

Loan impairment

The Group classifies impaired assets as either Risk Elements in Lending (REIL) or Potential Problem Loans (PPL). REIL represents non-accrual loans, loans that are accruing but are past due 90 days and restructured loans. PPL represents impaired assets which are not included in REIL but where information about possible credit problems cause management to have serious doubts about the future ability of the borrower to comply with loan repayment terms.

Both REIL and PPL are reported gross of the value of any security held, which could reduce the eventual loss should it occur, and gross of any provision marked. Therefore impaired assets which are highly collateralised, such as mortgages, will have a low coverage ratio of provisions held against reported impaired balance.

The table below sets out the Group's loans that are classified as REIL and PPL:

| | Including ABN AMRO 2007 £m | Including ABN AMRO net of minority interest 2007 £m | Excluding ABN AMRO 2007 £m | 2006 £m | 2005 £m |
|---|-------------------------------------|---|-------------------------------------|--------------|--------------|
| REIL and PPL | | | | | |
| Non-accrual loans ⁽¹⁾ | 10,362 | 7,949 | 6,668 | 6,232 | 5,926 |
| Accrual loans past due 90 days ⁽²⁾ | 369 | 302 | 256 | 105 | 9 |
| Troubled debt restructurings ⁽³⁾ | — | — | — | — | 2 |
| Total REIL | 10,731 | 8,251 | 6,924 | 6,337 | 5,937 |
| PPL ⁽⁴⁾ | 671 | 131 | 64 | 52 | 19 |
| Total REIL and PPL | 11,402 | 8,382 | 6,988 | 6,389 | 5,956 |
| REIL and PPL as % of customer loans and advances – gross ⁽⁵⁾ | 1.64% | 1.49% | 1.49% | 1.57% | 1.60% |

The sub-categories of REIL and PPL are calculated as described in notes 1 to 4 below.

Notes:

- (1) All loans against which an impairment provision is held are reported in the non-accrual category.
- (2) Loans where an impairment event has taken place but no impairment recognised. This category is used for fully collateralised non-revolving credit facilities.
- (3) Troubled debt restructurings represent loans that have been restructured following the granting of a concession by the Group to the borrower.
- (4) Loans for which an impairment event has occurred but no impairment provision is necessary. This category is used for fully collateralised advances and revolving credit facilities where identification as 90 days overdue is not feasible.
- (5) Gross of provisions and excluding reverse repurchase agreements.

REIL as at 31 December 2007 was £10,731 million (2006 – £6,337 million). Excluding ABN AMRO minority interest, REIL was £8,251 million, an increase of £1,914 million (30%) during the year. As a percentage of customer lending, REIL and PPL in aggregate, excluding ABN AMRO minority interest, show an improving trend, amounting to 1.49% of customer loans and advances at 31 December 2007 (2006 – 1.57%).

REIL by division

The table below shows REIL by division.

| | 2007 £m | 2006 £m | 2005 £m |
|--------------------------------------|---------------|--------------|--------------|
| REIL | | | |
| Corporate Markets | | | |
| – Global Banking & Markets | 373 | 492 | 496 |
| – UK Corporate Banking | 1,236 | 1,034 | 969 |
| Retail Markets | | | |
| – Retail | 4,286 | 4,078 | 3,783 |
| – Wealth Management | 45 | 43 | 58 |
| Ulster Bank | 667 | 498 | 436 |
| Citizens | 317 | 175 | 195 |
| Other | — | 17 | — |
| | 6,924 | 6,337 | 5,937 |
| ABN AMRO excluding minority interest | 1,327 | — | — |
| | 8,251 | 6,337 | 5,937 |
| ABN AMRO minority interest | 2,480 | — | — |
| Total REIL | 10,731 | 6,337 | 5,937 |

During 2007, REIL in Retail Markets increased by £210 million, Ulster Bank by £169 million and Citizens by £142 million.

Business review continued

Impairment loss provision methodology

Provisions for impairment losses are assessed under three categories as described below:

Individually assessed provisions are the provisions required for individually significant impaired assets which are assessed on a case by case basis, taking into account the financial condition of the counterparty and any guarantor. This incorporates an estimate of the discounted value of any recoveries and realisation of security or collateral. The asset continues to be assessed on an individual basis until it is repaid in full, transferred to the performing portfolio or written-off.

Collectively assessed provisions are provisions on impaired credits below an agreed threshold which are assessed on a portfolio basis, to reflect the homogeneous nature of the assets, such as credit cards or personal loans. The provision is determined from a quantitative review of the relevant portfolio, taking account of the level of arrears, security and average loss experience over the recovery period.

Latent loss provisions are provisions held against the estimated impairment in the performing portfolio which have yet to be identified as at the balance sheet date. To assess the latent loss within the portfolios, the Group has developed methodologies to estimate the time that an asset can remain impaired within a performing portfolio before it is identified and reported as such.

Provision analysis

The Group's consumer portfolios, which consist of small value, high volume credits, have highly efficient largely automated processes for identifying problem credits and very short timescales, typically three months, before resolution or adoption of various recovery methods.

Corporate portfolios consist of higher value, low volume credits, which tend to be structured to meet individual customer requirements. Provisions are assessed on a case by case basis by experienced specialists, with input from professional valuers and accountants as appropriate. The Group operates a provisions governance framework which sets thresholds whereby suitable oversight and challenge is undertaken. These opinions and levels of provision are overseen by each division's Provision Committee. Significant cases are presented to, and challenged by, the Group Problem Exposure Review Forum.

Early and active management of problem exposures ensures that credit losses are minimised. Specialised units are used for different customer types to ensure that the appropriate risk mitigation is taken in a timely manner.

Portfolio provisions are reassessed regularly as part of the Group's ongoing monitoring process.

The following table shows an analysis of the loan impairment charge.

| | Including ABN AMRO 2007 £m | Including ABN AMRO net of minority interest 2007 £m | Excluding ABN AMRO 2007 £m | 2006 £m | 2005 £m |
|---|-------------------------------------|---|-------------------------------------|--------------|--------------|
| Loan impairment charge | | | | | |
| Latent loss provisions charge | 88 | 25 | 2 | 87 | 14 |
| Collectively assessed provisions charge | 1,744 | 1,669 | 1,644 | 1,573 | 1,399 |
| Individually assessed provisions charge | 274 | 244 | 198 | 217 | 290 |
| Total charge to income statement | 2,106 | 1,938 | 1,844 | 1,877 | 1,703 |
| Charge as a % of customer loans and advances – gross (1) | 0.30% | 0.34% | 0.39% | 0.46% | 0.46% |

Note:

(1) Gross of provisions and excluding reverse repurchase agreements.

Provisions for loan impairment charged to the income statement in 2007 were £2,106 million. Excluding ABN AMRO minority interest, the charge was £1,938 million, up £61 million (3%) from 2006 and as a percentage of customer lending, the impairment charge was 0.34% (2006 – 0.46%).

Summary of loan impairment provisions

| | Including ABN AMRO 2007 £m | Including ABN AMRO net of minority interest 2007 £m | Excluding ABN AMRO 2007 £m | 2006 £m | 2005 £m |
|--|-------------------------------------|---|-------------------------------------|--------------|--------------|
| Loan impairment provisions (1) | | | | | |
| Latent loss provisions | 1,050 | 734 | 600 | 593 | 543 |
| Collectively assessed provisions | 3,834 | 3,167 | 2,996 | 2,645 | 2,587 |
| Individually assessed provisions | 1,554 | 1,060 | 637 | 695 | 754 |
| Total provisions | 6,438 | 4,961 | 4,233 | 3,933 | 3,884 |
| Total provision as a % of customer loans and advances – gross (2) | 0.9% | 0.9% | 0.9% | 1.0% | 1.0% |

Notes:

- (1) Excludes provisions against loans and advances to banks of £3 million (2006 – £2 million; 2005 – £3 million).
(2) Gross of provisions and excluding reverse repurchase agreements.

As at 31 December 2007 total customer provisions were £6,438 million. Excluding ABN AMRO minority interest, total customer provisions were £4,961 million, up £1,028 million (26%) from 31 December 2006.

Provisions coverage

The Group's provision coverage ratios are shown in the table below.

| | Including ABN AMRO 2007 | Including ABN AMRO net of minority interest 2007 | Excluding ABN AMRO 2007 | 2006 | 2005 |
|--|-------------------------------|---|-------------------------------|------|------|
| Total provision expressed as a: | | | | | |
| % of REIL | 60% | 60% | 61% | 62% | 65% |
| % of REIL and PPL | 56% | 59% | 61% | 62% | 65% |

The coverage ratio of closing provisions to REIL and PPL decreased from 62% to 56% during 2007. Excluding ABN AMRO minority interest, the coverage ratio was 59%. The lower coverage ratio reflects amounts written-off and the changing mix from unsecured to secured exposures.

Movement in loan impairment provisions balance

The movement in provisions balance is shown in the table below.

| | 2007 £m | 2006 £m |
|--|--------------|--------------|
| Balance as at 1 January | 3,935 | 3,887 |
| Currency translation and other adjustments | 137 | (61) |
| Acquisition of subsidiaries | | |
| – ABN AMRO excluding minority interest | 657 | — |
| – ABN AMRO minority interest | 1,547 | — |
| – Other | 6 | — |
| Amounts written-off | (2,171) | (1,841) |
| Recoveries of amounts previously written-off | 390 | 215 |
| Charge to income statement | 2,106 | 1,877 |
| Discount unwind (1) | (166) | (142) |
| Balance as at 31 December (2) | 6,441 | 3,935 |

Notes:

- (1) The impact of discounting inherent within the provisions balance is unwound as the time to receiving the expected recovery cash flows draws nearer.
(2) Includes provisions against loans and advances to banks of £3 million (2006 – £2 million).

An impairment provision calculated using the effective interest rate method leaves a discounted asset; the discount unwinds at a constant effective rate until the outstanding asset is completely realised.