



Direction

To: On a solo basis:
Abbey National plc (the "principal firm(s)")
Abbey National Treasury Services plc ("ANTS")

On a consolidated basis:
Abbey National plc
Cater Allen Ltd
Abbey Stockbrokers Ltd
James Hay WRAP Managers Ltd
James Hay Administration Co. Ltd
Abbey National Treasury Services plc ("ANTS")
Cater Allen International Ltd

Each other firm in the Abbey Group (the "group") as at the date of this direction, that falls into *BIPRU* 8.1.1R (collectively the "firms")

Ref: 852466

Of: 2-3 Triton Square
London
NW1 3AN

Date: 31 December 2007

Handbook Version as in force at the date of this Direction

Power

1. This direction is given by the *FSA* under section 148 of the *Act*.

Duration

- 2.1 This direction takes effect on 1 January 2008
- 2.2 This direction shall expiry on the date a new direction is issued by the FSA to implement the joint decision to be issued under section 129 of Directive 2006/48/EC.

Rules Waived/Modified

3. The *FSA* directs that the *rules* listed below and, where applicable, in Schedule 2 apply to the firms with the modifications shown or, where indicated, do not apply to the firms.

Chapter/Rule	Modification/Waiver
<i>GENPRU</i> 2.1.51R	This <i>rule</i> is modified as follows: A <i>BIPRU firm</i> <u>principal firm</u> must calculate its <i>credit risk capital requirement</i> as the sum of: (1) the <i>credit risk capital component</i>; (2) the <i>counterparty risk capital component</i>; and (3) the <i>concentration risk capital component</i>; <u>subject to the following:</u> (4) for <i>exposures</i> covered by the IRB permission (as set out in Schedule 1 of the IRB permission), the principal firm must calculate its <i>credit risk capital requirement</i> and (to the extent that the relevant <i>Handbook</i> provisions provide for the use of the <i>IRB approach</i>) the <i>counterparty risk capital component</i> and the <i>concentration risk capital component</i> in accordance with the <i>IRB approach</i> and the IRB permission; (5) the principal firm must comply with other requirements in the IRB permission; and (6) the IRB permission means direction number 852466 and a "principal firm" means the same thing as it does in that direction.
<i>BIPRU</i> 3.1.1R	The <i>rule</i> is modified by inserting after 'a <i>BIPRU firm</i>', the following: "but does not apply to a <i>firm</i> in relation to <i>exposures</i> to which the <i>IRB approach</i> is applied"
<i>BIPRU</i> 8.8	The table inserted after <i>BIPRU</i> 8.8.1R by direction number 678354 is modified by adding the following provisions:

Chapter/Rule	Modification/Waiver	
"BIPRU 8.8.1AR Table: Permissions to use advanced approaches		
This table belongs to BIPRU 8.8.1R		
Advanced prudential calculation approach	Scope	Remarks
IRB approach [Note 2]	(1) Subject to (2), applies to the <i>exposures</i> coming within the scope of Schedule 1 of the IRB permission in relation to a <i>firm's UK consolidation group</i> and each <i>non-EEA sub-group</i> as applied on a consolidated basis. (2) Applies to the <i>exposures</i> of the following <i>undertakings</i>: • Abbey National plc • Cater Allen Ltd • Abbey Stockbrokers Ltd • James Hay WRAP Managers Ltd • James Hay Administration Co. Ltd • Abbey National Treasury Services plc ("ANTS") • Cater Allen International Ltd	A firm must comply with the requirements of the IRB permission as applied on a consolidated basis.
Note 2: The IRB permission means direction number 852466 and a "principal firm" means the same thing as it does in that direction."		

Conditions

4.1 This direction applies to the firms for so long as they remain part of the Abbey Group.

4.2 This direction is subject to the following conditions being met by the firms during the roll-out of the RMM but not later than 31 December 2008:

- (a) With regard to governance, the firms must:
 - finalise how and in what format will report model output actual versus estimates to the Designated Committee; and
 - incorporate the Long-run PD estimates and results of stress testing into management reporting and include assessment of their position within the economic cycle.
- (b) The firms must ensure that triggers and thresholds for ongoing monitoring of the PD in the RMM are appropriate and effective.
- (c) As part of the harmonised framework of Santander Group standards, the firms must complete the development and implementation of specific modelling standards across scorecards and capital models for the amended PD, EaD and LGD models.
- (d) With regard to the Long-run Average Probability of Default (LRPD), the firms must:
 - allocate grades and calculate grade-level LRPD after future scorecard recalibrations;
 - continue to assess the relationship between the grade level and portfolio level default rates over the economic cycle as new data becomes available. If this assessment indicates that the current assumption is not accurate (i.e. that the portfolio and grade level default rates will increase and decrease by a constant multiple) then the long-run grade level PDs must be re-estimated;
 - include and consider the current economic conditions when assessing the accuracy of their rating systems; and
 - compare actual versus expected default rates at grade level, with triggers around expected levels of accuracy.
- (e) With regard to LGD, the firms must:
 - justify why a number of account balances increase > 25% before sale; and
 - review the LGD estimates applied to pools of over-collateralised exposures, particularly with respect to the volatility of collateral recovery values. This review should not assume the continuation of a floor set only by the administration costs.
- (f) With regard to stress testing, the firms must:
 - consider the level of cyclical variation within underlying scorecards when estimating stressed PDs;
 - ensure that the PDs used in stress testing of regulatory capital requirements are those the firms would expect to use in the event of the downturn scenario materialising. In this respect, the latest analysis assumes that the average PD in the first year of the downturn scenario (4.038%) is lower

than the average PD currently being used (5.59%). Therefore, the firms must revisit and test the plausibility of this assumption;

- ensure that the LGDs used in its stress testing of regulatory capital requirements are the estimates appropriate for a downturn, and take full account of how those estimates will change in the event of the downturn scenario materialising.
- (g) The firms' approach to converting stressed PDs into grade migration assumes that economic conditions will decrease the score of every account by an equal margin. As data becomes available, the firms must monitor the accuracy of this assumption and, where appropriate, alter the approach accordingly.
- (h) With regard to the accuracy and integrity of the data, the firms must extend the pre-vetting and testing of data quality standards and reporting to cover all key data used and not limit testing to the fields that enter the RWA calculation.
- (i) The firms must complete the documentation of the Use Test, including governance and triggers.
- (j) With regard to the validation framework, the firms must deliver the bank accounts model validation and the stress testing validation reports promptly and confirm that the escalation procedures and corrective action plans and deliverables set out in the validation report recommendations are addressed and presented to the FSA no later than the end of June 2008.

4.3 This direction is subject to the following conditions being met by the firms during the roll-out of the SHM but not later than 31 December 2008:

- (a) With regard to Loss Given Default (LGD), the firms must apply a 10% floor to all LGD estimates.
- (b) The firms must complete the introduction of standards and work programme for monitoring of ongoing performance of the rating system.
- (c) With regard to the definition of default, the firms must:
- take account of the possible impact where government intervention is lost from a systemic, sectoral and idiosyncratic perspective; and
 - ensure that PD estimates reflect all aspects of the firms' definition of default.
- (d) With regard to the PD, the firms must analyse how the firms' regional adjustment might vary under different (stressed) economic conditions.
- (e) The firms must complete a process for ongoing validation of their LGD methodology.

4.4 This direction is subject to the following conditions being met by the firms during the roll-out of the Banks Model but not later than 31 December 2009.

Regarding the rating system:

- (a) As a general matter, the difficulty involved in extracting the default definition comprised in the CDS spread, because it includes additional information (mainly liquidity), should be underlined. Moreover, the institution assumes that the estimated relationship between the Distance to Default and the financial variables could be applied to the entities that do not have CDSs. The rating system must be continuously monitored, evaluating its accuracy, its predictive power and its fit with the external ratings at least twice a year.
- (b) The firms must establish a warning system to evaluate the divergences between observed values and assumed values in the intermediate parameters.
- (c) The firms should evaluate the stability of the rating system over the business cycle.
- (d) The firms must draft a manual for the qualitative module that explains how each of the qualitative aspects should be analysed and evaluated, in order to guarantee a homogeneous evaluation of all the qualitative aspects.

Regarding parameter estimates:

- (e) The firms must justify the value assigned to the parameters used to transform the PIT 'risk-neutral' PDs into PIT 'real' PDs (asset correlation and Sharpe ratio).
- (f) The firms must continuously monitor the internal parameters (asset correlation and Sharpe ratio).
- (g) The firms must prepare an analysis of both theories involved in the procedure (Merton Model and CAPM) to verify that they are compatible.
- (h) The firms must analyse the sensitivity of the final results (PDs and capital requirements) to using a 5 –year CDS spread instead of the 1-year CDS spread (the one used to calibrate PDs). The statistical rating system was created using the 5-year CDS spread.
- (i) The firms must prepare a well-documented definition of liquid counterparty, compatible with the one used to calibrate the statistical rating system.
- (j) The firms must prepare a good explanation for the adjustment made to the PDs obtained for ratings lower than 7.

Guidance

- 5.1 The schedules to this direction in part contain requirements referred to in *GENPRU* 2.1.51R (as modified), and provisions in *BIPRU*, which the firm must comply with as *rules*. Schedule 2 sets out details of the how the *IRB permission* applies for the purposes of *BIPRU* 4.1.23R (1) to (6). The schedules also contain guidance for the firm and where this is the case this is indicated.



- 5.2 As set out in *SUP 8*, the firm must notify the *FSA* immediately if it becomes aware of any matter which could affect the continuing relevance or appropriateness of this *waiver*. In particular any material change to the models needs to be reported to the *FSA* by the firms.
- 5.3 Any changes to any of Schedules 1 to 3 of this direction will require a variation of this direction.
- 5.4 As part of the supervisory process, the *FSA* will from time to time reissue Schedule 5. This does not represent a variation of this direction. Instead it is a process for recording in one place cumulative changes to the matters set out in the Schedules.
- 5.5 *BIPRU 8* has already been amended by direction number 678354 to allow a firm to use an *advanced prudential calculation approach* for the purposes of consolidated requirements. This direction further modifies *BIPRU 8* to require a firm to use the *IRB approach* on a consolidated basis.

Interpretation

6. Interpretative provisions of the *Handbook* apply to this direction in the same way they apply to the *Handbook*.

Relationship Manager
Major Retail Groups Division
Financial Services Authority

Note on Disclosure

The FSA has decided not to publish the full text and schedules of the waiver direction as it has been deemed inappropriate and unnecessary. In particular, to do so might prejudice, to an unreasonable degree, the commercial interests of the firm concerned.

However, in the interests of transparency, the FSA's policy is to publish an abridged version of the waiver direction, as a record that the advanced prudential approach waiver has been granted.



Schedule 1 – High level scope and coverage of IRB permission granted

The FSA has granted an *IRB permission* for the categories of *exposure* identified in table 1 below (boxes containing a tick) with the exception of the permanent exemptions in table 2. *Exposures* that are not applicable to the firm are left blank.

Table 1

<i>IRB exposure classes*</i>	Sub-classes	<i>Advanced IRB approach</i>	Geographies (by domicile of obligor)		
			All countries	UK only	(Further column on a case by case basis)
Claims or contingent claims on central governments and <i>central banks</i>					
Claims or contingent claims on <i>institutions</i>		✓	✓		
Claims or contingent claims on corporates	Secured/ Development and investment lending on real estate	✓		✓	
	Other Corporate				
Retail claims or contingent retail claims	Mortgage (Prime)			✓	
	Mortgage (sub prime/ non-performing/ Buy-to-let/ Others)				
	<i>Qualifying revolving retail exposure</i>			✓	
	<i>Retail SME</i>			✓	
	Other Retail			✓	
Equity claims					
<i>Securitisation positions</i>					

<i>Non credit-obligation assets</i>					
* This is the list of broad classes of <i>exposures</i> within the scope of this direction as referred to in <i>BIPRU</i> 4.3.2 R.					

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Portfolios permanently exempted from the <i>IRB approach</i> for application of the <i>standardised approach</i> (As referred to in <i>BIPRU</i> 4.2.26 R)			
Category	Exposure class	Portfolio	Description
Permanent exemptions for sovereigns, churches, religious communities, and institutions (As referred to in <i>BIPRU</i> 4.1.23 R (1), <i>BIPRU</i> 4.2.26 R (2) and <i>BIPRU</i> 4.2.26 R (3))	N/A	N/A	
Non-significant business units and immaterial exposure classes (As referred to in <i>BIPRU</i> 4.1.23 R (1) and <i>BIPRU</i> 4.2.26 R (4))	Retail Corporate	- Other Retail - Porterbrook - Social Housing - Other Subsidiaries and Portfolios	- Permanently Standardised Residential Mortgages - ROSCO - Social Housing (bonds issued by counterparties)
Other (As referred to in <i>BIPRU</i> 4.1.23 R (1) and <i>BIPRU</i> 4.2.26 R (5)-(10))	N/A	N/A	

Schedule 2:

This Schedule sets out details of the requirements in respect of how the *IRB permission* applies for the purposes of *BIPRU* 4.1.23R (1) to (6). The notes in this schedule are *guidance* only.

For firms using their own estimates of LGD and conversion factors

1. The firm may take into account *unfunded credit protection* to reduce *LGD* in the following manner:

N/A

Note. If the firm uses its own estimates of *LGD* and *conversion factors* it may only take into account *unfunded credit protection* to reduce *LGD* in the manner set out in its *IRB permission* (see *BIPRU* 4.1.23 R (3)).

2. The firm may only recognise the effects of financial collateral under *BIPRU* 10.6.17 R in the following manner:

N/A

Note. As set out in *BIPRU* 10.6.17R, in calculating the value of its *exposures* to a *counterparty* or to a *group of connected clients* the firm, within the scope of its *IRB permission*, the firm must satisfy the *FSA* that the effects of financial collateral can be separately estimated from other *LGD* aspects, and must be able to demonstrate the suitability of the estimates produced. (see *BIPRU* 4.1.23 R (4)).

For all firms with IRB permission

3. The firm must deal with *equity exposures* in the following manner (see *BIPRU* 4.1.23 R (5) and *BIPRU* 4.7.3 R):
 - 1) The simple risk weight approach (see *BIPRU* 4.7.8 R);
4. The firm may recognise as eligible collateral a physical item of a type other than those types indicated in *BIPRU* 4.10.6R - *BIPRU* 4.10.12R (Eligibility of real estate collateral) and if the conditions in *BIPRU* 4.10.16R are met.

Note. A firm may only recognise such collateral as eligible if its *IRB permission* provides that the firm may treat collateral of that type as eligible and if the firm is able to demonstrate the following (see *BIPRU* 4.1.23 (6) and *BIPRU* 4.10.16 R):

- 1) the existence of liquid markets for disposal of the collateral in an expeditious and economically efficient manner;
- 2) the existence of well-established, publicly available market prices for the collateral; and
- 3) there is no evidence that the net prices it receives when collateral is realised deviates significantly from the market prices referred to in (b).

Schedule 3: Roll-out plan

This is the table referred to in *BIPRU 4.1.23 R (1)* and *BIPRU 4.2.18R- BIPRU 4.2.19R* (detailed implementation plan of the *IRB approach* coming within the scope of this direction). Firms should inform the *FSA* as soon as possible should they think they are not able to roll out in accordance with the plan before the end of window.

Table x

Exposure Class	Portfolio	Description	Planned Implementation Window		For Information: FSA review* to take place before roll-out (Tick if applicable)
			Start of Window	End of Window	
Retail	Residential Mortgages	Abbey Retail IRB UK models	1/1/08	2008	
Retail	Mortgage Offers		1/1/08	2008	
Retail	Customer Bank Accounts (Overdrafts)		1/1/08	2008	
Retail	Unsecured Personal Loans		1/1/08	2008	
Retail	Cahoot Credit Cards		2010	2011	
Retail	Cahoot Unsecured Personal Loans		2010	2011	
Retail	Cahoot Bank Accounts		2010	2011	
Retail	Business Banking		2010	2011	
Financial Institutions	Inter-Bank Exposures	Santander Group AIRB model	1/1/08	2008	
Financial Institutions	Non Banking Financial Institutions		2010	2011	
Financial Institutions	Securities Financing Transactions		2009	2010	
Corporate	Social Housing	Abbey AIRB UK model	1/1/08	2008	
Corporate	Corporates		2010	2011	
Corporate	Commercial Mortgages		2010	2011	

* Or review by another regulator as specified.

Schedule 4: Reporting Requirements

This Schedule sets out reporting requirements for the firm for the purposes of *GENPRU* 2.1.51R as modified.

Reporting requirements

The firm must keep the *FSA* informed about its *IRB rating systems* and the environment within which they are being operated. The firm must provide information to the *FSA* in a manner that allows the *FSA* to exercise adequate oversight of the firm's *IRB approach*. In particular the firm is required to provide reports to the *FSA* in accordance with the requirements below.

1. The firm must inform the *FSA* in advance of significant events affecting the operation of ratings, such as:
 - introduction of new *rating systems*,
 - significant changes to *rating systems*,
 - significant changes to governance or senior management arrangements,
 - any other significant event affecting the *rating systems*.

Any material changes to one or more of the above must be notified to the *FSA* as soon as practicable. Detailed information should be provided on quantitative and qualitative aspects of the change.

Where changes to *rating systems* are involved the firm must report these changes to be reported in advance of their occurring in order to allow the *FSA* to review the *rating system* prior to live introduction.

2. In addition the firm must provide the *FSA* with details of any other changes relating to approved *rating systems*. This information may be provided after the event occurs.



Schedule 5 (Version control)

Guidance – this table is used to maintain an audit trail of the evolution this direction. A new version number should be created each time a schedule to the direction is amended, whether or not the direction itself is formally revoked and reissued.

Version	Comment	Authorisation	Date
1.0	GCD Approved Draft Direction	Tamanna Talukder	31/12/07