 24,054 | 1,224 | 63 | 12 | 3,465 | **56,920** |
| **Total** | **133** | **31** | **34** | **504** | **18,526** | **10,405** | **24,127** | **1,232** | **174** | **12** | **3,465** | **58,643** |

[1] The following ratings apply to the credit quality assessment steps as follows:

Credit quality assessment step 1: AAA to AA (S&P / Fitch / DBRS); Aaa to Aa3 (Moody's)
Credit quality assessment step 2: A+ to A- (S&P / Fitch / DBRS); A1 to A3 (Moody's)
Credit quality assessment step 3: BBB+ to BBB- (S&P / Fitch / DBRS); Baa1 to Baa3 (Moody's)
Credit quality assessment step 4: BB+ to BB- (S&P / Fitch / DBRS); Ba1 to B3 (Moody's)
Credit quality assessment step 5: B+ to B- (S&P / Fitch / DBRS); B1 to B3 (Moody's)
Credit quality assessment step 6: CCC+ and below (S&P / Fitch / DBRS); Caa1 and below (Moody's)

[2] There is a total of € 104 million credit risk mitigation; all of which relates to the unrated portion of the corporates exposure class. Therefore within corporates exposure class, total unrated, pre CRM is €17,230 million.

## Table 8: Standardised credit risk exposure class



# 7. Credit risk - Foundation Internal Ratings Based Approach

Exposures rated under Foundation IRB Approach amounted to € 137,751 million, with a capital requirement of € 5,855 million as at 31 December 2008. This amounts to 58.7% of the total capital requirement for credit risk.

### Regulatory approval and transition

As at 31 December 2008, the Group has received approval from the Financial Regulator for use of the Foundation IRB Approach for the following portfolios and exposure classes:

| Division | AIB Portfolio | Exposure class |
|---|---|---|
| ***AIB Bank RoI*** | Commercial / large SME<br>Property<br>Residential Mortgages | Corporate<br>Corporate<br>Retail |
| ***Capital Markets*** | Bank<br>Corporate<br>Not-for-profit<br>Project finance<br>Sovereign | Institutions<br>Corporate<br>Corporate<br>Corporate<br>Central governments and central banks |
| ***AIB Bank UK*** | Bank<br>Sovereign | Institutions<br>Central governments and central banks |
| ***Central & Eastern Europe*** | Bank<br>Sovereign | Institutions<br>Central governments and central banks |

AIB monitors its roll-out plans to transition other standardised portfolios in the Group to the Foundation IRB Approach.

### *Governance of the rating process*

AIB has a formalised governance framework around the entire internal ratings model process. The Credit Risk Measurement Committee is chaired by the Group Chief Risk Officer. Membership of this Committee includes executive director representation. The Board has designated the Credit Risk Measurement Committee as the body responsible for approval of material aspects of credit risk measurement systems and processes. The Committee's responsibilities include:

a) ensuring that the credit risk rating models used in regulatory capital calculations comply with the requirements of the CRD;
b) approval of Group standards for the development, validation, maintenance and use of credit risk rating models;
c) approval of new credit risk rating models to be used in the estimation of minimum regulatory capital requirements, and approval of changes to these models;
d) establishment and maintenance of governance structures and processes required for credit risk rating model development and validation; and
e) confirmation that the requirements for independence in the above processes have been met.

### *Credit Risk Control function*

The Credit Risk Control function within the Group is an integrated set of independent units and functions which share responsibility for key control aspects of the Group's rating systems. These responsibilities include rating model development, use, performance monitoring and oversight. The Credit Risk Control function supports risk management organisation and governance structures at Group and divisional level. The Group Chief Risk Officer has primary responsibility for the Credit Risk Control function at Group level. At divisional level, responsibility is divided between the Chief Risk Officer (rating model design and development, performance monitoring) and in some circumstances the Chief Credit Officer (rating system implementation), in line with credit process responsibilities.

To ensure independence, credit risk management functions have separate reporting lines into the divisional Chief Risk Officers and the divisional Chief Credit Officers respectively. Divisional Chief Risk Officers report directly to the Group Chief Risk Officer and divisional Chief Credit Officers report directly to their divisional managing directors, independently of the business originating functions. Divisional Chief Credit Officers also have a secondary reporting line into the Group Chief Credit Officer.

### *Use of rating models*

Rating models and systems are core to credit and risk management in the Group. In recent years, the Group has invested significantly in the development and enhancement of these models, and has greatly expanded their use in credit processes. The outputs from Foundation IRB models play an essential role in a wide range of risk processes:

a) Credit approval: Grades assigned by IRB risk models are a key input to the assessment of credit applications. Grades are also used in determining the size of delegated credit authorities. The outputs of the models are also used in assessing risk-return and pricing of loans;

b) Risk management and decision-making processes: In the management of existing exposures grades, rating models are fundamental to management reporting and in determining the level and nature of management attention applied to exposures;

c) Internal capital allocation: The outputs from IRB risk models are a core input to the Internal Capital Adequacy Assessment Process (“ICAAP”) including stress tests of capital adequacy;

d) Annual planning: Risk forecasts based on the outputs of IRB models are embedded in the annual planning process.

### *Use of and process for recognising credit risk mitigation*

When calculating the capital requirements for Foundation IRB Approach the Group takes account of collateral as a credit risk mitigant for residential real estate in its retail (home mortgage) portfolio but does not recognise credit risk mitigation techniques in the sovereign, institution and corporate exposure classes, with the exception of financial collateral.

The Group uses its own estimates of LGD in the calculation of risk weighted assets for exposures secured on residential real estate in its retail (home mortgage) portfolio. The Group's approach to taking, perfecting, valuing and monitoring real estate collateral is consistent with its broad framework for credit risk mitigation as described in Section 8.

## Internal ratings process by exposure class

The following tables set out the divisional analysis split out by portfolio for the exposure classes (a) Central governments and central banks; (b) Institutions; (c) Corporates; and (d) Retail rated under the Foundation IRB Approach. All of the PD estimates attached to the internal rating models described below are calibrated on a *"though the cycle"* basis.

*(a) Central government and central banks*

The following portfolios within the Group's IRB Approach approval are treated under the Central governments and central banks exposure class:

| AIB Division | AIB Portfolio | Portfolio description |
|---|---|---|
| Capital Markets | Sovereign | Central governments<br>Central banks<br>Other specified multinational development banks and international organisations |
| AIB Bank UK | Sovereign | Central governments<br>Central banks<br>Other specified multinational development banks and international organisations |

| AIB Division | AIB Portfolio | Portfolio description |
|---|---|---|
| Central & Eastern Europe | Sovereign | Central governments<br>Central banks<br>Other specified multinational development banks and international organisations |

Under the Foundation IRB Approach, internal rating models are used to assign sovereign obligors to borrower grades, to which estimates of PD are attached. The Group uses regulatory LGD and EAD measures in calculating risk weighted assets.

Ratings are assigned on the basis of expert judgement, based upon perceived political risk, government policy risk, economic policy and external liquidity risk. PDs are calibrated on the basis of expert judgement, benchmarked to available external ratings. The definition of default is consistent with the CRD definition.

*(b) Institutions*

The following portfolios within the Group's IRB Approach approval are treated under the institutions exposure class:

| AIB Division | AIB Portfolio | Portfolio description |
|---|---|---|
| Capital Markets | Bank | Banks<br>Securities firms subject to the same regulation as banks |
| AIB Bank UK | Bank | Banks<br>Securities firms subject to the same regulation as banks |
| Central & Eastern Europe | Bank | Banks<br>Securities firms subject to the same regulation as banks |

Under the Foundation IRB Approach, internal rating models are used to assign institutional obligors to borrower grades, to which estimates of PD are attached. The Group uses regulatory LGD and EAD measures to calculate risk weighted assets.

Ratings are assigned on the basis of a hybrid model (a statistical model or scorecard with some expert judgement). External ratings for the country of domicile are used to establish a 'country ceiling' on the rating, and as an input into the quantitative score. Due to the lack of internal default data, PDs are calibrated to an equivalent external rating grade. The definition of default is consistent with that used by the rating agencies, which in general is considered to occur at an earlier stage than that defined by the CRD and hence considered to be more conservative.

*(c) Corporates*

The following portfolios within the Group's IRB Approach approval are treated under the corporate exposure class:

| AIB Division | AIB Portfolio | Portfolio description |
|---|---|---|
| AIB Bank ROI | Commercial / large SME | Predominantly commercial business - all sectors except property. |
| AIB Bank ROI | Property | Property investment or development exposures where such exposures constitute more than 50% of total exposure to the borrower. Includes buy-to-let exposures where there are two or more buy-to-lets. |
| Capital Markets | Corporate | Companies that are engaged in the provision of goods or services with the intention of generating profit for the owners. Excluded from this category are:<br>a) Financial service providers;<br>b) Special purpose entities that do not have a diversified income stream; and<br>c) Special purpose entities set up to facilitate securitisations. |
| Capital Markets | Not-for-profit | Exposures to not-for-profit entities in Allied Irish America. |

| AIB Division | AIB Portfolio | Portfolio description |
|---|---|---|
| Capital Markets | Project finance | Long-term loans made to projects in the energy, infrastructure and transportation sectors in Europe, North America, Middle East and Asia-Pacific. |

Under the Foundation IRB Approach, internal rating models are used to assign corporate obligors to borrower grades, to which estimates of PD are attached. The Group uses regulatory LGD and EAD measures in calculating risk weighted assets.

The ratings methodology and criteria used in assigning borrowers to grades vary across the five models, but all five models use a combination of statistical analysis (using both financial and non-financial inputs) and expert judgement. PDs are calibrated on the basis of both internal and external available loss data and through benchmarking. External ratings, where available, play a role in both the assignment and calibration process, but their role is that of one factor amongst several others. The definition of default used for all five portfolios is consistent with the CRD. The Group's validation processes are rigorous. They test, *inter alia*, the rank ordering of borrowers in terms of probability of default, the stability of the ratings, the stability of the portfolio and the probability of default estimates.

*(d) Retail*

The following portfolios within the Group's IRB Approach approval are treated under the retail exposure class:

| Division | AIB Portfolio | Portfolio description |
|---|---|---|
| AIB Bank ROI | Branch originated - home mortgages | Home mortgage lending and first buy-to-let |
| AIB Bank ROI | Mortgages - finance and leasing | Home mortgage lending and first buy-to-let |

Under the IRB Approach for retail, the Group uses its own estimates of PD, LGD and EAD in calculating risk weighted assets for residential mortgages originated in the Republic of Ireland. The rating methodology is primarily statistical, with limited use of expert judgement. Application and behavioural scorecards are used. PDs and LGDs are calibrated on the basis of internal data, supplemented with benchmarking to external sources. EAD is calculated both on drawn facilities and on 'pipeline' business (mortgages which have been sanctioned but not yet drawn down). The definition of default is consistent with the CRD definition of default.

## Table 9: Geographic [1] distribution of credit exposures (EAD) - Foundation IRB Approach

**31 December 2008**

| Exposure class / Geography | Central governments and central banks € m | Institutions € m | Corporates € m | Retail[2] € m | Securitisation positions € m | Non-credit obligation assets € m | Total € m |
|---|---|---|---|---|---|---|---|
| Republic of Ireland | 10,540 | 18,174 | 60,002 | 22,773 | 7,143 | 6 | **118,638** |
| United Kingdom | 2,706 | 758 | 1,902 | - | - | 1 | **5,367** |
| Poland | 3,570 | 552 | - | - | - | - | **4,122** |
| United States of America | - | 379 | 7,506 | - | 536 | - | **8,421** |
| Rest of the world | - | 2 | 1,201 | - | - | - | **1,203** |
| **Total exposures**[3] | **16,816** | **19,865** | **70,611** | **22,773** | **7,679** | **7** | **137,751** |
| **Total gross exposures**[3] | **16,411** | **29,622** | **74,098** | **23,145** | **7,679** | **7** | **150,962** |
| **Average exposures over the period**[4] | **12,612** | **21,000** | **66,914** | **17,566** | **5,370** | **7** | **123,469** |

[1] AIB Group monitors geographic breakdown based on the country of the borrower and the guarantor of the ultimate risk.

[2] All exposures under the IRB Approach for retail are secured by real estate collateral and represent the residential mortgage portfolio in the Republic of Ireland.

[3] Certain bank exposures (within institutions asset class) are covered by a sovereign guarantee. In such cases a substitution approach is applied. The total gross exposures covered under the sovereign guarantee take the PD of the sovereign, thus attracting a lower risk weight, and are then categorised as a total exposure under the central governments and central banks asset class. Any total gross exposures not covered by the guarantee remain within the institution asset class (and the PD of the institution applies). The increase in total exposure under the central governments and central banks asset class reflects the amount covered by the sovereign guarantee.

[4] Included in the calculation of average exposures for the period are exposures that were included under the Standardised Approach at the beginning of 2008 but which received Foundation IRB approval during 2008. The average exposures for the period may therefore be reflective of movements to Foundation IRB of models approved during the year.

## Table 10: Industry distribution of credit exposures (EAD) - Foundation IRB Approach

31 December 2008

| Exposure class / Sector code | Central governments and central banks € m | Institutions € m | Corporates € m | Retail € m | Securitisation positions € m | Non-credit obligation assets € m | Total € m |
|---|---|---|---|---|---|---|---|
| Agriculture | - | - | 918 | - | - | - | **918** |
| Construction [1] | - | - | 11,143 | - | - | 1 | **11,144** |
| Distribution | - | - | 8,868 | - | - | 2 | **8,870** |
| Energy | - | - | 2,659 | - | - | 1 | **2,660** |
| Financial | - | - | 685 | - | 5,716 | - | **6,401** |
| Home loans | - | - | 2,983 | 22,773 | 9 | - | **25,765** |
| Manufacturing | - | - | 6,420 | - | - | 1 | **6,421** |
| Other loans - personal | - | - | 2,902 | - | - | - | **2,902** |
| Other services | - | - | 11,387 | - | 1,954 | 1 | **13,342** |
| Property [1] | - | - | 19,581 | - | - | - | **19,581** |
| Transport & communications | - | - | 3,065 | - | - | 1 | **3,066** |
| Bank, sovereign & public sector entities | 16,816 | 19,865 | - | - | - | - | **36,681** |
| Other | - | - | - | - | - | - | **-** |
| **Total exposure** | **16,816** | **19,865** | **70,611** | **22,773** | **7,679** | **7** | **137,751** |

[1] The significant majority of total exposures (EAD) under the construction and property sector codes represent property exposures in AIB Bank ROI which are graded through the approved Foundation IRB Approach property model.

**Table 11: Residual maturity of credit exposures (EAD) – Foundation IRB Approach**

**31 December 2008**

| **Residual maturity** | **Central governments and central banks** | **Institutions** | **Corporates** | **Retail** | **Securitisation positions** | **Non-credit obligation assets** | **Total** |
|---|---|---|---|---|---|---|---|
| | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** |
| On demand | 2,439 | 925 | 1,367 | - | - | - | **4,731** |
| < 3 months | 1,511 | 2,360 | 15,417 | 153 | 9 | 1 | **19,451** |
| 3 < 6 months | 449 | 1,212 | 3,532 | 553 | 19 | 1 | **5,766** |
| 6 months < 1 year | 1,348 | 1,752 | 9,809 | 434 | 2 | 1 | **13,346** |
| 1 < 3 years | 3,982 | 7,175 | 11,557 | 555 | 172 | 4 | **23,445** |
| 3 < 5 years | 3,007 | 3,145 | 12,094 | 427 | 189 | - | **18,862** |
| 5 < 10 years | 2,233 | 2,760 | 7,264 | 1,324 | 967 | - | **14,548** |
| 10 years + | 1,847 | 536 | 9,571 | 19,327 | 6,321 | - | **37,602** |
| **Total** | **16,816** | **19,865** | **70,611** | **22,773** | **7,679** | **7** | **137,751** |

## Foundation IRB obligor grades

For the purpose of calculating credit risk and ultimately its capital requirement using the Foundation IRB Approach, AIB has allocated all relevant exposures to obligor grades and an associated PD. These obligor grades are a risk category within the Group's rating systems. An obligor grade is assigned to obligors on the basis of rating criteria within each rating model from which estimates of probability of default are derived. These rating models have been calibrated at an individual business unit level. These individual rating models continue to be refined and recalibrated based on experience.

For the purposes of aggregate reporting, the Group uses a 13 point ratings masterscale which provides a common and consistent framework for aggregating, comparing and reporting exposures across all lending portfolios. The ratings masterscale is PD based. Under the ratings masterscale:

Grades 1 – 3 would typically include strong corporate and commercial lending combined with elements of residential mortgages;

Grades 4 – 10 would typically include new business written and existing satisfactorily performing exposures across all portfolios. The lower end of this category (Grade 10) includes a portion of the Group's criticised loans (i.e. loans requiring additional management attention over and above that normally required for the loan type).

Grades 11 – 13 contains the remainder of the Group's criticised loans, including impaired loans, together with loans written with a higher level of risk and a higher PD.

Tables 12 and 13 set out an analysis of exposure classes by obligor grade, within the Foundation IRB Approach for the Group, excluding Securitisation positions (amounting to € 7,679 million), which are analysed in greater detail in Section 11.

## Table 12: Foundation IRB - obligor grade disclosures (excluding securitisation positions)

| Obligor grade | Central Government & central banks | | Institutions | | Retail | |
|---|---|---|---|---|---|---|
| | Exposure value (EAD) | Exposure - weighted average risk weight % | Exposure value (EAD) | Exposure - weighted average risk weight % | Exposure value (EAD) | Exposure - weighted average risk weight % |
| | € m | % | € m | % | € m | % |
| Grade 1 - 3 | 16,816 | 1% | 19,822 | 11% | 12,769 | 10% |
| Grade 4 - 10 | - | - | 11 | 140% | 9,279 | 22% |
| Grade 11 - 13 | - | - | 32 | 0% | 725 | 130% |
| **Total** | **16,816** | **1%** | **19,865** | **11%** | **22,773** | **15%** |

| Obligor grade | Corporates | | Non-credit obligation assets | | Total Foundation - IRB | |
|---|---|---|---|---|---|---|
| | Exposure value (EAD) | Exposure - weighted average risk weight % | Exposure value (EAD) | Exposure - weighted average risk weight % | Exposure value (EAD) | Exposure - weighted average risk weight % |
| | € m | % | € m | % | € m | % |
| Grade 1 - 3 | 8,598 | 33% | - | - | 58,005 | 10% |
| Grade 4 - 10 | 57,032 | 95% | 7 | 100% | 66,329 | 85% |
| Grade 11 - 13 | 4,981 | 148% | - | - | 5,738 | 145% |
| **Total** | **70,611** | **92%** | **7** | **100%** | **130,072[1]** | **54 %** |

[1] Excludes securitisation positions of €7,679 m

## Table 13: Retail Foundation IRB Approach

| Obligor grade | Retail | |
|---|---|---|
| | Exposure value (EAD) | Exposure - weighted average LGD % |
| | € m | % |
| Grade 1 - 3 | 12,769 | 20% |
| Grade 4 - 10 | 9,279 | 22% |
| Grade 11 - 13 | 725 | 24% |
| **Total** | **22,773** | **21%** |

# 8. Credit Risk Mitigation

Within both the Standardised and Foundation IRB Approaches, an important element in managing exposure to credit risk for AIB Group is the use of Credit Risk Mitigation ("CRM") techniques. However AIB takes limited account of CRM in its calculation of minimum Pillar 1 capital.

AIB takes collateral in support of its lending activities when it is deemed appropriate and has a set of written policies and procedures in place to guide lenders in the assessment, valuation and taking of such collateral. In some circumstances, depending on the customer standing and/or the nature of the product AIB may lend on an unsecured basis.

The main types of collateral for loans and receivables to customers are as follows:

- Retail mortgages: The Group takes collateral in support of lending transactions for the purchase of residential property. There are clear policies in place which set out the type of property acceptable as collateral and the relationship of loan to property value. All properties are required to be fully insured and be subject to a legal charge in favour of the Group.
- Corporate and commercial lending: For property related lending, it is normal practice to take a charge over the property being financed. This includes investment and development properties. For non-property related lending, collateral typically includes a charge over business assets such as stock and debtors but may also include property. In some circumstances, personal guarantees supported by a lien over personal assets are also taken as security.

Cross guarantees from companies within a connected group may also be taken to facilitate cross collateral cover. AIB rarely uses credit default swaps to mitigate credit risk. In assessing and approving overall credit limits for borrowers or groups of borrowers, the levels of guarantees given by such borrowers to third parties are taken into consideration. AIB monitors the nature and value of collateral by type, geography and sector.

The Group enters into master netting agreements with counterparties, to ensure that if an event of default occurs, all amounts outstanding with those counterparties will be settled on a net basis.

For the Standardised Approach the total exposure after netting and volatility adjustments covered by eligible financial collateral is € 104 million, all of which relates to the corporate exposure class. For the Foundation IRB Approach the total exposure after netting and volatility adjustments covered by eligible financial collateral is € 865 million, all of which relates to the institutions exposure class. Further information in relation to CRM framework is discussed within Section 3.1. There is also more information in relation to repurchase transactions in Section 10 Counterparty credit risks.

# 9. Credit Risk - Impairment

## Criticised loans

Criticised loans are loans requiring additional management attention over and above that normally required for the loan type. This includes impaired loans.

## Impairment

A financial asset or portfolio of financial assets is impaired and impairment losses are incurred if, and only if:

a) there is objective evidence of impairment as a result of one or more loss events that occurred after the initial recognition of the asset on or before the balance sheet date, ('a loss event'); and

b) that loss event or events has had an impact such that the estimated present value of future cash flows is less than the current carrying value of the financial asset, or portfolio of financial assets.

Objective evidence that a financial asset or a portfolio of financial assets is impaired includes observable data that comes to the attention of the Group about the following loss events:

a) significant financial difficulty of the issuer or obligor;

b) a breach of contract, such as a default or delinquency in interest or principal payments;

c) the granting to the borrower of a concession, for economic or legal reasons relating to the borrower's financial difficulty that the Group would not otherwise consider;

d) it becomes probable that the borrower will enter bankruptcy or other financial reorganisation;

e) the disappearance of an active market for that financial asset because of financial difficulties; or

f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the portfolio, including adverse changes in the payment status of borrowers in the portfolio and/or national or local economic conditions that correlate with defaults on the assets in the portfolio.

## Determining impairment provisions and value adjustments

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (i.e. individually insignificant). If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and includes these performing assets under the collective incurred but not reported ("IBNR") assessment. Assets that are individually assessed for impairment and for which an impairment loss is, or continues to be recognised are not included in a collective assessment of impairment. For loans and receivables and assets held to maturity, the amount of impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's effective interest rate. The amount of the loss is recognised using an allowance account and is included in the income statement.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure, costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purpose of collective evaluation of impairment (individually insignificant impaired assets and IBNR), financial assets are grouped on the basis of similar risk characteristics. These characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the counterparty's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the group and historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not currently exist.

The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Following impairment, interest income is recognised using the original effective rate of interest which was used to discount the future cash flows for the purpose of measuring the impairment loss. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in the income statement.

When a loan has been subjected to a specific provision and the prospects of recovery do not improve, a time will come when it may be concluded that there is no real prospect of recovery. When this point is reached, the amount of the loan which is considered to be beyond the prospect of recovery is written off against the related provision for loan impairment. Subsequent recoveries of amounts previously written off decrease the amount of the provision for loan impairment in the income statement.

Assets acquired in exchange for loans and receivables in order to achieve an orderly realisation are accounted for as a disposal of the loan and an acquisition of an asset. Any further impairment of the assets or business acquired is treated as an impairment of the relevant asset and not as an impairment of the original instrument.

In the case of equity instruments classified as available for sale, a significant or prolonged decline in the fair value of the instrument below its cost is considered in determining whether impairment exists. Where such evidence exists, the cumulative net loss that had been previously recognised directly in equity is removed from equity and recognised in the income statement. Reversals of impairment of equity shares are not recognised in the income statement and increases in the fair value of equity shares after impairment are recognised directly in equity.

In the case of debt instruments classified as available for sale, impairment is assessed based on the same criteria as for all other financial assets. Reversals of impairment of debt securities are recognised in the income statement.

### Past due

When a borrower fails to make a contractually due payment, a loan is deemed to be *past due*. *Past due days* is the term used to describe the cumulative numbers of days a missed payment is overdue. Past due days commence from the close of business on the day on which a payment is due but not received. In the case of overdrafts, past due days are counted once a borrower:

a) has breached an advised limit;
b) has been advised of a limit lower than the then current outstanding; or
c) has drawn credit without authorisation.

When a loan or exposure is past due, the entire exposure is reported as past due, not just the amount of any excess or arrears.

The figures reported in table 14 for past due are based on loans and receivables to customers (both standardised and IRB) and are in line with reporting under IFRS 7. These relate to loans and receivables to customers which are contractually past due but not impaired.

### Table 14: Total exposure contractually past due - industry and geographic distribution

31 December 2008

| Industry | Past due 1 < 30 days € m | Past due 31 < 60 days € m | Past due 61 < 90 days € m | Past due 91 days + € m |
|---|---|---|---|---|
| Agriculture | 185 | 42 | 18 | 4 |
| Energy | 5 | 2 | 1 | - |
| Manufacturing | 78 | 18 | 13 | 4 |
| Construction & property | 3,813 | 912 | 541 | 147 |
| Distribution | 464 | 136 | 181 | 15 |
| Transport | 52 | 16 | 4 | 1 |
| Financial | 25 | 3 | 3 | 5 |
| Other services | 490 | 67 | 37 | 41 |
| Home mortgages | 326 | 164 | 105 | 38 |
| Other personal | 667 | 165 | 58 | 29 |
| **Total** | **6,105** | **1,525** | **961** | **284** |

| Geography | € m | € m | € m | € m |
|---|---|---|---|---|
| Republic of Ireland | 5,357 | 1,382 | 888 | 153 |
| United Kingdom | 463 | 92 | 59 | 117 |
| Poland | 279 | 47 | 14 | 1 |
| United States of America | - | - | - | 13 |
| Rest of the world | 6 | 4 | - | - |
| **Total** | **6,105** | **1,525** | **961** | **284** |

### Table 15: Impaired exposures and provisions - industry and geographic distribution

**31 December 2008**

| Industry | Loans and receivables to customers – gross of provisions € m | Impaired exposures € m | Specific balance sheet provisions € m | Specific provision charge for year € m |
|---|---|---|---|---|
| Agriculture | 2,537 | 88 | 54 | 14 |
| Energy | 2,080 | 42 | 12 | 9 |
| Manufacturing | 6,957 | 167 | 69 | 34 |
| Construction & property | 47,926 | 1,653 | 556 | 548 |
| Distribution | 13,055 | 266 | 114 | 66 |
| Transport & communications | 1,869 | 16 | 11 | 5 |
| Financial | 2,783 | 20 | 12 | 7 |
| Other services | 12,446 | 125 | 60 | 33 |
| Home loans | 31,625 | 246 | 47 | 30 |
| Other loans -personal | 8,972 | 315 | 180 | 102 |
| Lease financing | 1,913 | 53 | 31 | - |
| **Total** | **132,163** | **2,991** | **1,146** | **848** |

| **Geography** | | € m | € m | € m |
|---|---|---|---|---|
| Republic of Ireland | 92,662 | 1,972 | 762 | 545 |
| United Kingdom | 26,072 | 689 | 228 | 232 |
| Poland | 8,688 | 250 | 137 | 52 |
| Rest of the world | 4,741 | 80 | 19 | 19 |
| **Total** | **132,163** | **2,991** | **1,146** | **848** |

| | | |
|---|---|---|
| **IBNR provision** | **1,146** | **974** |
| Specific provision in relation to loans and receivables to banks | 2 | - |
| **Total impairment provisions** (specific and IBNR) | **2,294** | **1,822** |

### Table 16: Movement in impairment provisions of loans and receivables

| | Specific € m | IBNR € m | Total € m |
|---|---|---|---|
| 1 January 2008 | 526 | 218 | 744 |
| Exchange translation adjustments | (71) | (46) | (117) |
| Transfer between specific and IBNR provisions | 848 | (848) | - |
| Charge against income statement (see below) | - | 1,822 | 1,822 |
| Amounts written off | (166) | - | (166) |
| Recoveries of amounts written off in previous periods | 11 | - | 11 |
| **31 December 2008** | **1,148** | **1,146** | **2,294** |

The charge against income statement of € 1,822 million comprises € 848 million of a specific provision charge for impaired loans and € 974 million of an incurred but not reported ("IBNR") provision charge for losses in the performing book.

The global economic downturn has contributed significantly to a substantial increase in the provision for the year to December 2008 and reflects the serious deterioration in the property sector which impacted particularly on AIB Bank ROI and AIB Bank UK. The IBNR charge acknowledges the heightened level of incurred loss in the performing book.

Further information is available in the Group Annual Financial Report, which is available on the Group website (www.aibgroup.com).

## Loss experience in the preceding period – Foundation IRB Approach

An analysis of the expected loss ("EL") and actual loss experience by exposure class for the year ended 31st December 2008 is outlined in table 17. The EL is the level of loss that was expected in 2008 based on the grade profile and associated probability of default ("PD") of the asset class at the beginning of 2008. The actual loss is the specific provision charged to the Income Statement for the year ended 31 December 2008.

**Table 17: Expected loss analysis – Foundation IRB Approach**

| | 31 December 2008 | |
|---|---|---|
| | Expected loss[1] | Actual loss[2] |
| **Exposure class** | **€ m** | **€ m** |
| Institutions | 2 | - |
| Corporates | 308 | 455 |
| Retail[3] | - | 10 |
| Securitisation positions[4] | - | 8 |
| **Total** | **310** | **473** |

| | 31 December 2008 | |
|---|---|---|
| | Expected loss[1] | Actual loss[2] |
| **Retail IRB** | **€ m** | **€ m** |
| Retail exposures secured by real estate collateral | - | 10 |
| **Total Retail** | **-** | **10** |

(1) Expected loss is derived at the beginning of the year, i.e. as at 1 January 2008

(2) Actual loss is calculated at the end of the year, i.e. as at 31 December 2008

(3) The Foundation IRB retail model was approved in May 2008; therefore there were no comparable EL figures at the beginning of 2008.

(4) Under the Foundation IRB Approach, rating agency ratings, as opposed to EL, are used in the determination of capital for securitisation positions. For this reason AIB does not calculate EL for securitisation positions.

The corporate and institutional portfolio models were approved for the Foundation IRB Approach at the beginning of 2008. Hence, comparatives are given for those asset classes only. The Foundation IRB Retail model for residential mortgages, in the AIB Bank ROI division was approved in May 2008; therefore there were no comparable EL figures at the beginning of 2008. In comparing these outcomes it is important to note that AIB uses *through the cycle* PDs in its calculation of EL and capital requirements, while provisions are driven by accounting standards which are calculated at point in time. The actual losses in 2008 have been particularly influenced by provisions raised on the property portfolio in AIB Bank ROI division.

AIB monitors actual default and loss experience on an ongoing basis and uses this information in its review of PD estimates used in its rating tools. The PD of an individual credit will change with its grade profile.

AIB's risk weightings for Foundation IRB models as at 31 December 2008 are set out in table 18. These weightings are influenced by the grade profile and associated PD of the portfolios, having applied loss given defaults ("LGD") of 45% to all portfolios, with the exception of residential mortgages which had an LGD of 21% applied as at 31st December 2008.

**Table 18: CRD risk weightings (as a percentage of EAD) for Foundation IRB models**

| Foundation IRB rating models | 31 December 2008<br>% |
|---|---|
| **AIB ROI** | |
| Property | 99 |
| Commercial | 107 |
| Mortgage[(1)] | 15 |
| **Capital Markets** | |
| Corporate | 85 |
| Bank | 15 |
| Sovereign | 1 |
| Not-for-profit | 29 |
| Project finance[(1)] | 103 |

[(1)] The mortgage and project finance models were approved for use under Foundation IRB Approach during 2008.

# 10. Counterparty credit risks

## Assigning internal capital and credit limits for counterparty credit exposure

The Group is exposed to counterparty credit exposure through its portfolio of derivatives and repurchase agreements ('repos').

### *Derivatives*

Credit exposure arises on derivative transactions as there is a risk that the counterparty to a contract could default prior to its maturity. If at that time, the Group were to incur a loss to replace the contract this gives rise to a claim on the counterparty.

The credit exposure on derivatives is managed in the same way as other types of credit exposure. The Group applies the same credit control and risk management policies as relate to counterparty credit approval, limit setting and monitoring procedures.

Counterparty Credit Exposure ("CCE") consists partly of current replacement cost (or mark-to-market) of the contracts and partly of potential future exposure. The potential future exposure component is an estimation which reflects possible changes in market values during the remaining life of the individual contract. The CCE for an individual counterparty will take into account the existence of valid bilateral netting or collateral agreements, where these are in place.

AIB applies the simplified method for calculating exposure amounts for the purposes of calculating internal capital on counterparty credit exposure for derivatives.

Pre-settlement CCE limits must be approved in advance of any transactions being entered into by the appropriate credit approval authority. This forms a part of the normal credit management and review process. Settlement and maturity limits must conform to general credit policy requirements. Limits on the maximum residual maturity of derivative activities are governed by individual counterparty maturity constraints.

When approving CCE transactions, Credit Committees take into consideration the dynamic nature of the transaction(s) temporal exposure profile, particularly in setting CCE limits, with Group policy basing the limit on the potential peak exposure over the transaction's residual life. In addition, it is Group practice that all appropriate documentation, such as facility letters or International Swaps and Derivatives Association ("ISDA") agreements be put in place before any limits are made available for use.

The Group uses a volatility-based risk weighting for internal purposes to determine potential future exposure values. These weightings or *add-on-factors* are derived from a rolling 3-year historical time series of price volatility data, raised to a 95$^{th}$ percentile one-tailed confidence interval. The Group updates these *add-on-factor* tables, which are organised by product, currency and residual maturity, on a monthly basis. Pre-settlement CCE limits for derivative transactions are established by reference to the specific transaction's *add-on-factors* equivalent.

Although Credit Support Annexes are taken into consideration when setting the internal credit risk utilisation for derivative counterparties, they are not recognised as credit risk mitigation for reducing the exposure at default on the derivative transactions in the Pillar 1 regulatory capital calculations.

### *Repurchase agreements*

AIB Group is also active in repurchase transactions on capital market instruments. This is achieved through repo/reverse repo products and Sell Buy Back ("SBB")/Buy Sell Back ("BSB") products (together called repurchase transactions). Repurchase transactions are undertaken on both bilateral and tri-party basis.

Repo/reverse repos and SBB/BSB are products which are economically equivalent. Where appropriate netting documentation is in place; both sets of products also become legally equivalent from a credit risk mitigation perspective. The Group only engages in such transactions once the appropriate documentation has been executed.

Risk Management functions, independent of the front office, have responsibility for managing the margining of the Group's bilateral repo / reverse repo and SBB/BSB activities.

Margining has been predominantly cash-based although the documentation in general allows for securities to be used as collateral. Tri-party margining is managed through Euroclear.

The associated credit risk is managed in the same way as other types of credit exposure. Exposures are calculated to take account of historical price volatility reflecting the maturity of both the collateral and repurchase transaction. The exposures are aggregated with all other exposures to the counterparty.

In addition to the normal credit control and risk management policies relating to counterparty credit approval, limit setting and monitoring procedures, the following credit terms receive additional focus for repurchase transactions:

a) Acceptable collateral
b) Acceptable counterparties
c) Appropriate nominal exposure limits by counterparty
d) Appropriate risk weighted exposure limits by counterparty
e) Haircut amounts (where appropriate)

As an IRB bank, AIB applies the Financial Collateral Comprehensive method for the purposes of calculating counterparty credit exposure for repurchase type transactions.

## Policies for securing collateral and establishing credit reserves

It is Group practice that all counterparty specific documentation such as ISDA Master Agreements are put in place to cover derivatives business on a counterparty specific basis. On a selective basis, the ISDA documentation has been supplemented with a Credit Support Annex to accommodate the reduction of net exposure on an agreed basis, and in line with market practice, by way of transferring a margin amount, typically cash (as opposed to securities).

AIB employs robust procedures and processes to control the residual risk that may arise when taking financial collateral, including strategy, consideration of the underlying credit and collateral management/valuation process. In addition, the Group has established standards to ensure legal certainty exists and that there is a low correlation between the credit quality of the obligor and the collateral value provided.

## Policies with respect to one-way exposures

Where the pattern of transactions with a given counterparty is dominated by trades in one direction (e.g. customer is buyer of US dollars, but not a seller), the resulting derivative exposure may be referred to as a 'one-way' exposure. Such counterparty exposures are subject to the credit process, including grade assessment, limit setting, exposure measurement and credit review.

## Change in credit rating

A downgrade in the Group's credit rating would have the effect of reducing the market value threshold for margin calls on some of the Credit Support Annexes. This would result in a potential increase in the amount of collateral the Group would have to provide against the derivatives within the Credit Support Annexes. However, due to the very small number of Credit Support Annexes with downgrade triggers, this is not deemed a significant risk for the Group.

## Credit derivative hedges

The Group had minimal credit derivative activity during the year ended 31 December 2008.

Table 19 analyses the counterparty credit risk exposure to derivative transactions. Table 19a analyses the notional value of credit derivative transactions in the trading book by product type, according to their origin and the purposes for which they are used. Table 19a reflects the counterparty credit risk element of the credit default swaps at 31 December 2008.

**Table 19 Counterparty credit risk - trading & banking book**

**31 December 2008**

| | Positive fair value of contracts (A) | Add-ons (B) | Netting benefits[1] (C) | Gross positive fair value of contracts (incl. add-ons) [Netted current credit exposure] = A+B+C | Financial collateral held | Net derivatives credit exposure |
|---|---|---|---|---|---|---|
| | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** | **€ m** |
| OTC derivatives[2] | 7,327 | 1,322 | (1,318) | 7,331 | - | **7,331** |
| Credit derivatives | 1 | 3 | - | 4 | - | **4** |
| **Total derivatives** | **7,328** | **1,325** | **(1,318)** | **7,335** | **-** | **7,335** |

[1] The netting benefits relate to cross currency interest rate swaps only and do not reflect the effect of master netting agreements that are in place to protect the Group's position.

[2] Over the counter ("OTC") derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary.

**Table 19a CCR - Credit derivative transactions product distribution**

**31 December 2008**

| Credit derivative product type | Notional credit derivative transactions | | | |
|---|---|---|---|---|
| | **Group's own credit portfolio use** | | **Intermediation activities** | |
| | **Purchased** | **Sold** | **Purchased** | **Sold** |
| | **€ m** | **€ m** | **€ m** | **€ m** |
| Credit default swaps | 55 | 7 | - | - |
| **Total** | **55** | **7** | **-** | **-** |

# 11. Securitisations

### Objectives in relation to securitisation activity

AIB utilises securitisation in the ordinary course of business, primarily to support the following business objectives:

a) as an investor as part of the management of the Group's Interest Rate and Liquidity risks in Global Treasury;

b) as an investor in securitisations where the Group believes that the transaction offers a superior risk adjusted return opportunity; and

c) as an originator of securitisations, to meet customer demand to offer a full range of investment opportunities by making available opportunities to invest in AIB-managed Collateralised Debt Obligations ("CDOs") and Collateralised Bond Obligations ("CBOs").

### Roles played by the Group in the securitisation process

AIB is primarily an investor in securitisations issued by other credit institutions. The Group has arranged five structured bond transactions (CDOs and CBOs) in order to meet specific customer preferences in terms of credit risk, interest rate risk, prepayment risk, maturity etc.

## Extent of the Group's involvement in each securitisation

Securitisations form a small part of AIB's balance sheet, accounting for less than 3% of total Group assets. The most significant involvement with securitisations is via Global Treasury's investment in AAA-rated prime Residential Mortgage Backed Securities assets. In fulfilling its primary interest rate and liquidity management objective, Global Treasury applies stringent qualifying criteria to the Residential Mortgage Backed Securities assets it purchases, including LTV, seasoning, location and quality of originator. These assets are contained in the available for sale portfolio.

The Group also has a smaller portfolio of investments in securitisations held by the Corporate Banking business unit. The portfolio consists of both cash and synthetic structures across a variety of asset classes, including Collateralised Debt Obligations ("CDOs"), Collateralised Bond Obligations ("CBOs"), Collateralised Mortgage Obligations ("CMOs") and Residential Mortgage Backed Securities ("RBMS").

Finally, the Group has small equity interests in five CDO/CBO transactions which are not consolidated in the Group's Financial Accounts. The Group does not have control over these CDOs, nor does it bear the significant risks and rewards that are inherent in these assets. The deals are funded with long term financing which consists of approximately 90% rated debt notes and 10% equity. Four of these vehicles (CDOs) were created primarily to fund the European buyout market, while the fifth is invested in US High yield Bonds (CBO).

AIB does not provide liquidity lines to Asset-Backed Commercial Paper conduits or similar entities.

## Accounting policies

Under IFRS, financial statements transactions and events should be accounted for and presented in accordance with their substance and economic reality and not merely their legal form. As a result, the substance of transactions with a special purpose entity ("SPE") forms the basis for their treatment in the Group's financial statements. An SPE is consolidated in the financial statements when the substance of the relationship between the Group and the SPE indicates that the SPE is controlled by the entity and meets the criteria set out in IAS 27 Consolidated and separate financial statements and SIC 12 Consolidation - Special purposes entities.

## Calculating risk weighted exposure amounts

AIB Group uses the Ratings Based Method to calculate the risk-weighted exposure amount for securitisations. Under this approach, risk weights are assigned to securitisation tranches on the basis of the credit ratings applied to these by approved External Credit Assessment Institutions ("ECAIs"). Where there is no rating agency but other criteria is met to apply a risk band other than unrated, credit quality assessment steps are applied to the exposures to establish the preferential risk weight.

## External Credit Assessment Institutions

AIB uses the following ECAIs for all types of securitisation exposures:

a) Moody's Investors Service
b) Standard & Poor's Ratings Services
c) Fitch Ratings
d) Dominion Bond Rating Service ("DBRS")

The process used to assign credit assessments to risk weights follows the mapping guidelines issued by the Committee of European Banking Supervisors ("CEBS") and adopted by the Financial Regulator.

There is no outstanding amount of securitised revolving exposures. All exposures securitised are within the corporate / sovereign / banks (tranches) exposure type. In relation to the following sets of tables:

a) *exposure type* refers to the assets that are contained in the pool on which the securitisation paper is issued.

b) *traditional* securitisation means a securitisation involving the economic transfer of the exposures being securitised to a securitisation special purpose entity which issues securities. This is accomplished by the transfer of ownership of the securitised exposures from the originator credit institution or through sub participation. The securities issued do not represent payment obligations of the originator credit institution.

c) *synthetic* securitisation means a securitisation where the tranching is achieved by the use of credit derivatives or guarantees, and the pool of exposures is not removed from the balance sheet of the originator credit institution.

**Table 20: Securitisation losses and assets impaired or past due**

*In the role of originator* **31 December 2008**

| Exposure type | Outstanding amount of exposures subject to securitisation framework | | Of which: | | |
|---|---|---|---|---|---|
| | Traditional transactions [1] | Synthetic transactions | Impaired | Past due | Recognised losses |
| | € m | € m | € m | € m | € m |
| Corporate/sovereign/banks | 1,600 | - | 8 | - | (18) |
| **Total** | **1,600** | **-** | **8** | **-** | **(18)** |

[1] The outstanding exposures securitised relate to AIB-managed Collateralised Debt Obligations ("CDOs") and Collateralised Bond Obligations ("CBOs") in which AIB maintains a small equity interest.

Table 21 details the Group's involvement in securitisations by risk weight bands, split between the equity interests retained in the CDO/CBO transactions where AIB Group has acted as originator ("retained") and the investments made by Global Treasury and Corporate Banking in asset backed securities ("purchased"), the most significant of which are in AAA-rated prime Residential Backed Securities. See previous page for further details.

## Table 21: Securitisation positions - risk weight bands

31 December 2008

| | Securitisation positions - total exposures | |
|---|---|---|
| | Retained | Purchased |
| Risk weight band | € m | € m |
| 7 - 10 % | - | 6,144 |
| 11 - 19 % | - | 268 |
| 20 - 49 % | - | 324 |
| 50 - 75 % | - | 342 |
| 76 - 99 % | - | - |
| 100% | - | 194 |
| 250% | - | 10 |
| 350% | - | - |
| 425% | - | 186 |
| 650% | - | 2 |
| 1250% or Deducted | 30 | 179 |
| **Total** | **30** | **7,649** |

The deduction in relation to retained securitisation positions relates to equity interests in the five CDO/ CBOs. Certain tranches of the purchased non-originated investments in securitisations were downgraded (below BB-) during the year, accordingly these are deducted from capital.

# 12. Equity exposures in the banking book

AIB calculates its capital requirements for equity exposures in the banking book using the Standardised Approach. The Group's equity activity can be divided into the following five sub-categories:

a) Quoted investments: a limited number of straight equity positions that are quoted on recognised stock exchanges;
b) Unquoted investments: typically comprising exposure to equities or the equity tranche in a structured transaction or SPE;
c) Managed funds: typically comprising exposure to the equity component of a managed investment fund;
d) Retained equity tranches in CBO/CDO SPEs, established and managed by the Group on an ongoing basis; and
e) Investments in associate undertakings which are held by the Group for strategic purposes.

While individual transactions will vary in structure, the Group’s profit objectives are typically realised through a combination of fee income (e.g. structuring or management fees), dividend income and capital gains on realisation.

The principal accounting policies applied by the Group to equity investments is informed by International Accounting Standards IFRS 7, IAS 28 and IAS 39 which set out the rules for classification, balance sheet recognition, methods of valuation (i.e. fair value), income and impairment recognition and disclosures. Further information in relation to the Group accounting policies for financial assets, which include equities, can be found in the Group’s Annual Financial Report. Investments in associated undertakings are initially recorded at cost and increased (or decreased) each year by the Group’s share of the post acquisition net income (or loss), and other movements reflected directly in the equity of the associated undertaking. Other banking book equities are carried on the Balance Sheet at fair value.

Goodwill arising on the acquisition of an associated undertaking is included in the carrying amount of the investment (net of any accumulated impairment loss). For regulatory purposes, goodwill in associates is deducted directly from capital.

The cumulative realised gains from sales and liquidations in the banking book of equity investments amount to € 75 million for the year ended 31 December 2008. The total gross unrealised gains for the year, in the banking book of equity investments amounts to € 139 million. An unrealised loss, after tax, of € 10 million is included in tier 1 capital whilst an unrealised gain, after tax, of € 131 million is included in tier 2 capital for regulatory capital calculations. There were no latent revaluation gains or losses. Further details in relation to this are contained in Appendix 1: Own funds.

## Table 22: Banking book equity values

| | | | 31 December 2008 |
|---|---|---|---|
| | | | **Balance Sheet value** |
| | **Type** | **Nature** | **€ m** |
| Exchange traded exposures | Quoted | A limited number of straight equity positions that are quoted on recognised stock exchanges. | 34 |
| Other exposures | Unquoted | Exposure to equities or the equity tranche in a structured transaction or SPE | 130 |
| | Funds | Exposure to the equity component of a managed investment fund. | 93 |
| | CDOs/ CBOs | Equity interest in Collateralised Debt Obligation SPEs created and managed by Group on an ongoing basis. | 30 |
| Investments in associate undertakings | | | 1,968 |
| Less goodwill [1] | | | (1,018) |
| | | | 950 |
| **Total** | | | **1,237** |
| Of which are risk weighted | | | 959 |
| Of which deducted from capital | | | 278 |
| **Total** | | | **1,237** |

[1] Deducted from tier 1 capital.

## Table 22b: Risk weighted asset equivalents of equity exposures

| | | 31 December 2008 |
|---|---|---|
| | **Exposure € m** | **Risk weighted asset € m** |
| Equity investments subject to a 20% risk weight | 133 | 27 |
| Equity investments subject to a 50% risk weight | 541 | 271 |
| Equity investments subject to a 100% risk weight | 220 | 220 |
| Equity investments subject to a 150% risk weight | 65 | 98 |
| **Total** | **959** | **616** |

# 13. Interest rate risk in the banking book

As already described in Section 3.3, Interest rate risk in the banking book ("IRRBB") is the Group's sensitivity to earnings volatility in its non-trading activity arising from movements in interest rates. The nature of interest rate risk arising in the banking book and the key assumptions used in measuring interest rate risk are also explained in Section 3.3.

The table below sets out the impact on the Group's own funds for a 1 per cent upward and 1 per cent downward interest rate shock, broken down by the Group's main currencies.

**Table 23: Interest rate risk variation in the banking book**

**31 December 2008**

| Currency | Interest rate risk variation | | | |
|---|---|---|---|---|
| | +1% | -1% | +1% | -1% |
| | Absolute (€ m) | | % of Own funds | |
| EUR | 177 | (170) | 1.3% | (1.2%) |
| GBP | (130) | 147 | (0.9%) | 1.0% |
| PLN | (17) | 15 | (0.1%) | 0.1% |
| USD | (17) | 21 | (0.1%) | 0.2% |
| Other | (17) | 17 | (0.1%) | 0.1% |
| **Total** | **(4)** | **30** | **0.1%** | **0.2%** |

# Appendix 1: Own funds

Summary information on the main components of own funds items, and their terms and conditions as applicable, is set out below.

## TIER 1

### *Core tier 1*

### Paid up ordinary share capital

Share capital represents funds raised by issuing shares in return for cash or other consideration. Share capital comprises ordinary shares of the parent company.

### Eligible reserves

Included in eligible reserves are the following capital components:

*Share premium*
When ordinary shares are issued at a premium whether for cash or otherwise, the excess of the amount received over the par value of the shares is transferred to share premium.

*Revenue reserves*
Revenue reserves represent retained earnings of the parent company, its subsidiaries and its associated undertakings. Revenue reserves are shown gross of the cumulative deficit within the defined benefit pension schemes.

*Available for sale equity securities*
Unrealised losses on available for sale equity securities are deducted from tier 1 eligible reserves.

*Proposed dividends*
Dividends proposed or declared before the issue of the financial statements but not accrued in the balance sheet are deducted from tier 1 eligible reserves.

*Foreign currency translation reserve*
The foreign currency translation reserve represents the cumulative gains and losses on the retranslation of the Group's net investment in foreign operations, at the rate of exchange at the balance sheet date.

*Treasury shares*
Where the parent or other members of the Group purchase the share capital of Allied Irish Banks, p.l.c., the consideration paid is deducted from total shareholders' equity as Treasury shares. Where such shares are subsequently sold or re-issued, any consideration received is included in shareholders' equity.

*Share based payment reserve*
The share based payment expense charged to the income statement is credited to the share based payment reserve over the vesting period of the shares and options. Upon grant of shares or exercise of options and consequent re-issue of Treasury shares, the amount in respect of the award credited to the share based payment reserve is transferred to revenue reserves.

*Capital reserves*
Capital reserves represent transfers from retained earnings in accordance with relevant legislation.

### Equity minority interests in subsidiaries

Equity minority interests in subsidiaries comprise those retained earnings attributable to the minority shareholders in subsidiaries.

## *Non-core tier 1*

## Non-equity minority interests in subsidiaries

Non-equity minority interests in subsidiaries relate to Fixed Rate/Floating Rate Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities ("Preferred Securities") in the amount of € 1,000 million which were issued through a Limited Partnership in December 2004. The Preferred Securities were issued at par and have the benefit of a subordinated guarantee of Allied Irish Banks, p.l.c. ("AIB"). The Preferred Securities have no fixed final redemption date and the holders have no rights to call for the redemption of the Preferred Securities.

The Preferred Securities are redeemable in whole but not in part at the option of the general partner and with the agreement of the Financial Regulator (i) upon the occurrence of certain events, or (ii) on or after 17 December 2014, subject to the provisions of the Limited Partnership Act, 1907.

In the event of the dissolution of the Limited Partnership, holders of Preferred Securities will be entitled to receive a liquidation preference in an amount equal to the distributions that those holders would have received in a dissolution of AIB at that time, if they had held, instead of the Preferred Securities, non-cumulative preference shares issued directly by AIB, having the same liquidation preference as the Preferred Securities, and ranking junior to all liabilities of AIB including subordinated liabilities.

## Non-cumulative preference shares

Non-cumulative preference shares in the amount of 250,000 of US$25 each were issued in 1998 by Allied Irish Banks, p.l.c. ("AIB") at a price of US$995.16 per share raising US$248.8 million before expenses. The holders of the non-cumulative preference shares were entitled to a non-cumulative preferential dividend, payable quarterly in arrears.

The preference shares were redeemable at the option of AIB and with the agreement of the Financial Regulator were redeemed on 15 July 2008 at a price equal to US$1,000 per share (consisting of a redemption price of US$995.16 plus a special dividend of US$4.84 per share), plus accrued dividends.

## Non-cumulative perpetual preferred securities

Fixed Rate/Floating Rate Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities ("Preferred Securities") were issued in June 2006 through Limited Partnerships, in the amount of Stg£350 million and € 500 million. The Preferred Securities were issued at par and have the benefit of a subordinated guarantee of Allied Irish Banks, p.l.c. The Preferred Securities have no fixed final redemption date and the holders have no rights to call for the redemption of the Preferred Securities. The substitution of the Preferred Securities with fully paid non-cumulative preference shares issued by the guarantor is subject, in particular cases, to certain events and conditions that are beyond the control of both the guarantor and the holders of the Preferred Securities.

The Preferred Securities are redeemable in whole but not in part at the option of the general partner and with the agreement of the Financial Regulator (i) upon the occurrence of certain events or (ii) on or after 14 June 2016 for the Stg£350 million Preferred Securities and 16 June 2016 for the € 500 million Preferred Securities.

Distributions on the Preferred Securities are non-cumulative. In the event of the dissolution of the Limited Partnerships, holders of Preferred Securities will be entitled to receive a liquidation preference in an amount equal to the distributions that those holders would have received in a dissolution of AIB at that time, if they had held, instead of the Preferred Securities, non-cumulative preference shares issued directly by AIB, having the same liquidation preference as the Preferred Securities, and ranking junior to all liabilities of AIB including subordinated liabilities.

## Reserve capital instruments

Reserve capital instruments ("RCI") of € 500 million were issued by Allied Irish Banks, p.l.c. in

February 2001 at an issue price of 100.069%. The RCIs are perpetual securities and have no maturity date. The RCIs are redeemable, in whole but not in part, at the option of the Group and with the agreement of the Financial Regulator (i) upon the occurrence of certain events, or (ii) on or after 28 February 2011, an authorised officer having reported to the trustees within the previous six months that a solvency condition has been met.

The rights and claims of the RCI holders and the coupon holders are subordinated to the claims of the senior creditors and the senior subordinated creditors of the issuer. In the event of a winding up of the issuer, the RCI holders will rank *pari passu* with the holders of the classes of preference shares (if any) from time to time issued by the issuer and in priority to all other shareholders.

# TIER 2

## *Upper tier 2*

### Eligible reserves

Included in eligible reserves are the following capital components:

*Fixed asset revaluation reserves*
Revaluation reserves represent the unrealised surplus, net of tax, which arose on revaluation of properties prior to the implementation of IFRS at 1 January 2004.

*Available for sale equity securities*
Unrealised gains on available for sale equity securities are added to tier 2 eligible reserves.

### Incurred but not reported provisions

For IFRS purposes impairment provisions on financial assets are required to be recognised in respect of losses that have been incurred but not reported ("IBNR"). An IBNR provision represents an interim step pending the identification of impairment losses on an individual asset in a group of financial assets. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group. This IBNR provision is included as tier 2 capital.

### Subordinated perpetual loan capital

This consists of the following capital issues:
a) US$100 million Floating Rate Primary Capital Perpetual Notes;
b) €200 million Fixed Rate Perpetual Subordinated Notes; and
c) Stg£400 million Perpetual Callable Step-Up Subordinated Notes.

The US$100 million Floating Rate Primary Capital Perpetual Notes have no final maturity but may be redeemed at par at the option of the Group, with the prior approval of the Financial Regulator. Interest is payable quarterly on the US$100 million Floating Rate Primary Capital Perpetual Notes.

The € 200 million Fixed Rate Perpetual Subordinated Notes have no final maturity but may be redeemed at the option of the Group, with the prior approval of the Financial Regulator, on each coupon payment date on or after 3 August 2009.

The Stg£400 million Perpetual Callable Step-Up Subordinated Notes have no final maturity but may be redeemed at the option of the Group, with the prior approval of the Financial Regulator, on 1 September 2015 and every interest payment date thereafter.

## *Lower tier 2*

### Subordinated term loan capital

This consists of the following capital issued by Allied Irish Banks, p.l.c.:
a) US$400 million Floating Rate Notes;
b) € 400 million Floating Rate Notes;

c) € 500 million Callable Subordinated Step-up Floating Rate Notes;
d) Stg£700 million Callable Fixed/ Floating Rate Notes;
e) Stg£500 million Callable Subordinated Fixed/Floating Rate Notes;
f) Stg£350 million Fixed Rate Notes; and
g) JPY 20 billion Callable Subordinated Step-up Fixed/Floating Rate Notes.

The dated loan capital issued under the European Medium Term Note Programme is subordinated in right of payment to the ordinary creditors, including depositors, of the Group.

The US$400 million Floating Rate Notes, with interest payable quarterly, may be redeemed in whole but not in part, on any interest payment date falling on or after July 2010.

The € 400 million Floating Rate Notes with interest payable quarterly may be redeemed, in whole but not in part, on any interest payment date falling on or after March 2010.

The € 500 million Callable Subordinated Step-Up Floating Rate Notes with interest payable quarterly may be redeemed in whole but not in part on any interest payment date falling on or after 24 October 2012.

The Stg£700 million Callable Fixed/Floating Rate Notes due July 2023 were issued under the € 30 billion European Medium Term Note Programme. Interest is payable semi-annually at a rate of 7.875% per annum, up to 5 June 2018 and thereafter at a rate of 3.5% above 3 month GBP Libor payable quarterly.

The Stg£500 million Callable Subordinated Fixed/Floating Rate Notes, with interest payable annually, up to 10 March 2020 and with interest payable quarterly from 10 June 2020 thereafter may be redeemed, in whole but not in part on any interest payment date falling on or after 10 March 2025.

The Stg£350 million Fixed Rate Notes, with interest payable annually in arrears on 26 November in each year, may be redeemed in whole but not in part, on the 26 November 2025 and on each interest payment date thereafter.

In March and June 2007, Japanese Yen (“JPY”) 15 billion and JPY 5 billion respectively, Callable Subordinated Step-up Fixed/Floating Rate Notes were issued, interest is payable semi-annually. Both the JPY 15 billion and JPY 5 billion Callable Subordinated Step-up Fixed/Floating Rate Notes are redeemable in whole but not in part on any interest payment date falling on or after 8 March 2037.

In all cases, redemption prior to maturity is subject to the necessary prior approval of the Financial Regulator. There is no exchange exposure as the proceeds of these notes are retained in their respective currencies.

## *Supervisory deductions*

### Supervisory deductions from core tier 1

*Goodwill and intangible assets*
Goodwill and intangible assets are deducted from core tier 1 capital.

*Pension scheme deficit*
Cash contributions to pension schemes are agreed between the trustees and the employer on a triennial basis and comprise an amount to cover the expected current service cost and an amount to eliminate any pension deficit arising at the triennial valuation. Excess contributions to eliminate a pension deficit are deducted from capital based on the rules applied by the local regulator.

### Supervisory deductions from tier 1 and tier 2 capital

*Holdings in other credit and financial institutions*
Holdings in other credit and financial institutions equity capital or other qualifying capital instruments are required to be deducted if the holding exceeds 10% of the regulatory capital of the institution. The deduction amounts to the excess of the investment in these instruments over 10% of the regulatory capital of the institution. The required deduction is made 50% from tier 1 and 50% from tier 2 capital.

*Securitisation deduction*
Certain securitisation exposures, where the Group is either an originator or an investor, are treated as deductions from capital and thus excluded from the risk weighted asset calculation. The required deduction is made 50% from tier 1 and 50% from tier 2 capital.

*Expected loss*
The expected loss on the IRB portfolios is compared to the IFRS provisions on the IRB Portfolios. The excess of the expected loss over the IFRS provisions is deducted 50% from tier 1 and 50% from tier 2 capital.

## Supervisory deductions from total capital

*Holdings in insurance undertakings*
Holdings in insurance undertakings are required to be deducted if the holding exceeds 10% of the capital of the institution. The deduction amounts to the excess of the investment in the institution over 10% of the capital of the institution. The required deduction is made from total capital.

# Appendix 2: Subsidiary disclosures

Article 72 of the CRD, requires the Group to disclose various information on the calculation of capital ratios and own funds of its significant subsidiaries. The Group has provided this information on the following pages for the significant subsidiaries:

a) Allied Irish Banks, p.l.c.;
b) AIB Mortgage Bank;
c) AIB Group (UK) p.l.c.; and
d) Bank Zachodni WBK S.A.

The Basel II capital ratios are based on Pillar 1 ('minimum capital requirements') under the CRD. Under Pillar 2 ('supervisory review') banks may estimate their own capital requirements through an Internal Capital Adequacy Assessment Process ("ICAAP") which is subject to supervisory review and evaluation. The ICAAP evaluation is currently in progress.

Figures reported for AIB Group (UK) p.l.c. and Bank Zachodni WBK S.A. represent the position as reported to their local regulators.

The closing exchange rate on 31 December 2008 used to translate Polish zloty ("PLN") and sterling ("Stg£") to euro are € 1 = PLN 4.1535 and € 1 = Stg£0.9525 respectively, consistent with the 2008 Group Annual Financial Report.

**Table 24: Capital base of significant subsidiaries**

31 December 2008

| | Allied Irish Banks, p.l.c. € m | AIB Mortgage Bank[(1)] € m | AIB Group (UK) p.l.c. € m | Bank Zachodni WBK S.A. € m |
|---|---|---|---|---|
| **Tier 1** | | | | |
| Paid up ordinary share capital | 294 | 450 | 462 | 176 |
| Eligible reserves | 6,769 | 88 | 1,062 | 888 |
| Equity minority interests in subsidiaries | - | - | - | 58 |
| Supervisory deductions from core tier 1 capital | (379) | - | (1) | (42) |
| **Core tier 1 capital** | **6,684** | **538** | **1,523** | **1,080** |
| Non-equity minority interests in subsidiaries | 990 | - | - | - |
| Non-cumulative perpetual preferred securities | 867 | - | - | - |
| Reserve capital instruments | 497 | - | - | - |
| Supervisory deductions from tier 1 capital | (1,179) | (20) | (21) | (5) |
| **Total tier 1 capital** | **7,859** | **518** | **1,502** | **1,075** |
| **Tier 2** | | | | |
| Fixed asset revaluation reserves | 27 | - | 4 | 73 |
| IBNR provisions | 138 | - | 149 | - |
| Subordinated perpetual loan capital | 692 | 200 | 1,050 | - |
| Subordinated term loan capital | 2,970 | 100 | - | - |
| Supervisory deductions from tier 2 capital | (1,179) | (20) | (21) | (5) |
| **Total tier 2 capital** | **2,648** | **280** | **1,182** | **68** |
| Gross capital | 10,507 | 798 | 2,684 | 1,143 |
| Supervisory deductions | - | - | - | - |
| **Total capital** | **10,507** | **798** | **2,684** | **1,143** |
| **Risk weighted assets** | | | | |
| Credit risk | 94,477 | 5,920 | 19,659 | 9,385 |
| Market risk | 1,288 | - | - | 63 |
| Operational risk | 3,524 | 186 | 957 | 1,185 |
| Capital floor | - | 3,244 | - | - |
| **Total risk weighted assets** | **99,289** | **9,350** | **20,615** | **10,632** |
| **Capital ratios** | | | | |
| Core tier 1 | 6.7% | 5.8% | 7.4% | 10.1% |
| Tier 1 | 7.9% | 5.5% | 7.3% | 10.1% |
| Total | 10.6% | 8.5% | 13.0% | 10.7% |

[(1)] Following the application of the CRD requirements, the risk weightings of the assets within AIB Mortgage Bank reduced considerably. As a result AIB Mortgage Bank was the only licensed bank within AIB Group that was impacted by the capital floor requirements as discussed in Section 4.

### Table 25: Minimum capital requirement of significant subsidiaries

**31 December 2008**

| | Allied Irish Banks, p.l.c. € m | AIB Mortgage Bank[1] € m | AIB Group (UK) p.l.c. € m | Bank Zachodni WBK S.A. € m |
|---|---|---|---|---|
| **Standardised credit risk exposure class** | | | | |
| Central governments and central banks | - | - | 1 | - |
| Administrative bodies and non-commercial undertakings | 3 | - | - | - |
| Institutions[2] | 235 | - | 1 | 17 |
| Corporates | 1,354 | 10 | 1,298 | 475 |
| Retail | 417 | - | 70 | 131 |
| Secured on real estate property | 17 | - | 93 | 83 |
| Past due items[3] | 40 | - | 86 | 12 |
| Items belonging to regulatory high risk categories | 11 | - | - | 3 |
| Collective investment undertakings | - | - | - | 1 |
| Other items | 104 | - | 22 | 29 |
| **Total for Standardised Approach** | **2,181** | **10** | **1,571** | **751** |
| **Foundation IRB exposure class** | | | | |
| Central governments and central banks | 1 | - | - | - |
| Institutions[2] | 239 | - | - | - |
| Corporates | 4,875 | 295 | - | - |
| Retail | 107 | 169 | - | - |
| Securitisation positions | 154 | - | - | - |
| Non-credit obligation assets | - | - | - | - |
| **Total for Foundation IRB Approach** | **5,376** | **464** | **-** | **-** |
| **Total for credit risk** | **7,557** | **474** | **1,571** | **751** |
| **Total for operational risk** | **282** | **15** | **76** | **95** |
| **Total for market risk** | **103** | **-** | **-** | **5** |
| **Total for capital floor** | **-** | **259** | **-** | **-** |

(1) Following the application of the CRD requirements, the risk weightings of the assets within AIB Mortgage Bank reduced considerably. As a result AIB Mortgage Bank was the only licensed bank within AIB Group that was impacted by the capital floor requirements as discussed in Section 4.

(2) Institution exposure class predominantly relates to banks.

(3) The Basel standardised asset class past due items only includes exposures that are (a) standardised, (b) greater than 90 days past due or defaulted and (c) impaired.

# Glossary of definitions and explanations

## A

AIB UK – In Northern Ireland, through its wholly-owned subsidiary AIB Group (UK) p.l.c., which trades there as First Trust Bank, AIB Group operates from approximately 48 branches and outlets. In Britain, AIB Group (UK) p.l.c., trades there as Allied Irish Bank (GB) providing a range of banking services through 31 branches and 5 development offices.

## B

Banking book (also *non-trading book*) – The Group's banking book consists of its retail and corporate deposit books, Global Treasury's cash books and the Group's investment portfolios and derivatives hedging interest rate risk within these portfolios.

BZWBK – In Poland, the AIB Group operates from 505 branches and 56 outlets, primarily in Western Poland, through its 70.5 per cent owned subsidiary Bank Zachodni WBK S.A.

## C

Collective Investment Undertakings ("CIU") is an exposure class and includes:

i. undertakings where the sole object is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk-spreading; and

ii. units which are, at the request of the holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a CIU to ensure that the stock exchange value of its units does not vary significantly from their net asset value shall be regarded as equivalent to such repurchase or redemption.

Conversion factor – is the ratio of the currently undrawn amount of a commitment that is estimated to be drawn and outstanding at default to the currently undrawn amount of the commitment. The extent of the commitment shall be determined by the advised limit, unless the unadvised limit is higher.

Counterparty Credit Exposure ("CCE") – is an exposure or a potential credit exposure that may take the form, for example, of a loan of cash or securities (where the counterparty would traditionally be called the borrower) of securities posted as collateral, of a commitment, or of an exposure under an over the counter ("OTC") derivatives contract.

Credit Conversion Factor ("CCF") – convert off balance sheet items and items which are committed but undrawn into on balance sheet credit exposure equivalents.

Credit Risk Mitigation ("CRM") – a technique used by a credit institution to reduce the credit risk associated with an exposure or exposures which the credit institution continues to hold.

Credit Support Annexes ("CSA") – provides credit protection by setting out the rules governing the mutual posting of collateral. CSAs are used in documenting collateral arrangements between two parties that trade over-the-counter derivative securities. The trade is documented under a standard contract called a master agreement, developed by ISDA. The two parties must sign the ISDA master agreement and execute a credit support annex before they trade derivatives with each other.

## D

Default – A default shall be considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place:

(a) the credit institution considers that the obligor is unlikely to pay its credit obligations to the credit institution, the parent undertaking or any of its subsidiaries in full, without recourse by the credit institution to actions such as realising security (if held);

(b) the obligor is past due more than 90 days on any material credit obligation to the credit institution, the parent undertaking or any of its subsidiaries.

For overdrafts, days past due commence once an obligor has breached an advised limit, has been advised a limit smaller than current outstandings, or has drawn credit without authorisation and the underlying amount is material. An 'advised limit' shall mean a limit which has been brought to the knowledge of the obligor. Days past due for credit cards commence on the minimum payment due date. In the case of retail exposures and exposures to public sector entities ("PSE") the competent authorities shall set a number of days past due as specified in the CRD. In the case of corporate exposures the competent authorities may set a number of days past due as specified in Article 154(7) of the CRD. In the case of retail exposures credit institutions may apply the definition of default at a facility level. In all cases, the exposure past due shall be above a threshold defined by the competent authorities and which reflects a reasonable level of risk.

Dilution risk – the risk that an amount receivable is reduced through cash or non-cash credits to the obligor.

## E

Eligible financial collateral – is any of the following (See Annex V111, 1.3.1 of CRD)

(a) cash on deposit with, or cash assimilated instruments held by, the lending credit institution;
(b) debt securities issued by central governments or central banks, which securities have a credit assessment by an ECAI or export credit agency recognised as eligible for the purposes of Articles 78 to 83 which has been determined by the competent authority to be associated with credit quality step 4 or above under the rules for the risk weighting of exposures to central governments and central banks under Articles 78 to 83;
(c) debt securities issued by institutions, which securities have a credit assessment by an eligible ECAI which has been determined by the competent authority to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to credit institutions under Articles 78 to 83;
(d) debt securities issued by other entities, which securities have a credit assessment by an eligible ECAI which has been determined by the competent authority to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to corporates under Articles 78 to 83;
(e) debt securities with a short-term credit assessment by an eligible ECAI which has been determined by the competent authority to be associated with credit quality step 3 or above under the rules for the risk weighting of short term exposures under Articles 78 to 83;
(f) equities or convertible bonds that are included in a main index; and
(g) gold

Expected Loss ("EL") – the ratio of the amount expected to be lost on an exposure from a potential default of a counterparty or dilution over a one year period to the amount outstanding at default.

Exposure at default ("EAD") – represents the institution's best estimate of its expected gross exposure for each facility upon a borrower's default, giving full recognition to drawn and undrawn credit lines and regardless of whether such undrawn lines are committed or advised lines.

Exposure value – for on balance sheet exposures, is the amount outstanding less provisions and collateral held taking into account relevant netting agreements. No account is taken of the residual maturity or ratings from external credit rating agencies. For commitments and guarantees, it is the amount outstanding less provisions and collateral held taking into account relevant netting agreements and credit conversion factors.

External Credit Assessment Institution ("ECAI") – National supervisors are responsible for determining whether an ECAI meets the eligibility criteria listed in paragraph 91 of the paper "International Convergence of Capital Measurement and Capital Standards" issued by the Basel Committee in November 2005 (Basel II), so that banks incorporated in their jurisdictions can use the ECAIs risk assessments for the calculation of capital requirements under Basel II.

## F

Fair value – according to the International Financial Reporting Standards ("IFRS"), fair value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arms length transaction.

## G

Gross exposure – gross exposure is the exposure at default before Credit Risk Mitigation ("CRM"), Credit Conversion Factors ("CCF") and other offsets. See Credit Risk Mitigation and Credit Conversion Factor defined above.

## I

IFRS – International Financial Reporting Standards are accounting standards and interpretations adopted by the International Accounting Standards Board.

ISDA – International Swaps and Derivatives Association. ISDA represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms.

## L

Loss – is economic loss, including material discount effects, and material direct and indirect costs associated with collecting on the instrument.

Loss given default ("LGD") – is the ratio of the loss on an exposure due to the default of a counterparty to the amount outstanding at default.

## M

Market value – the market value is the prevailing price at which goods and/or services may be bought or sold in the open market.

## O

Operational risk **–** is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.

Originator – is either of the following:

(a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or

(b) an entity which purchases a third party's exposures onto its balance sheet and then securitises them.

Other items – refers to other assets including land and buildings, plant and machinery, other fixtures and fittings, tools and equipment, payments on account and tangible assets in the course of construction.

## P

Past due items – the Basel standardised asset class past due items only includes exposures that are (a) standardised; (b) greater than 90 days past due or defaulted; and (c) impaired. When one account on a customer line is greater than 90 days past due, all accounts on the customer line are classified as 90 days past due.

Past due – under IFRS 7, a financial asset is past due when a counterparty has failed to make a payment when contractually due. Only the account that is in arrears is past due, other accounts on the customer line that are operating satisfactorily are not included.

Probability of Default ("PD") – is the probability of default of a counterparty over a one year period.

## R

Revolving exposure – an exposure whereby customers' outstanding balances are permitted to fluctuate based on their decisions to borrow and repay, up to an agreed limit, and an early amortisation provision shall be a contractual clause which requires, on the occurrence of defined events, investors' positions to be redeemed before the originally stated maturity of the securities issued.

## S

Securitisation - a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

Securitisation position – an exposure to a securitisation.

Sponsor – a credit institution other than an originator credit institution that establishes and manages an asset backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities.

Synthetic securitisation – a securitisation where the tranching is achieved by the use of credit derivatives or guarantees, and the pool of exposures is not removed from the balance sheet of the originator credit institution.

## T

Total exposure – see exposure value.

Trading book – The interest rate trading book includes all securities and interest rate derivatives that are held for trading purposes in Global Treasury. These are revalued daily at market prices (market to market) and any changes in value are immediately recognised in income.

Traditional securitisation – a securitisation involving the economic transfer of the exposures being securitised to a securitisation special purpose entity which issues securities. This shall be accomplished by the transfer of ownership of the securitised exposures from the originator credit institution or through sub-participation. The securities issued do not represent payment obligations of the originator credit institution.