

Provident Financial plc

Pillar III regulatory capital disclosures

Year ended 31 December 2013



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1. Introduction

1.1 Background

The Provident Financial plc group (the group) comprises two principal trading divisions:

- Vanquis Bank which provides credit cards to the non-standard UK consumer credit market and accepts retail deposits. In 2012, Vanquis Bank established a Polish branch and commenced a pilot issuing credit cards to the non-standard Polish consumer credit market; and
- The Consumer Credit Division (CCD) primarily providing home credit to the non-standard UK consumer credit market. In November 2013, CCD also launched Satsuma Loans, an online instalment loan product, closely aligned with home credit.

At 31 December 2012, Vanquis Bank was regulated by the Financial Services Authority (FSA). Following the legal transition on 1 April 2013, Vanquis Bank is now authorised by the Prudential Regulation Authority (PRA) and regulated by the PRA and the Financial Conduct Authority (FCA). The PRA sets requirements for Vanquis Bank relating to capital and liquidity adequacy and large exposures.

CCD operates under a number of consumer credit licences granted by the OFT but is not subject to PRA regulation. The group, incorporating both Vanquis Bank and CCD, is the subject of consolidated supervision by the PRA by virtue of Provident Financial plc being the parent company of Vanquis Bank. The PRA sets requirements for the consolidated group in respect of capital adequacy and large exposures, but not in respect of liquidity.

Under changes to the regulatory regime introduced by the Financial Services Act 2012, consumer credit regulation is to be transferred from the OFT to the FCA on 1 April 2014.

1.2 BASEL II

The BASEL II regulatory framework revised the BASEL I regulatory framework. The aim of BASEL II is to make regulatory capital requirements more risk sensitive and representative of risk management controls and procedures in place within firms.

The BASEL II regulatory framework was implemented in the European Union via the Capital Requirements Directive (CRD). The group and Vanquis Bank adopted the CRD with effect from 1 January 2008. The CRD comprises three Pillars:

- Pillar I is the calculation of minimum regulatory capital requirements which firms are required to hold against risk, the most significant elements for the group being credit risk and operational risk.
- Pillar II requires an Internal Capital Adequacy Assessment Process (ICAAP) by firms to assess whether additional regulatory capital over and above Pillar I should be held based on the risks faced by a firm and the risk management processes in place. A firm's Individual Capital Guidance (ICG) is set by the PRA based on the ICAAP.
- Pillar III complements Pillars I and II and aims to encourage market discipline by developing a set of disclosure requirements which allow market participants to assess key pieces of information on a firm's capital, risk exposures, risk management processes and remuneration.

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The Basel III regulatory framework was finalised in December 2010 by the Basel Committee on Banking Supervision and is being implemented in Europe through the Capital Requirement Directive IV (CRD IV).

In December 2013, the PRA published its rules and supervisory statements which complement the CRD IV EU legislative package. The EU text was formally published in the Official Journal of the EU in June 2013. CRD IV is effective 1 January 2014 and is made up of the Capital Requirements Regulation (CRR), which is directly applicable on firms across the EU, and the Capital Requirements Directive (CRD), which must be implemented through national law. CRD IV also makes changes to rules on corporate governance, including remuneration, and introduces standardised EU regulatory reporting, referred to as COREP and FINREP.

1.3 Pillar III disclosure policy

The group's Pillar III disclosure policy is as follows:

Frequency of disclosures

Pillar III regulatory capital disclosures will be made on an annual basis using the group's year-end date of 31 December. The disclosures will be published by 30 April each year. More frequent disclosures will be made if there is a material change in the nature of the group's risk profile during any particular year.

Media and location of Pillar III disclosures

The Pillar III regulatory capital disclosures will be published on the group's corporate website www.providentfinancial.com.

The group's annual report and financial statements set out a summary of the group's risks together with the controls and procedures in place to mitigate the risks. The latest annual report and financial statements are also published on the group's corporate website.

Board approval

The group's Pillar III regulatory capital disclosure policies were approved by the board of directors (the board) on 19 June 2008.

1.4 Basis of Pillar III disclosures

The Pillar III disclosures have been prepared for the group as a whole in accordance with the rules laid out in the PRA BIPRU Handbook, Chapter 11. The disclosures provide information on the capital adequacy and risk management processes of the group.

The results of all subsidiary undertakings have been included in the Pillar III disclosures. Vanquis Bank's requirement to maintain regulatory capital and liquid resources above a level determined by the PRA could restrict the ability and size of dividend payments to Provident Financial plc and the ability to repay amounts under a loan facility from Provident Financial plc to Vanquis Bank. There are no other current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayments of liabilities between Provident Financial plc and its subsidiary undertakings.

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From 2011, Vanquis Bank has been required to prepare remuneration code Pillar III disclosures in addition to the regulatory capital disclosures. These disclosures are the subject of a separate and stand-alone document and are published on the Vanquis Bank website, www.vanquis.co.uk, on an annual basis.

The Pillar III disclosures were approved for publication by Provident Financial plc and Vanquis Bank in March 2014.

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2. Risk management objectives and policies

2.1 Risk management objectives

The board is responsible for the alignment of strategy and risk, and for maintaining a sound system of risk management and internal controls. The system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and maintain a sufficient level of regulatory capital in excess of the ICG set by the PRA.

The risk management framework is overseen by the risk advisory committee. The committee is required to consider the nature and extent of the risks facing the group, keep them under review, review the framework to mitigate such risks and notify the board of changes in status and control of risks. The risk advisory group reviews the divisional risk registers and reports to the risk advisory committee.

During 2013, the group has reviewed and approved the group's risk appetite framework, performed a full financial review, established an overall risk management status report and begun to develop a separate conduct risk framework, approach and processes due to the transition to the FCA regime from 1 April 2014.



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2.2 ICAAP

In accordance with the regulations, the group is required to conduct an ICAAP on an annual basis or more frequently if there is a material change in the nature, trading status or risk profile of the group. The ICAAP allows the board to assess whether the group's risk management objective is being met.

The key output of the ICAAP is a document which:

- Provides a background to the group including the group structure, strategy, key management and the internal control framework and risk management processes;
- Calculates the minimum capital required under Pillar I of the regulations for both the group and Vanquis Bank;
- Identifies the various additional risks facing the group and Vanquis Bank not included in Pillar I and considers the required level of additional capital to be held against those risks (Pillar II);
- Calculates the overall regulatory capital requirement of the group and Vanquis Bank as a result of Pillar I and Pillar II; and
- Performs stress testing on the group and Vanquis Bank's budget projections to ensure that both the group and Vanquis Bank's calculated regulatory capital requirement and the ICG is sufficient even under extreme scenarios.

The group and Vanquis Bank operate to the ICGs set by the FSA in June 2011.

The ICAAP is embedded into the group and Vanquis Bank's risk management framework. The group and Vanquis Bank's risk registers are periodically updated to ensure each of the risks are allocated into the PRA risk categories. In addition, estimates are made of the level of regulatory capital, if any, that should be held against each risk and then, after aggregating these amounts, this total is compared to the group and Vanquis Bank's regulatory capital requirement as set by the PRA and the group and Vanquis Bank's actual level of regulatory capital. On an annual basis, or more frequently if required, the group's ICAAP document is updated and approved by the board.

Sections 2.3 and 2.4 of this report set out:

- The key features of the group and Vanquis Bank's internal control and risk management framework that are assessed as part of the ICAAP; and
- The key risks which are considered within the ICAAP to assess the overall level of regulatory capital required to be held by the group and Vanquis Bank after taking account of the adequacy of the group's internal control and risk management framework.

2.3 Risk management framework

The board is responsible for the alignment of strategy and risk, and for maintaining a sound system of risk management and internal controls. The group continues to drive improvements to the risk management processes and systems, which are designed to manage, rather than eliminate, the risk of failure to achieve business objectives.

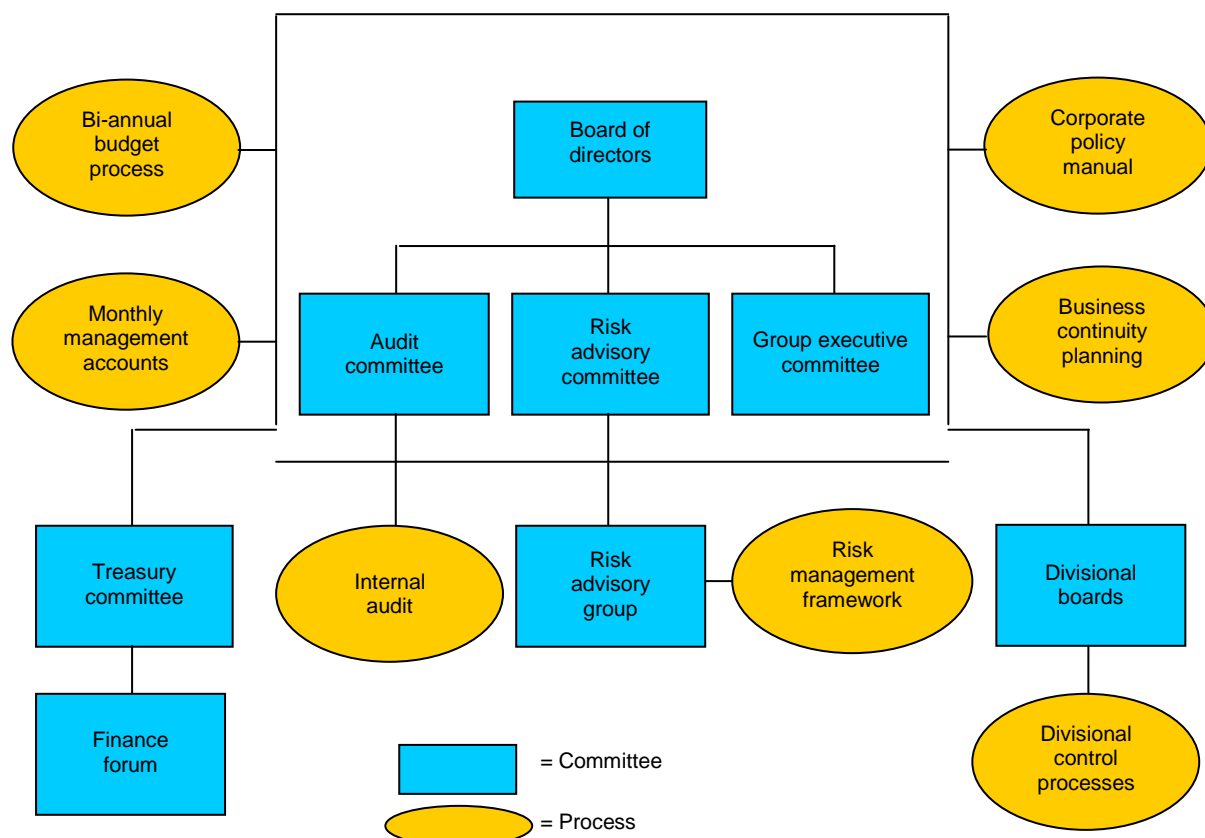
The group has a robust governance and internal control framework. The key elements of the internal control system, including the financial reporting processes, have been established in accordance with the FRC's Internal Control: Guidance for Directors and the FCA's Disclosure

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and Transparency Rules. Certain responsibilities in respect of internal control and risk management are delegated to various sub-committees, who report directly to the group board.

The group board and its committees are supported by various policies, procedures and reporting mechanisms as set out in the following chart:



The group's risk appetite is aligned with the policies, controls and approval limits determined within the risk management framework. This ensures that the group has an effective system of internal control and risk management to manage the group prudently within its regulatory capital requirements and to mitigate the potential for material financial loss to the business.

The roles and responsibilities of the committees noted above are as follows:-

Board of directors

The board is responsible for the group's overall system of internal control and for reviewing its effectiveness. The board comprises two executive directors, four non-executive directors and a non-executive Chairman and normally meets nine times a year including an annual two day planning conference. The board delegates authority to a number of formal sub-committees including the audit committee, the risk advisory committee (RAC) and the group executive committee. The board is considered to be well-balanced and has significant financial services and public company experience.

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Audit committee

The audit committee comprises the non-executive Chairman and the four non-executive directors and up to 28 February 2014 was chaired by Stuart Sinclair. From 1 March 2014, Alison Halsey has taken over the chairmanship. The Chief Executive, Finance Director, Company Secretary and General Counsel, Head of Audit, Group Financial Controller and external audit partner from Deloitte LLP normally attend all meetings by invitation. The audit committee meets six times a year and is responsible for monitoring group-wide internal financial controls, appointment and appraisal of the external auditor, agreeing the internal audit plan each year, reviewing the reports produced by internal audit and reviewing the group's whistleblowing policy. The audit committee also reviews the financial statements, interim reports and preliminary announcements including any significant accounting judgements made in preparing them.

Risk advisory committee (RAC)

The group's risk management framework is managed by the RAC on behalf of the board. The RAC comprises the non-executive Chairman and the four non-executive directors and up to 28 February 2014 was chaired by Rob Anderson. From 1 March 2014, Stuart Sinclair has taken over the chairmanship. The Chief Executive, Finance Director, Company Secretary and General Counsel, Director of Corporate Strategy and Risk, and Head of Audit normally attend by invitation. The RAC is responsible for designing, implementing and monitoring the risk management framework, considering the nature and extent of risks facing the group and appropriate mitigation, reviewing and approving the the group's annual ICAAP for submission to the board, reviewing the group's business continuity plans and notifying the board of any changes in the status and control of risks. The RAC meets at least three times a year and delegates a number of responsibilities to the risk advisory group (RAG).

Risk advisory group (RAG)

The RAG comprises the Finance Director, Chief Executive, Company Secretary and General Counsel, Group Financial Controller, Director of Corporate Strategy and Risk and Group Treasurer. The Head of Audit, Deputy Company Secretary and divisional risk managers also attend the meetings by invitation. The RAG considers the extent and nature of the risks facing the group, the extent and categories of risk which are acceptable to bear, the likelihood of any risk materialising, the group's ability to mitigate any risk, and the costs of operating particular controls relative to the benefits obtained. It also reviews the key risk registers prepared by the group and the divisional risk committees three times a year, challenging and making changes where appropriate. It submits a schedule of key risks, the group and divisional risk registers and the ICAAP to the RAC for review and approval.

Treasury committee

The treasury committee is chaired by the Finance Director and comprises the Group Treasurer, divisional finance directors, Group Financial Controller, Head of Tax and other key members of the finance function. The treasury committee manages the treasury activities of the group and meets at least six times a year. The treasury committee is not a formal sub-committee of the board but it regularly reports to the board on compliance with treasury policies and other treasury matters. The treasury committee is also responsible for monitoring the group's capital adequacy and liquidity positions.

Finance forum

The finance forum is chaired by the Finance Director and comprises the heads of finance, treasury, tax and legal within the group. The role of the finance forum is to monitor and discuss accounting and internal control issues, trading performance, tax and investor relations

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matters. The finance forum meets at least six times a year in conjunction with the treasury committee.

Divisional boards

The group has two divisional boards; Vanquis Bank and CCD. Each divisional board is responsible for the day-to-day operations of their division. The divisional boards and their committees are responsible for managing the divisional risks and preparing divisional risk registers for review by the RAG and submission to the RAC.

The committees are supported by the following business functions and processes.

Risk management framework

The group has a robust risk management framework which is overseen by the RAC on behalf of the board. The committee is required to consider the nature and extent of the risks facing the group, keep them under review, review the framework to mitigate such risks and notify the board of changes in the status and control of risks. The RAG reviews the divisional risk register three times a year and reports to the RAC.

Internal audit

The group's internal audit function is provided by an in-house team led by the Head of Audit and regularly reviews the adequacy of internal controls (including financial, operational and compliance controls) in conjunction with the auditor and reports to the RAC and audit committee. An annual programme of work is established and approved by the audit committee which targets and reports on higher-risk areas. The board and audit committee papers include a summary of the results and recommendations from each internal audit review and a follow-up of previously reported recommendations.

Corporate policies manual

The group has a corporate policies manual which is fully aligned with the group's risk management framework and risk appetite and sets out authority levels and policy requirements within the group. The board requires the divisions and the corporate office to operate in accordance with the corporate policies manual and the divisions and the corporate office are obliged to certify compliance on a biannual basis. The corporate policy manual is supported by divisional policies documents.

Business continuity planning

Each division is responsible for preparing, maintaining and testing its own business continuity plans and ensuring that their plans are fit for purpose within the framework and strategy agreed by the RAG.

Bi-annual budget process

Each division produces a budget in November each year covering the current year out-turn, the budget for the following year and the forecast for the four subsequent years. The budgets are fully aligned with the group's strategy. Each division presents its budget to the executive directors before the budgets are consolidated and submitted to the board for approval at the December board meeting. A formal budget update is produced in May of the following year which is approved by the board at its June board meeting.

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Monthly management accounts

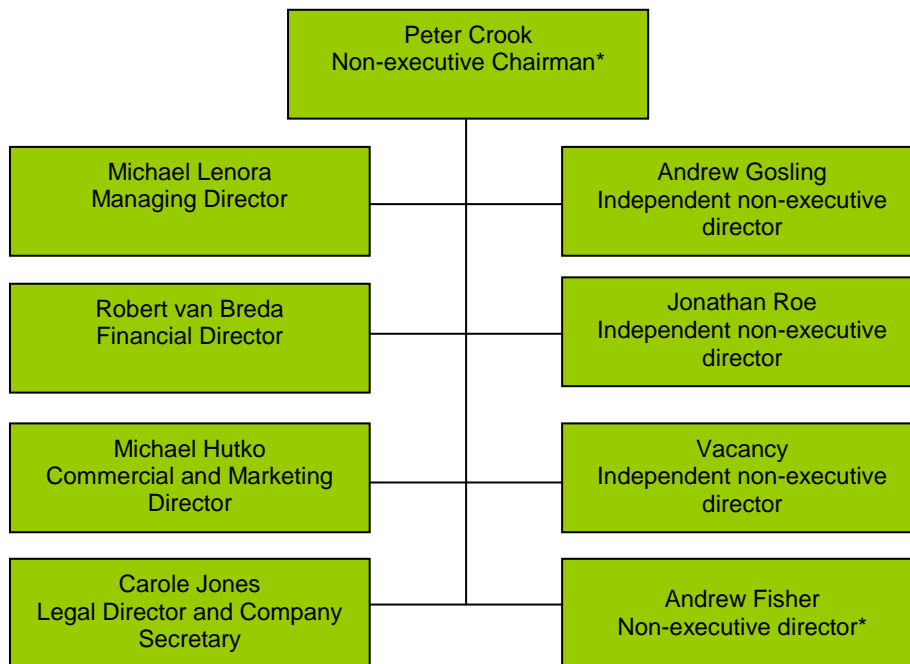
Monthly management accounts are prepared comparing actual trading results by division to budget and the prior year. Capital adequacy, operational KPIs, funding and economic trends are also reported monthly. A rolling forecast of the full year out-turn is produced as part of the management accounts pack. Management accounts are distributed to the executive directors and senior members of the management team on a monthly basis and are distributed to the board for each board meeting.

Divisional control processes

The divisions have a number of important controls to manage risk as follows:

Vanquis Bank

Vanquis Bank has a well-established and robust governance structure. As a regulated entity with a banking licence, Vanquis Bank replicates a number of the internal control and risk management processes that are typically only held at a group level in many organisations. The board of Vanquis Bank is as follows:



**Provident Financial plc board member*

The Vanquis Bank board comprises four executive directors, two independent non-executive directors and two non-executive directors. A further independent non-executive director is in the process of being recruited. The board of Vanquis Bank is considered to be well-balanced with significant financial services.

The board has a number of formal sub-committees, the most significant committees and functions within Vanquis Bank are as follows:

- *Audit committee* – Responsible for monitoring internal controls and accounting policies/issues. Chaired by an independent non-executive director.

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- *Compliance committee* – Responsible for compliance and treating customers fairly (TCF). Chaired by an independent non-executive director.
- *Credit committee* – Implements credit policy and monitors credit performance. Chaired by Vanquis Bank's Credit Director.
- *Customer experience forum* – Reviews risks to the fair treatment of customers including conduct risk.
- *Deposits committee* – A sub-committee of the treasury committee with delegated responsibility for retail deposit pricing, tranche size and product changes. Chaired by Vanquis Bank's Finance Director.
- *Exco Risk Forum* – Monitors risks to customers, staff and business performance in order to provide assurance to the Risk Committee that risks are adequately managed.
- *International steering group* – Oversees the management of the Poland pilot operation. The Poland Risk Forum and Poland Credit Committee also support the management of the operation in Poland.
- *Project management office* – An executive sign-off committee to oversee project justification and execution. Chaired by Vanquis Bank's Head of IT.
- *Remuneration committee* – Responsible for remuneration policy implementation and compliance with the Remuneration Code. Chaired by an independent non-executive director.
- *Risk committee* – Responsible for the management and reporting of risk and for updating the divisional risk register on at least a quarterly basis. Chaired by an independent non-executive director.
- *Treasury committee* – Responsible for the day-to-day monitoring of liquidity and capital requirements. Chaired by Vanquis Bank's Finance Director.
- Business areas and processes which support the risk management and controls framework are as follows:
 - *Compliance function* – Responsible for assessing compliance with laws and regulations.
 - *Early warning bulletin* – A pre-determined process to escalate potential loss events/business issues throughout the business.
 - *In-house reviews* – An internal audit function which performs specific Vanquis Bank audit reviews and works with and is overseen by the group internal audit function in determining risk areas for review.
 - *Risk identification and controls self assessment framework* – Ongoing self assessment of control effectiveness against identified risks facing each business area.
 - *Risk management function* – Supports the risk committee in the identification and management of risks.

CCD

In addition to the control from the divisional board and those group-wide controls, the most significant divisional controls within CCD are as follows:

- *Business risk committee (BRC)* – To ensure an appropriate and effective risk and governance framework is in place, including the setting of the overall risk appetite and enterprise wide risk policies and tolerances, enabling all business risks to be identified (including conduct risk and the ongoing consideration of customer outcomes), monitored, mitigated and reported, including the updating of the divisional risk register on at least a quarterly basis. The direct operational risk committee (DORC) and the home credit operational risk committee (HORC) more closely monitor operational and conduct risk and report into the BRC.

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- *Credit committee* – To approve and implement credit policy, monitor credit performance and ensure that credit risk and customer portfolio activity are compliant with legislation and regulation.
- *SEBCo* – To set the business strategy to meet both customer needs and business objectives, to review the financial performance, customer research and customer needs, product propositions and changes to product design, prioritisation of change projects against the strategy and monitoring of progress, review market and competitor trends and the impact on company strategy and review the people strategy and engagement.
- Business areas and processes which support the risk management and controls framework are as follows:
 - *Compliance function* – Responsible for assessing compliance with laws and regulations.
 - *Field audit* – Responsible for the auditing of the field network covering locations over a 3 year cycle.
 - *Field risk* – Responsible for the detection of fraud in the field operations.
 - *Risk management* – Supports the BRC in the identification and management of risks.
 - *Hierarchy of field structure* – Well-established hierarchical structure to manage and control the field workforce.

2.4 Key risks faced by the group

In the course of its business, the group is exposed to a wide range of risks. For the purposes of undertaking the ICAAP, the group's risks are categorised into the group's risk universe categories which are:

- Credit risk;
- Business/Strategic risk;
- Operational risk;
- Financial risk: and
- Regulatory risk.

As part of the ICAAP process, the group's risk universe categories are mapped to the PRA's GENPRU 1.2.30 risk classes to ensure that all GENPRU risk categories have been considered.

The definition of these risks and the associated controls and procedures in place to mitigate the risks are as follows:

2.4.1 Credit risk

Credit risk is the risk that the group will suffer loss in the event of a default by a customer, bank or other counterparty. A default occurs when the customer or a counterparty fails to honour repayments as they fall due. Customer defaults in the non-standard credit market are typically higher than in more mainstream markets although demonstrate greater stability since customers are impacted to a lesser extent than prime borrowers by economic cycles. However, current economic conditions remain challenging, which has led to continued pressure on home credit customers' disposable incomes from food, fuel and utility price inflation, and any deterioration in the employment market could increase the level of defaults.

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(i) Amounts receivable from customers

The group's maximum exposure to credit risk on amounts receivable from customers as at 31 December 2013 is the carrying value of amounts receivable from customers of £1,606.6m (2012: £1,513.8m).

Vanquis Bank

Credit risk within Vanquis Bank is managed by the Vanquis Bank credit committee which meets at least quarterly and is responsible for ensuring that the approach to lending is within sound risk and financial parameters and that key metrics are reviewed to ensure compliance with policy.

A customer's risk profile and credit line is evaluated at the point of application and at various times during the agreement. Internally generated scorecards based on historic payment patterns of customers are used to assess the applicant's potential default risk and their ability to manage a specific credit line. For new customers, the scorecards incorporate data from the applicant, such as income and employment and data from an external credit bureau. Each potential new customer receives a welcome call from contact centre staff to verify details and complete the underwriting process. Initial credit limits are small and manageable, as low as £250. For existing customers, the scorecards also incorporate data on actual payment performance and product utilisation and take data from an external credit bureau each month to refresh customers' payment performance position with other lenders' data. Credit lines can go up as well as down according to this point-in-time risk assessment.

Arrears management is a combination of central letters, inbound and outbound telephony, SMS, email and outsourced debt collection agency activities. Contact is made with the customer to discuss the reasons for non-payment and specific strategies are employed to support the customer in returning to a good standing or appropriate forbearance arrangements are put in place.

CCD

Credit risk within CCD is managed by the CCD credit committee which meets at least every two months and is responsible for approving credit control policy and decisioning strategy.

Credit risk is managed using a combination of lending policy criteria, credit scoring (including behavioural scoring), policy rules, individual lending approval limits, central underwriting, and a home visit to make a decision on applications for credit.

The loans offered by the weekly home credit business are short-term, typically a contractual period of around a year, with an average value of approximately £500. The loans are underwritten in the home by an agent with emphasis placed on any previous lending experience with the customer and the agent's assessment of the credit risk based on a completed application form and the home visit. Once a loan has been made, the agent visits the customer weekly, or in some cases monthly, to collect payment. The agent is well placed to identify signs of strain on a customer's income and can moderate lending accordingly. Equally, the regular contact and professional relationship that the agent has with the customer allows them to manage customers' repayments effectively even when the household budget is tight. This can be in the form of taking part-payments, allowing missed payments or occasionally restructuring the debt in order to maximise cash collections.

Agents are primarily paid commission for what they collect and not for what they lend, so their main focus is on ensuring loans are affordable at the point of issue and then on collecting cash. Affordability is reassessed by the agent each time an existing customer is re-served, or

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not as the case may be. This normally takes place within 12 months of the previous loan because of the short-term nature of the product.

Arrears management within the home credit business is a combination of central letters, central telephony, and field activity undertaken by field management. This will often involve a home visit to discuss the customer's reasons for non-payment and to agree a suitable resolution.

(ii) Bank counterparties

The group's maximum exposure to credit risk on bank counterparties as at 31 December 2013 was £21.1m (2012: £15.4m).

Counterparty credit risk arises as a result of cash deposits placed with banks and the use of derivative financial instruments with banks and other financial institutions, which are used to hedge interest rate risk and foreign exchange rate risk.

Counterparty credit risk is managed by the group's treasury committee and is governed by a board-approved counterparty policy which ensures that the group's cash deposits and derivative financial instruments are only made with high-quality counterparties with the level of permitted exposure to a counterparty firmly linked to the strength of its credit rating. In addition, there is a maximum exposure limit for all institutions, regardless of credit rating. This is linked to the group's regulatory capital base in line with the group's regulatory reporting requirements on large exposures to the PRA.

2.4.2 Business and strategic risk

The group's business/strategic risk category comprises reputational risk, business risk, market risk and concentration risk. Risk descriptions together with the key controls in place to mitigate the risks are set out below:

Reputational risk

Reputational risk is the risk that an event or circumstance could adversely impact on the group's reputation. Operating in the non-standard market leads to greater scrutiny of the group's activities and any adverse publicity from the activities of legislators, pressure groups and the media could potentially have a detrimental impact on the group's sales and collections activities. In particular, media and pressure group activity can increase during an economic downturn or when the group is performing well. In addition, there is an increased focus on regulation, particularly of non-standard lenders and the read-across from any legislation or regulatory measures introduced to address the practices of payday lenders, that could have an adverse impact.

Reputational risk is managed in a number of ways. At a group level there is a specialist dedicated team and established procedures for dealing with media issues. Credit and collection policies are designed to ensure that both businesses adhere to responsible lending principles. A compliance committee oversees the application of the FCA's treating customers fairly regime in Vanquis Bank and both the risk and credit committee within CCD oversee compliance with the OFT's guidelines. In addition, a pro-active communication programme to foster a better understanding of the group's products is co-ordinated at a group level and is targeted at key opinion formers.

Both divisions regularly conduct customer satisfaction surveys to ensure that customer's needs are being met and that customers are satisfied with the service they are receiving.

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Customer satisfaction in Vanquis Bank is 88% (2012: 89%) and in the CCD business is 93% (2012: 92%). In addition, customer complaints remain low in both businesses.

In 2011 and 2012, the group have received a maximum score rating and was ranked joint first globally amongst financial services companies in the FTSE4Good Index Series which measures the environmental, social and governance ratings of publicly listed companies worldwide. This achievement reflects the continued investment that the group and its employees have made in embedding the corporate responsibility programme across all areas of the business.

Continued investment and focus on corporate responsibility and investment in a group co-ordinated community programme helps to foster good relations with customers and the areas in which they live.

Business risk

Business risk is the risk of loss arising from the failure of the group's strategy or management actions over the planning horizon.

Increased marketing activity from existing competitors may impact Vanquis Bank's growth rates. Whilst Polish customers have a much greater propensity to use the credit card to access cash rather than at the point of sale which may impact the ability to export the UK business of Vanquis Bank into Poland.

In addition, CCD may not be able to build the necessary capability to capture the growth opportunity in the online loans market with Satsuma, the recently launched online instalment lending product, and the continued pressure on customers' incomes from rises in fuel, food and utility costs could impact the demand for credit, impairment and profitability in home credit. Potential increased competition from competing formats such as direct mail and rent-to-own may reduce further the flow of new customers into home credit.

The group has developed a clear strategy to grow the business and the business risk associated with failure to deliver this strategy is mitigated by a number of actions:

- A clear board strategy is in place.
- A corporate planning conference (CPC) is held annually.
- Central resource is in place to develop the corporate strategy.
- New products and processes are thoroughly tested prior to roll-out.
- There is comprehensive monitoring of competitor products, pricing and strategy.
- Robust business change functions oversee change programmes.
- The group has comprehensive monthly management accounts, a monthly rolling forecast and a biannual budgeting process.
- Loans are short-term in nature and, in home credit, agents visit customers in their homes and are therefore able to stay up to date with customer circumstances.
- The group has demonstrated the ability to manage the business through the deterioration seen in the UK economy and employment market over the past five years.

Market risk

Market risk is the risk of loss due to adverse market movements caused by active trading positions taken in interest rates, foreign exchange markets, bonds and equities.

The group's corporate policies do not permit it to undertake position taking or trading books of this type and therefore it does not do so.

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Concentration risk

Concentration risk is the risk arising from the lack of diversification in the group's business either geographical, demographic or by product.

The group's operations are concentrated wholly in the non-standard consumer credit market in the UK, Republic of Ireland, and a pilot credit card operation in Poland which may indicate concentration risk. However, the group's customer base is well diversified throughout the UK, and the Republic of Ireland, and is not concentrated in a particular region. In addition, the group offers a number of different products in addition to the core Vanquis Bank credit card and the core home credit loan to ensure that there is not an over reliance on a particular product.

2.4.3 Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems.

The group manages operational risk as part of the risk management process. Each division has the responsibility for putting in place appropriate controls to mitigate operational and other risks. Both Vanquis Bank and CCD operate their own risk functions whose responsibility it is to monitor operational risks at a divisional level, monitor the controls in place to mitigate those risks and determine the likelihood, value and impact of the risks. Regular reporting of all risks, including operational risk, is presented to the divisional boards and to the RAG on a quarterly basis by means of updated risk registers.

The principal operational risks and the key controls in place to mitigate those risks are as follows:

- **IT systems** – Like any other financial services organisation, the group's divisions rely on the effective and efficient use of IT systems. Vanquis Bank is reliant on third-party IT applications and systems providers: FDI for its core customer credit card platform; and Newcastle Building Society (NBS) for its retail deposit platform. In addition, the repositioning of home credit as a leaner better-quality, more modern, high returns business relies heavily on the development and effective roll-out of technology.

IT is managed in Vanquis Bank and CCD by experienced teams. There is significant experience of managing third party IT arrangements within the businesses and rigorous selection processes for third-party suppliers ensure that they are 'best in class'.

Specialist project teams are used to manage change programmes and well established change control and testing processes are established for new business developments.

The group has established disaster recovery procedures, which are tested on a regular basis. Insurance policies are in place to cover eventualities such as business interruption, loss of IT systems and crime.

- **Health and safety** – The health and safety of employees and agents is a key concern for the group. The group has a duty of care to the agents it engages. Home credit agents are required to carry cash to issue credit and they receive cash as a result of their collections activities.

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Significant time and expenditure is invested in ensuring staff are safety conscious and assistance is given to agents to ensure that they are safety aware. Induction sessions and regular updates are provided on safety awareness with safety awareness weeks forming part of the annual calendar. Safety incidents are monitored closely by management with follow-up actions taken and an annual independent audit of health and safety policies and procedures is carried out by the group's insurers, AIG.

- **Data loss** – Both Vanquis Bank and CCD utilise and store sensitive personal data as part of their day-to-day operations. In addition, there continues to be a heightened focus and emphasis on data loss by the Information Commissioners' Office.

IT and physical security policies are in place with dedicated resources in place to support the management of information security. Security-related incidents are reported to divisional risk committees. In addition, there are specialist departments in place in each business to prevent, detect and monitor fraud with regular fraud reporting to divisional boards and to the group audit committee. The hierarchical field management structure and weekly agent performance reviews ensure a strong controls environment within home credit.

- **Recruiting and retaining highly skilled management and staff** - The group is dependent on key staff, including the executive directors and the senior management team, to deliver the group's strategy. The loss of key staff and/or reductions in staff morale could impact adversely on business performance

The group has competitive remuneration and incentive structures and effective recruitment, retention and succession planning strategies are in place. Effective training and personal development plans are in place throughout the group.

In addition to the above mitigating controls, the group also maintains a range of insurance policies to cover eventualities such as business interruption, loss of IT systems and crime.

2.4.4 Financial risk

Financial risk is the risk of financial loss, whether in the form of profit, cash or capital, due to inadequate financial controls and processes. The group's financial risk category comprises liquidity risk, tax risk, interest rate risk, foreign exchange risk and pension risk. Risk descriptions together with the key controls to mitigate these risks are set out below:

Liquidity risk

Liquidity risk is the risk that the group will have insufficient liquid resources available to fulfil its operational plans and/or to meet its financial obligations as they fall due.

Liquidity risk is managed by the group's centralised treasury department through daily monitoring of expected cash flows in accordance with a board-approved group funding and liquidity policy. This process is monitored regularly by the treasury committee.

The group's funding and liquidity policy is designed to ensure that the group is able to continue to fund the growth of the business. The group therefore maintains headroom on its committed borrowing facilities to fund growth and contractual maturities for at least the following 12 months, after assuming that Vanquis Bank will fund 90% of its receivables book through retail deposits. As at 31 December 2013, the group's committed borrowing facilities had a weighted average maturity of 3.2 years (2012: 3.7 years) and the headroom on these committed facilities amounted to £235.2m (2012: £191.9m). On 31 January 2014, the group entered into a new £382.5m syndicated bank facility maturing in May 2017 and cancelled the existing facility which was due to expire in May 2015.

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The group is less exposed than other mainstream lenders to liquidity risk as the loans issued by the home credit business, are of short-term duration (typically around one year) whereas the group's borrowings extend over a number of years.

As a PRA-regulated institution, Vanquis Bank is required to maintain a liquid assets buffer, and other liquid resources, in order to ensure that it has sufficient liquid resources to fulfil its operational plans and meet its financial obligations as they fall due. As at 31 December 2013, the liquid assets buffer, including other liquidity resources, held by Vanquis Bank amounted to £86.3m (2012:£52.3m).

Tax risk

Tax risk is the risk of loss arising from unexpected tax liabilities, which could arise as a result of changes in tax legislation or practice, non-compliance with existing legislation, or changes in the employment status of CCD's self-employed agents.

The group has a board-approved tax strategy which is aligned with its mission and core values and which has been shared with HMRC. The strategy sets out the group's overall approach to tax, including its tax governance framework, how tax risk management is embedded within the group's overall corporate governance structure and how the group ensures it complies with the tax obligations in the territories in which it operates. In addition, policies and procedures are in place which support the management of key tax risks, along with documented systems, processes and controls to support the UK taxes which the group pays and the preparation and submission of related tax returns. This includes policies and procedures which seek to ensure that the agents engaged by the home credit business maintain their self-employed status. Processes and controls supporting the calculation of UK taxes and preparation of related returns are subject to annual internal audit review.

The group is committed to building open and straightforward relationships with tax authorities, including having a regular and constructive dialogue with HMRC. This regularly includes advance discussion of transactions and keeping HMRC informed of key business developments, particularly those that could potentially impact on self-employed status of agents. An experienced in-house team, supported by tax-aware personnel in the businesses, deal with all of the group's tax matters. Advice is sought from external advisors on material transactions and whenever the necessary expertise is not available in-house.

Interest rate risk

Interest rate risk is the risk of a change in external interest rates which leads to an increase in the group's cost of borrowing.

The group's exposure to movements in interest rates is managed by the treasury committee and is governed by a board-approved interest rate hedging policy which forms part of the group's treasury policies.

The group seeks to limit the net exposure to changes in interest rates. This is achieved through a combination of issuing fixed-rate debt and by the use of derivative financial instruments such as interest rate swaps.

A 2% movement in the interest rate applied to borrowings during 2013 and 2012 would not have had a material impact on the group's profit before taxation or equity as the group's interest rate risk was substantially hedged.

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Foreign exchange rate risk

Foreign exchange rate risk is the risk of a change in foreign currency exchange rates leading to a reduction in profits or equity.

The group's exposure to movements in foreign exchange rates is monitored regularly by the treasury committee and is governed by a board-approved foreign exchange rate risk management policy which forms part of the group's treasury policies.

The group's exposures to foreign exchange rate risk arise solely from: (i) the issuance of US dollar private placement loan notes, which are fully hedged into sterling through the use of cross-currency swaps; and (ii) the home credit operations in the Republic of Ireland and the Vanquis Bank operations in Poland, which are hedged by matching euro/zloty-denominated net assets with euro/zloty-denominated borrowings or forward contracts as closely as practicable.

As at 31 December 2013, a 2% movement in the sterling to US dollar exchange rate would have led to a £nil (2012: £0.9m) movement in external borrowings with an opposite movement of £nil (2012: £0.9m) in the hedging reserve within equity. Due to the hedging arrangements in place, there would have been no impact on reported profits (2012: £nil).

As at 31 December 2013, a 2% movement in the sterling to euro exchange rate would have led to a £1.1m (2012: £1.1m) movement in customer receivables with an opposite movement of £1.1m (2012: £1.1m) in external borrowings. Due to the natural hedging of matching euro-denominated assets with euro-denominated liabilities, there would have been a £nil impact on reported profits and equity (2012: £nil).

As at 31 December 2013, a 2% movement in the sterling to zloty exchange rate would have led to a £nil (2012: £nil) movement in customer receivables with an opposite movement of £nil (2012: £nil) in the valuation of forward contracts. Due to the net investment hedge in place, there would have been no impact on reported profits or equity (2012: £nil).

Pension risk

Pension risk is the risk that there may be insufficient assets to meet the liabilities of the group's defined benefit pension scheme.

There is a risk that the liabilities within the scheme materially exceed the assets in the scheme due to changes in corporate bond yields, inflation, equity and bond returns (investment risk) and mortality rates (mortality risk). The current economic environment has led to volatile movements in equity markets and corporate bond yields. In addition, mortality rates in the UK continue to improve.

In order to mitigate the pension risk, the defined benefit pension scheme was substantially closed to new members from 1 January 2003. New employees since 2003 have been invited to join the group's defined contribution pension schemes which carry no investment or mortality risk for the group. The defined benefit pension scheme was amended in 2012 so that accrued pension benefits are now linked to increases in CPI rather than future salary increases. This reduces the future liabilities of the scheme. In addition, cash balance arrangements are now in place within the defined benefit pension scheme to reduce the exposure to improving mortality rates and the pension investment strategy aims to maintain an appropriate balance of assets between equities and bonds.

As at 31 December 2013, the group had a pension asset, calculated in accordance with IAS 19 'Employee benefits', of £29.2m (2012: £23.0m) on its balance sheet. The group, in conjunction with its advisors, continues to monitor investment strategy carefully.

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2.4.5 Regulatory risk

Regulatory risk is the risk of loss arising from a breach of existing regulation or regulatory changes in the markets within which the group operates. There is increased focus on regulation, particularly for non-standard lenders and there is a potential read-across from any legislation or regulatory measures introduced to address the practices of payday lenders.

The FCA will replace the Office of Fair Trading (OFT) as the regulatory body for consumer credit businesses from 1 April 2014. The consultation on the authorisation, supervision and enforcement regimes as well as conduct rules and guidance has now closed and final guidance was issued in March 2014. In addition at the end of November 2013, the government announced that it intended to legislate to introduce a cap on the total cost of credit for payday loans. The duty on the FCA is to introduce the cap by January 2015 and was formally established through the Financial Services (Banking Reform) Act in December 2013. The FCA will determine the level and nature of the cap, as well as the precise definition of the loans to be covered by the cap. The FCA intends to conduct research and economic analysis before consulting on specific proposals during 2014. It will also consider the lessons of other countries that have adopted this power to ensure that any cap is right for UK consumers.

A central in-house legal team is in place which monitors legislative changes and supports divisional compliance functions and expert third-party legal advice is taken where necessary. Divisional compliance functions are in place which monitor compliance and report to divisional boards.

There is ongoing constructive dialogue with regulators and the group fully and actively participates in all relevant regulatory review and consultation processes in the UK and EU. In addition, the group has long relationships and has developed credibility with key regulators who recognise the different dynamics of the home credit and credit card sectors compared with the payday lending model. The group does not provide payday lending.

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3. Capital adequacy

3.1 Controls

The group prudently manages its regulatory capital to ensure that it is always maintained at a sufficient level in excess of the ICG set by the PRA. The key controls in achieving this objective are:

- Monitoring the level of regulatory capital against the ICG on a monthly basis as part of the group's management accounts;
- Producing a rolling forecast, as part of the management accounts, projecting regulatory capital against the ICG for the remainder of the financial year;
- As part of the budget and budget update processes, forecasting regulatory capital for the following five years and comparing this to the group's ICG;
- Assessing the impact that strategic projects could have upon regulatory capital;
- Submitting regulatory capital reports to the PRA periodically; and
- Assessing the appropriateness of the ICG as part of the group's ICAAP process, including stress and scenario testing, and reporting to the PRA if it is no longer considered to be appropriate.

3.2 Composition of regulatory capital resources

The group's regulatory capital resources comprise tier 1 and a small amount of lower tier 2 capital. The table below sets out the composition of the group's regulatory capital resources as at 31 December 2013 and 31 December 2012:

	Note	2013 £m	2012 £m
Core tier 1 capital:			
Called-up share capital		28.9	28.7
Share premium account		150.6	148.1
Retained earnings and other reserves	1	219.9	189.1
		<u>399.4</u>	<u>365.9</u>
Deductions from tier 1 capital:			
Intangible assets	2	(8.1)	(9.5)
Investment in own shares	3	(0.9)	(1.2)
		<u>(9.0)</u>	<u>(10.7)</u>
Total tier 1 capital after deductions		390.4	355.2
Tier 2 capital:			
Lower tier 2 capital - Subordinated loan notes	4	2.4	3.6
Total regulatory capital resources		<u>392.8</u>	<u>358.8</u>

Notes:

1. Retained earnings and other reserves for regulatory capital purposes represent the group's equity reserves, adjusted to exclude the group's pension asset, net of deferred tax, and fair value movements in respect of derivative financial instruments, net of deferred tax. The group's retained earnings and other reserves included in tier 1 regulatory capital can be reconciled to the amounts disclosed in the 2013 and 2012 financial statements as follows:

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	2013	2012
	£m	£m
Retained earnings	220.1	185.4
Other reserves:		
Profit retained by subsidiary	0.8	0.8
Capital redemption reserve	3.6	3.6
Hedging reserve	(5.1)	(7.0)
Share-based payment reserve	18.8	16.8
Retained earnings and other reserves included in the financial statements	238.2	199.6
Regulatory capital adjustments:		
Pension asset	(29.2)	(23.0)
Deferred tax on pension asset	5.8	5.4
Fair value of derivative financial instruments	6.4	9.1
Deferred tax on fair value of derivative financial instruments	(1.3)	(2.0)
Retained earnings and other reserves included in tier 1 regulatory capital	219.9	189.1

2. Intangible assets comprise capitalised software and software development costs. These are required to be deducted from capital for regulatory capital purposes.
3. The investment in own shares represents shares in Provident Financial plc which have been purchased to satisfy grants and awards made under the group's share incentive schemes. These are required to be deducted from capital for regulatory capital purposes.
4. The group's lower tier 2 capital represents subordinated loan notes which are repayable on 15 June 2015 and accrue interest at 5.5594%. The subordinated loan notes are hybrid instruments which have attributes of both debt and equity which, subject to certain criteria, allow the loan notes to qualify as eligible lower tier 2 capital. The criteria include the need for the loan notes to be long-term in nature, subordinated to all other borrowings and liabilities upon winding up of the company and not contain financial ratio covenants which may trigger early redemption by the note holders. There are two further restrictions on the recognition of the subordinated loan notes as eligible lower tier 2 regulatory capital:
 - (i) Lower tier 2 regulatory capital cannot exceed 50% of tier 1 capital; and
 - (ii) When the loan notes have more than 5 years until maturity, they are fully eligible, subject to (i) above, as lower tier 2 regulatory capital. However, when they have less than 5 years until maturity, the amount eligible for recognition as lower tier 2 regulatory capital reduces by 20% per annum for each year below 5 years.

As at 31 December 2013, the subordinated loan notes were not in excess of 50% of tier 1 capital and had 2 years until maturity. Accordingly, 40% of the full amount of the loan notes was eligible as lower Tier 2 capital.

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3.3 Pillar I minimum capital requirement

In calculating the Pillar I minimum capital requirement, the group has adopted the standardised approach to credit risk and the alternative standardised approach to operational risk.

An analysis of the Pillar I minimum capital requirement as at 31 December 2013 is as follows:

	<u>2013</u>	<u>2012</u>
	£m	£m
Credit risk:		
Retail – not past due	85.6	79.5
Retail – past due	16.3	16.7
Other	<u>4.2</u>	<u>4.9</u>
Total credit risk	106.1	101.1
Operational risk	9.1	8.5
Counterparty risk	0.1	0.2
Market risk	0.1	0.2
Pillar I minimum capital requirement as at 31 December	<u>115.4</u>	<u>110.0</u>

3.4 Capital adequacy ratio

The ICG set by the PRA is expressed as a percentage of the minimum regulatory capital required under Pillar I of the CRD together with certain additional capital add-ons to cover other risks.

As at 31 December 2013, the group's total regulatory capital resources amounted to £392.8m (2012: £358.8m). This was comfortably in excess of the ICG set by the PRA.

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4. Credit risk

4.1 Accounting policy for customer receivables

All customer receivables are initially recognised at the amount loaned to the customer plus directly attributable incremental issue costs. After initial recognition, customer receivables are subsequently measured at amortised cost. Amortised cost is the amount of the customer receivable at initial recognition less customer repayments, plus revenue earned calculated using the effective interest rate, less any deduction for impairment.

The group reviews its portfolio of loans and receivables for impairment at each balance sheet date. For the purposes of assessing the impairment of customer loans and receivables, customers are categorised into arrears stages as this is considered to be the most reliable indication of future payment performance. The group makes judgements to determine whether there is objective evidence which indicates that there has been an adverse effect on expected future cash flows.

Customer accounts in Vanquis Bank are deemed to be impaired when one contractual monthly payment has been missed. Impairment is calculated as the difference between the carrying value of receivables and the present value of estimated future cashflows discounted at the original effective interest rate.

In the weekly home credit business of CCD, receivables are deemed to be impaired when the cumulative amount of two or more contractual weekly payments have been missed in the previous 12 weeks, since only at this point do the expected future cash flows from loans deteriorate significantly. Loans with one missed weekly payment over the previous 12-week period are not deemed to be impaired. The amount of impairment loss is calculated on a portfolio basis by reference to arrears stages and is measured as the difference between the carrying value of the loans and the present value of estimated future cashflows discounted at the original effective interest rate.

The level of impairment in both businesses is calculated using models which use historical payment performance to generate the estimated amount and timing of future cash flows from each arrears stage, and are regularly tested using subsequent cash collections to ensure they retain sufficient accuracy. The impairment models are regularly reviewed to take account of the current economic environment, product mix and recent customer payment performance. However, on the basis that the payment performance of customers could be different from the assumption used in estimating future cash flows, a material adjustment to the carrying value of amounts receivable from customers may be required.

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4.2 Analysis of credit risk exposures

The group's maximum exposure to credit risk on customer receivables is the carrying value of customers receivables recorded in the group's balance sheet.

All customer receivables are classed as retail exposures. Vanquis Bank exposures are revolving retail exposures.

Exposures analysed by business division are as follows:

	<u>2013</u>	<u>2012</u>
	£m	£m
Vanquis Bank	866.6	643.3
CCD	740.0	870.5
Total	<u>1,606.6</u>	<u>1,513.8</u>

The average exposure in the year to 31 December 2013 was £1,486.5m (31 December 2012: £1,320.1m).

Exposures analysed by geographical area are as follows:

	<u>2013</u>	<u>2012</u>
	£m	£m
UK	1,545.1	1,451.0
Republic of Ireland	56.2	61.0
Poland	5.3	1.8
Total	<u>1,606.6</u>	<u>1,513.8</u>

The group's exposures are well dispersed across the United Kingdom (UK), Republic of Ireland (ROI). Poland balances represent the pilot in the Polish credit card market.

The following table shows the residual maturity of exposures by business on a contractual basis:

	<u>2013</u>			<u>2012</u>		
	Due within one year £m	Due in more than one year £m	Total £m	Due within one year £m	Due in more than one year £m	Total £m
Vanquis Bank	866.6	-	866.6	643.3	-	643.3
CCD	660.3	79.7	740.0	773.0	97.5	870.5
Total	<u>1,526.9</u>	<u>79.7</u>	<u>1,606.6</u>	<u>1,416.3</u>	<u>97.5</u>	<u>1,513.8</u>

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4.3 Credit quality of customer receivables

Within Vanquis Bank, customer balances are deemed to be impaired as soon as customers miss one contractual monthly payment. Therefore, within Vanquis Bank, there are no accounts/balances which are past due but not impaired.

In the home credit business, past due but not impaired balances relate to loans which are contractually overdue. However, contractually overdue loans are not deemed to be impaired unless the customer has missed two or more cumulative weekly payments in the previous 12-week period, since only at this point do the expected future cash flows from loans deteriorate significantly.

The credit quality of customer receivables is as follows:

	2013	2012
	£m	£m
Neither past due nor impaired	1,045.2	877.3
Past due but not impaired	99.4	138.0
Impaired	462.0	498.5
Total	<u>1,606.6</u>	<u>1,513.8</u>

The credit quality of customer receivables analysed by business division is as follows:

	2013			2012		
	Vanquis Bank	CCD	Total	Vanquis Bank	CCD	Total
	£m	£m	£m	£m	£m	£m
Neither past due nor impaired	785.9	259.3	1,045.2	580.9	296.4	877.3
Past due but not impaired	-	99.4	99.4	-	138.0	138.0
Impaired	80.7	381.3	462.0	62.4	436.1	498.5
Total	<u>866.6</u>	<u>740.0</u>	<u>1,606.6</u>	<u>643.3</u>	<u>870.5</u>	<u>1,513.8</u>

The credit quality of customer receivables analysed by geographical area is as follows:

	2013				2012			
	UK	ROI	Poland	Total	UK	ROI	Poland	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Neither past due nor impaired	994.9	27.2	4.9	1,027.0	847.8	27.8	1.7	877.3
Past due but not impaired	93.7	5.7	-	99.4	131.2	6.8	-	138.0
Impaired	456.5	23.3	0.4	480.2	472.0	26.4	0.1	498.5
Total	<u>1,545.1</u>	<u>56.2</u>	<u>5.3</u>	<u>1,606.6</u>	<u>1,451.0</u>	<u>61.0</u>	<u>1.8</u>	<u>1,513.8</u>

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4.4 Movement in impairment provisions

The impairment charge to the income statement in respect of customer receivables analysed by business division is as follows:

	<u>2013</u> £m	<u>2012</u> £m
Vanquis Bank	129.4	95.9
CCD	269.7	230.2
Total	<u>399.1</u>	<u>326.1</u>

The movement in the impairment allowance account within Vanquis Bank in the year is as follows:

	<u>2013</u> £m	<u>2012</u> £m
At 1 January	91.4	62.4
Charge for the year	129.4	95.9
Amounts written off during the year	(99.4)	(71.2)
Amounts recovered during the year	7.4	4.3
At 31 December	<u>128.8</u>	<u>91.4</u>

For CCD, impairment charges are deducted directly from the carrying value of receivables without the use of an impairment allowance account. Accordingly, it is not possible to disclose movements in an impairment allowance account for CCD.

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5. Counterparty credit risk

Details of the group's counterparty credit risk and the controls in place to mitigate the risk are set out in section 2.4.1.

5.1 Counterparty exposure limits

The counterparty credit limits that are applied to banks and similar institutions are based on:

- Credit rating limits; and
- An assessment of excess risk.

The group uses credit ratings as an independent measure of an institution's capacity for timely payment of debt. The group relies principally on two UK rating agencies; Moodys and Fitch Ratings. Rating limits are determined by reference to the lower of the long-term rating granted to an institution by Moodys and Fitch Ratings. In each case the institution must also have the highest short-term credit rating of P-1 to be acceptable.

Excess risk is considered by the board on a case by case basis. It is applicable for institutions with whom the group has a strong lending relationship.

5.2 Exposure to counterparties

The group measures exposure value on counterparty credit exposures under the counterparty credit risk (CCR) mark-to-market method. This exposure value is derived by adding the gross positive fair value of the contract (replacement cost) to the contract's potential credit exposure, which is derived by applying a multiple based on the contract's residual maturity to the notional value of the contract.

The group uses derivative financial instruments to hedge the interest rate risk and foreign exchange rate risk on its borrowings. The group does not enter into speculative transactions or positions.

The contractual/notional amounts and the fair value of derivative financial instruments are set out below:

	2013			2012		
	Contractual /notional amount	Fair value of assets	Fair value of liabilities	Contractual/ notional amount	Fair value of assets	Fair value of liabilities
	£m	£m	£m	£m	£m	£m
Interest rate swaps	120.0	-	(6.7)	120.0	-	(9.4)
Cross-currency swaps	36.3	5.4	-	84.9	8.1	(1.9)
Foreign exchange contracts	7.1	0.1	-	7.5	-	(0.1)
Total	<u>163.4</u>	<u>5.5</u>	<u>(6.7)</u>	<u>212.4</u>	<u>8.1</u>	<u>(11.4)</u>

Due to the high-quality nature of the group's counterparties, the group does not secure collateral and does not establish credit reserves. The group does not provide collateral to counterparties and there is no requirement to provide collateral in the event of a downgrade in

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the group's own credit rating (currently BBB with a stable outlook by Fitch Ratings) or any other circumstances. The group has no wrong-way risk exposures or credit derivative hedges.

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6. Interest rate risk

Details of the group's interest rate risk and the controls in place to mitigate the risk are set out in section 2.4.4.

The group measures its interest rate exposure by quantifying the impact of an immediate and sustained movement of 200bp in LIBOR rates upon its forecast profit.

In calculating this exposure, the group assumes that it will re-price products for new lending. It is possible for Vanquis Bank to re-price its receivables within 2 months' and for CCD loans to be issued at re-priced levels within 1 month. Given the short duration of the receivables book, on average the group would be able to re-price its receivables portfolio within 6 months to mitigate the impact upon forecast borrowing costs.

The level of fixed and floating rate receivables and borrowings beyond the next 6 months are forecast to be matched, resulting in a neutral interest rate position.

The level of downside risk resulting from exposure to interest rates calculated on the basis set out above as at 31 December 2013 and 31 December 2012 is as follows:

	<u>2013</u>	<u>2012</u>
	£m	£m
Sterling	0.9	1.4
Euro	0.5	0.4
Polish zloty	-	-
Total	<u>1.4</u>	<u>1.8</u>

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7. Market risk

As set out in section 2.4.2, the group's corporate policies do not permit it to undertake position taking or trading books in respect of interest rates, foreign exchange markets, bonds or equities.

The group has operations in both the Republic of Ireland and Poland and therefore has an element of foreign currency market risk.

The capital resource requirement for the group in respect of foreign currency PRR (position risk requirement) for the year ending 31 December 2013 was £0.1m (31 December 2012: £0.2m).