Coventry Building Society

Pillar 3 Disclosures
31 December 2012

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1. Overview

1.1 Background

The European Union Capital Requirements Directive (CRD) came into effect on 1 January 2007. Commonly referred to as Basel II, the legislative framework introduced capital adequacy standards governing how much capital all banks and building societies must hold to protect their members, depositors and shareholders.

In the UK, implementation of the Directive has been through rules introduced by the Financial Services Authority (the FSA), now the Prudential Regulation Authority (PRA). These rules dictate the disclosure requirements relevant to banks and building societies, and are prescribed within Chapter 11 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU). These are known as Pillar 3 disclosures because they complement the minimum capital requirements in Pillar 1 and the supervisory review process in Pillar 2. The Pillar 3 disclosures are aimed at promoting market discipline by providing information on risk exposures and the management of those risks.

From 1 January 2008 the FSA granted the Society permission to use the Basel II Internal Ratings Based (IRB) approach to retail credit risk and capital management. This allows the Society to calculate capital requirements for prime owner occupied and buy-to-let mortgage exposures (excluding as at 31 December 2012, those transferred from the merger with Stroud & Swindon in 2010, and the mortgage book acquired from Bank of Ireland) using internally developed models that reflect the credit quality of the Society's and its subsidiaries' mortgage books. As at 31 December 2012, this covered over 90% of the mortgage and other loan assets held. This permission reflects the Society's detailed understanding of its customer base and credit risk profile. The Society applied to the PRA for permission to extend the IRB approach to include the Stroud & Swindon mortgages, which was approved in July 2013.

The IRB approach allows the Society to set capital levels using internally developed models rather than through standardised percentages defined within the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU). In line with industry best practice the Society continuously reviews the IRB models used and the assumptions within them. On at least an annual basis, external experts are engaged to independently review and comment on the performance and management of the IRB rating system.

For other exposures and risk areas the standardised approach is adopted, which uses capital risk weighting percentages set by the PRA.

1.2 Basis and frequency of disclosures

This document sets out the 2012 Pillar 3 disclosures for the Society. These disclosures have been prepared solely to give information on the basis of calculating Basel II requirements and on the management of risks faced by the Society in accordance with the rules laid out in BIPRU Chapter 11. The disclosures may differ from similar information in the Annual Report and Accounts 2012 prepared in accordance with International Financial Reporting Standards (IFRS); the information in these disclosures may therefore not be directly comparable with that information. All figures are as at 31 December 2012, the Society's year end, unless otherwise stated.

Disclosures are issued on an annual basis and published as soon as practicable after the publication of the Annual Report & Accounts.

1.3 Location and verification

These disclosures have been reviewed by the Society's Board Audit Committee on behalf of the Board, and by the Internal Audit function, but have not been, and are not required to be, subject to independent external audit. They are published on the Society's website www.thecoventry.co.uk.

1.4 Remuneration

In order to comply with the disclosure requirements of the Capital Requirements Directive (CRD) III and the PRA's Remuneration Code, the responsibilities and decision-making process for determining remuneration policy, the link between pay and performance and the design and structure of remuneration, including the performance pay plans, have been disclosed in the 2012 Annual Report & Accounts on pages 46 to 52. The 2012 Annual Report & Accounts are published on the Society's website www.thecoventry.co.uk/accounts2012.

1.5 Scope of disclosures

The Pillar 3 disclosures in this document relate to Coventry Building Society (PRA registered number 150892) and its subsidiary undertakings (together referred to as 'the Society'). The Society also includes the business combination that occurred in 2010 from the merger with the Stroud & Swindon Building Society. The subsidiary undertakings included within these disclosures are:

Subsidiary undertakings	PRA Registered number	Total assets £m	Total reserves £m	Principal activity
Godiva Mortgages Limited	457622	6,165	48	Mortgage lending
ITL Mortgages Limited	302608	936	12	Mortgage lending and mortgage acquisition vehicle
Stroud & Swindon Funding Company	n/a	-	-	In members' voluntary liquidation as at 31.12.12 (Dissolved on 10.03.13)
Stroud & Swindon Funding Company (No.2) Limited	n/a	-	-	In members' voluntary liquidation as at 31.12.12 (Dissolved on 10.03.13)
Five Valleys Property Company Limited	n/a	5	(2)	Investment properties holding company

All funding for the subsidiaries is provided by the Society. This consolidated treatment reflects the scope of the Society's solo consolidation waiver approval from the PRA. This means that for prudential purposes the Society and its subsidiaries can be viewed as a single entity. This is consistent with the basis of consolidation for accounting purposes.

The Society does not foresee any practical or legal impediments to the transfer of capital resources or the repayment of liabilities between Coventry Building Society and its subsidiary undertakings.

2. Risk management policies and objectives

2.1 Overview

The Society is a mutual organisation run for the long-term benefit of its members. This objective is known throughout the Society as 'Putting Members First'. In keeping with this mutual status, the Board adopts a prudent approach to managing risk geared towards long-term value creation for the benefit of members. This low risk appetite is monitored and enforced through the Society's risk management framework described below.

2.2 Risk management structure

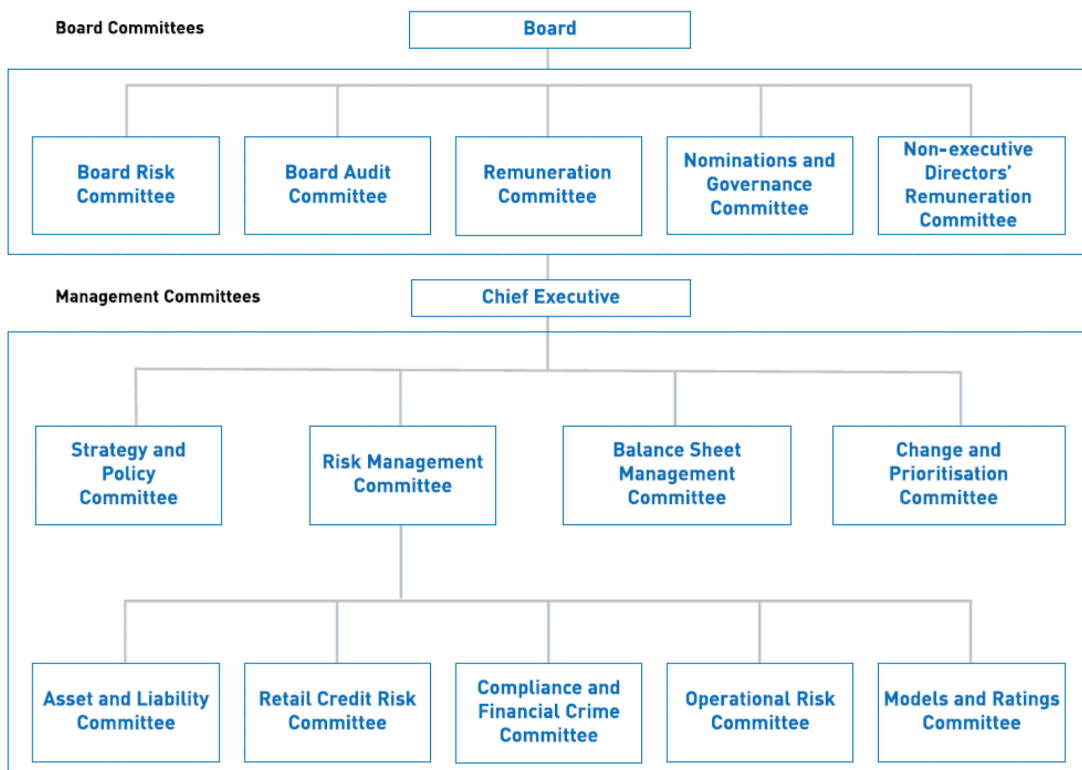
The Society's risk management structure is based on a three lines of defence model:

- **First line of defence –** risk management is primarily the responsibility of all managers and staff of the Society. Management have a responsibility to understand how risk impacts their area of the business and for putting in place controls or mitigating activities.

- **Second line of defence –** oversight is required to challenge managers and staff effectively in their performance of risk management activities and to provide risk management expertise. This is provided through risk support functions and risk committees. The Chief Risk Officer reports to the Chief Executive and has an independent reporting line directly to the Chairman of the Board Risk Committee.

- **Third line of defence –** the Society's internal audit function is responsible for independently reviewing the effectiveness of the Society's risk management structure and adherence to processes. The Head of Internal Audit reports to the Chief Executive and has an independent reporting line directly to the Chairman of the Board Audit Committee. The Board Audit Committee approves the work programme of internal audit and receives reports of the results on the work performed.

The structure and responsibility of management and Board Committees are set out below:



2.3 Governance and oversight of risk

Board

The Board is accountable to the Society's members for the overall direction and management of all affairs and business of the Society and places the highest priority on good corporate governance. The Board is responsible for setting the Society's strategy and risk appetite, and ensuring risk management is appropriate and effective. In carrying out these duties the Board is responsible for the Society's Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP brings together the risk management framework and the financial disciplines of business planning and capital management in order to assess for the Society:

- the significant risks to which it is exposed;
- the adequacy of its risk assessment and management; and
- the capital resources it needs to address its risk exposures over its planning horizon.

The Board is also responsible for the Individual Liquidity Adequacy Assessment (ILAA) which complements the solvency requirements of the ICAAP, providing the framework for the Society's management of Liquidity and Funding risks. In addition, there are other committees for managing certain risks that have their own terms of reference. Details are presented below.

Board Risk Committee

The Board Risk Committee is chaired by a non-executive director and membership is made up of two other non-executive directors, the Chief Executive, Finance Director, Chief Operating Officer and the Chief Risk Officer. In addition, the Head of Internal Audit and the Secretary and General Counsel attends Board Risk Committee Meetings. The Committee assists the Board in fulfilling its oversight responsibilities for risk management across the Society. In particular the Committee undertakes the following:

- oversees and advises the Board in relation to current and potential future risk exposures to the Society, including determination of risk appetite, risk limits and tolerances across the range of risks to which the Society may be exposed;
- satisfies itself on the design and completeness of the Society's internal control and assurance framework relative to the risks that it faces including culture, policy, processes, structure and systems; and
- reviews major initiatives, such as acquisitions or change projects, seeks assurance that appropriate due diligence has been carried out and that any associated movement in risks to which the Society may be exposed remains within risk appetite.

Board Audit Committee

The Board Audit Committee is chaired by a non-executive director and membership is made up of three other non-executive directors. The Society's external auditors, the Chief Executive, Finance Director, Secretary and General Counsel, Chief Risk Officer, Head of Internal Audit and also certain senior managers (if required) attend Board Audit Committee meetings. In addition, the external auditors meet members of the Committee in private sessions at least annually.

The responsibilities of the Committee are in line with the provisions of the Financial Reporting Council Guidance on Audit Committees. The main function of the Committee is to assist the Board in fulfilling its oversight responsibilities with specific regard to:

- monitoring the integrity of the half-year and annual financial statements and any formal announcements relating to financial performance, focusing particularly on significant financial reporting judgements contained in them;
- reviewing the adequacy of systems of internal control and risk management processes;
- approving the annual internal audit plan;
- monitoring the effectiveness of the external audit process and making recommendations to the Board on the appointment, re-appointment and remuneration of the external auditors;
- ensuring that an appropriate relationship between the Society and the external auditors is maintained, including reviewing non-audit services which can be provided and fees; and
- reviewing the effectiveness of the internal audit function. The Committee is responsible for approving the appointment and removal of the Head of Internal Audit.

Remuneration Committee

The Remuneration Committee consists exclusively of three non-executive directors and is chaired by the Senior Independent Director. The Committee is responsible for:

- considering and approving the remuneration of executive directors and senior management; and
- setting targets for the Society's performance related bonus scheme in which all staff members participate.

During 2012 the Committee reviewed the implications of the PRA's Remuneration Code and approved the Society's Remuneration Policy Statement on behalf of the Board. Further details of the Committee, the remuneration policy and directors' service contracts can be found in the Annual Report & Accounts on pages 46 to 52.

Nominations and Governance Committee

The Nominations and Governance Committee consists of the Chairman, Deputy Chairman and the Chief Executive of the Society. The Committee is responsible for making recommendations to the Board on matters relating to the composition of the Board (including Board succession planning, the appointment of new directors, the re-appointment of retiring directors, the appointment of non-executive and executive directors to Committees of the Board) and senior management appointments.

Non-executive Directors' Remuneration Committee

This Committee was established in 2012 and consists of the Chief Executive, the Finance Director and the Board Chairman. The Committee is responsible for considering and approving the remuneration of the non-executive directors, other than the Chairman, in accordance with the Society's Remuneration Policy Statement, and taking into account the roles undertaken by each director. Non-executive directors do not participate in the Society's performance related bonus scheme.

Strategy and Policy Committee

Chaired by the Chief Executive and comprised of the executive directors and senior management. This Committee meets when required and deals with matters that fall outside the mandates of other committees or where matters are escalated for review by other executive committees or business areas.

Risk Management Committee (RMC)

Chaired by the Chief Risk Officer and comprised of the executive directors and senior management. The minutes of the Committee are presented to the Board Risk Committee. The Committee's purpose includes:

- to obtain assurance that risk is being identified and managed effectively and consistently in accordance with the Society Risk Management Framework;
- to review and challenge the current and emerging risk portfolio against the Board's risk appetite;
- to oversee the adoption and application of the Society Risk Management Framework and monitor its effectiveness; and
- to ensure timely completion of actions taken in response to risk events or arising as a consequence of findings in audit or compliance reports.

The Society also has a number of sub-committees that report to the Risk Management Committee. The details of these committees are as follows:

Asset and Liability Committee (ALCO)

Chaired by the Finance Director and comprised of executive directors and senior management. The Committee oversees the asset and liability risks faced by the Society, specifically market risk, wholesale credit risk and liquidity risk. Further it recommends to the Board, through the Board Risk Committee, key treasury policy changes and risk frameworks for approval. The minutes of the Committee are presented to the Board Risk Committee.

The Committee's terms of reference include:

- to determine and implement an asset and liability management strategy for the Society;
- to determine strategy for, and exercise control over, the funding and lending activities of the Society;
- to develop and ensure compliance with the Board, approved risk management, liquidity and wholesale funding policies; and
- the setting and reviewing of assumptions for the Society's product pricing models.

Retail Credit Risk Committee

Chaired by the Chief Risk Officer and comprised of the executive directors and senior management. This Committee monitors the management of retail credit risk across the Society and its subsidiaries and the performance of the mortgage books to ensure compliance with limits approved by the Board. Further it recommends to the Board, through the Board Risk Committee, key lending policy changes and frameworks such as the retail credit risk appetite statement.

The Committee's terms of reference include:

- the setting and authorising of changes to lending policy, credit systems and credit processes;
- to ensure that the lending policy, credit systems and credit processes are designed to meet the volume, mix and quality of lending, as set by the corporate plan and agreed with the Board; and
- ensuring that the Society and its subsidiaries adopt policies and procedures in its lending activities which are responsible and deliver fair outcomes to its customers.

Compliance and Financial Crime Committee

The Committee is chaired by the Chief Risk Officer and membership is comprised of senior management. The Committee's primary purpose is to oversee the effective management of compliance and financial crime risks facing the Society and to ensure that appropriate and effective compliance and financial crime policies are in place for the key regulatory and financial crime risks faced by the Society.

The Committee's terms of reference include:

- to oversee the implementation of financial crime and compliance management frameworks to ensure that the Society is appropriately protected;
- to review and challenge the risk profile and management of operational functions; and
- to review and approve the relevant high level control policies.

Operational Risk Committee

Chaired by the Chief Operating Officer and comprised of senior management. Its purpose is to oversee and challenge the identification, measurement and management of operational risk including the controls, monitoring and reporting of those risks.

Its terms of reference provide that its purpose includes:

- to regularly review Operational Risk Practice, to ensure it is suitable for the management of operational risk;
- to ensure effective reporting, review, management of, and learning from, risk events, incidents and losses within the Society, mandating independent reviews as appropriate;
- to review and challenge the operational risk profile of the Society ensuring that residual risks are within the Society's risk tolerance or an appropriate Risk Acceptance has been approved;
- to consider and respond to emerging risks by monitoring external risk events and key operational risk indicators;
- to monitor that appropriate and effective operational risk management is in place to meet The Standardised Approach (TSA) to Operational Risk, as defined by Basel II and regulated by the PRA;
- to oversee the Society's operational risk stress testing and support the development of operational risk scenarios and events which will challenge and educate the capital adequacy, management and planning process; and
- to recommend the Society's operational risk tolerance for approval by RMC and Board Risk Committee.

Models and Ratings Committee

Chaired by a non-executive director and comprised of executive directors and senior management, this Committee monitors the performance of the Society's Basel II credit risk rating system and its use across the Society.

The committee's terms of reference include:

- to ensure compliance with the Basel II Accord and approve the resulting capital requirements;
- to approve the rating system and any subsequent amendments;
- to ensure that appropriate action is taken to address issues raised from performance monitoring; and
- to perform ongoing and formal annual reviews of the accuracy, adequacy and use of the rating system.

Balance Sheet Management Committee

Chaired by the Finance Director and comprised of executive directors and senior management. This Committee oversees the financial performance and balance sheet strategy of the Society, including product management, pricing and margin management of the retail savings and lending portfolios.

The Committee's terms of reference provide that its purpose is:

- to determine and implement an asset and liability management strategy for the Society with the objective of achieving the Corporate Plan and remain within Board approved risk appetites;
- overseeing product management, pricing and profitability of the retail savings and lending portfolios;
- ensuring optimal return on capital deployed and margin outcomes for the Society; and
- approval and maintenance of product pricing processes, such that consistent measure is applied ensuring that the consequent blend of volume, product mix, credit quality and margin are appropriate for both retail assets and liabilities achieving the required margin over the hurdle rate.

Change and Prioritisation Committee

Chaired by the Chief Operating Officer and comprised of the executive directors and senior management. This Committee is responsible for prioritisation and approval of all projects, including project expenditure, in line with the Society's Corporate Plan.

The Committee's purpose is as follows:

- to prioritise resource conflicts between projects;
- to agree and monitor overall portfolio of Corporate Projects, reviews projects that are amber or red status, may request specific assurance on the status of any project and may challenge viability or value of projects currently in progress; and
- to act as an escalation point for issues not resolvable elsewhere:

2.4 Risk monitoring and reporting

The Society maintains an independent risk management function that is responsible for ensuring that appropriate risk management techniques and measures are deployed. The Chief Risk Officer provides a formal update to each Board Risk Committee covering all areas of risk management, including both routine reporting and ad hoc issues, which is then summarised and presented to the Board. Relevant risk reporting is escalated through the appropriate committees which monitor and manage the Society's risk exposures in line with its risk appetite and tolerance framework. There is a hierarchy of reporting which acts as a filter to ensure that senior committees receive prioritised reporting that focuses on the current key issues relevant to the Society.

3. Capital resources

3.1 Compliance with capital requirements

Throughout 2012 the Society has complied in full with all of its externally imposed capital requirements. The table below provides a breakdown of the components of capital available to the Society as at 31 December 2012.

Capital available

	Notes	As at 31 December 2012 Per Statutory Balance Sheet[1] £m	Regulatory adjustments £m	As at 31 December 2012 Regulatory Capital £m	As at 31 December 2011 Regulatory Capital £m
Tier 1					
General reserve		**811.4**	**-**	**811.4**	747.9
Pension fund surplus adjustment		**(10.1)**	**-**	**(10.1)**	(3.9)
Intangible assets		**(9.2)**	**-**	**(9.2)**	(9.5)
Deductions from tier 1 capital	2	**n/a**	**n/a**	**(9.6)**	(9.2)
Core tier 1 capital				**782.5**	725.3
Permanent Interest Bearing Shares	3	**161.4**	**(1.4)**	**160.0**	160.0
Total tier 1 capital				**942.5**	885.3
Tier 2					
Collective provisions for impairment	4	**0.4**	**-**	**0.4**	0.4
Subordinated debt	5	**58.1**	**(2.6)**	**55.5**	67.0
Deductions from tier 2 capital	2	**n/a**	**n/a**	**(9.6)**	(9.2)
Total tier 2 capital				**46.3**	58.2
Total capital				**988.8**	943.5
IRB approach					
Credit risk – Retail exposures				**2,034.0**	1,920.7
Standardised approach					
Credit risk – Retail exposures				**857.6**	776.7
Credit risk – Liquidity book				**201.2**	199.0
Credit risk – Other				**43.8**	83.9
Operational risk				**230.6**	202.4
Risk-weighted assets				**3,367.2**	3,182.7
Core tier 1 ratio (as a percentage of risk exposure amount)				**23.2%**	**22.8%**

1. Details of the Group's balance sheet can be found in the 2012 Annual Report & Accounts (www.thecoventry.co.uk/accounts2012).
2. Under Basel II, a deduction is made for the excess of expected losses on loans and advances to customers, calculated on an IRB basis, over accounting provisions, and are allocated 50% to tier 1 and 50% to tier 2 capital.
3. Permanent Interest Bearing Shares - principal amount outstanding only, adjustments relate to the deduction of accrued interest.
4. Under Basel II, collective provisions for impairment relating to loans and advances to customers, calculated on a standardised basis, are included as tier 2 capital.
5. Subordinated debt – principal amount outstanding only, adjustments relate to the deduction of accrued interest, and if in the last five years to maturity, amortisation on a straight line basis.

Tier 1 capital

Tier 1 capital comprises the general reserve, Permanent Interest Bearing Shares and adjustments for the defined benefit pension fund surplus. Intangible assets do not qualify as capital for regulatory purposes and are deducted from capital. The Society's Available-for-sale reserve is excluded from tier 1 capital. The Society has £160 million of Permanent Interest Bearing Shares which is made up of the following:

	Call date	Group 2012 £m	Group 2011 £m
Permanent interest bearing shares 1992 - 12 1/8%	n/a	**40.0**	40.0
Permanent interest bearing shares 2006 - 6.092%	June 2016	**120.0**	120.0
Total		**160.0**	160.0

Interest is paid in arrears on £40 million permanent interest bearing shares at the rate of 12 1/8% per annum in half-yearly instalments, and on £120 million permanent interest bearing shares at the rate of 6.092% per annum in half-yearly instalments. The shares are repayable only in the event of a winding up of the Society or otherwise with the prior consent of the PRA. In a winding up or dissolution of the Society

the claims of the holders of Permanent Interest Bearing Shares would rank behind all other creditors of the Society including subordinated liabilities and the claims of members holding shares as to principal and interest. The holders of Permanent Interest Bearing Shares are not entitled to any share in any final surplus upon a winding up or final dissolution of the Society.

Tier 2 capital

Tier 2 capital comprises subordinated debt and the collective impairment provisions, for impairment relating to loans and advances to customers, calculated on a standardised basis. As at 31 December 2012 the Society has £57 million of subordinated debt which is made up of the following:

Subordinated note	Maturity date	Option to call date	Step up date	Type	Amount
Fixed rate subordinated notes 2016	4 December 2016	No option	n/a	Fixed 12.25%	£7 million
Fixed rate subordinated notes 2021	8 November 2021	8 November 2016	n/a	Fixed 6.12%	£10 million
Fixed rate subordinated notes 2022	25 June 2022	23 June 2017	23 June 2017	Fixed 6.469%	£15 million
Fixed rate subordinated notes 2026	29 August 2026	29 August 2021	n/a	Fixed 6.33%	£10 million
Fixed rate subordinated notes 2032	23 August 2032	23 August 2027	n/a	Fixed 7.54%	£15 million

In June 2012 the Society, with the consent of the PRA, redeemed early the £10.0 million 8.37% subordinated loan due 3 June 2017 at par.

The rights of repayment of the holders of the notes are subordinated to the claims of all depositors, creditors and shareholders in the Society, as regards the principal of the notes and interest due on them. The notes are repayable at the dates stated, or earlier in accordance with their terms at the option of the Society, with the prior consent of the PRA.

3.2 Impact of Basel III

The European Parliament and Council have now approved new capital reforms (referred to as CRD IV), which implement Basel III into Europe. The objective of the reform package is to improve the banking sector's ability to absorb shocks arising from financial and/or economic stress, thus reducing the risk of spill-over from the financial sector into the real economy. CRD IV legislation comes into force on 1 January 2014. The key elements of CRD IV are to be as follows:

- **Quality of capital**

CRD IV brings more stringent requirements for the eligibility of capital instruments with a focus on common equity (primarily reserves) as the principal component of regulatory tier 1 capital, and changes to the regulatory deductions from common equity. It sets a minimum of tier 1 capital at 6% of risk weighted assets (RWAs), of which common equity tier 1 (CET1) is required to be a minimum of 4.5% of RWAs. The total of tier 1 and tier 2 capital is to be a minimum of 8% of RWAs.

Basel III applies the principle that tier 1 capital is available to absorb losses of the business on a 'going concern' basis. The Society's Permanent Interest Bearing Shares (PIBS) are not designed to do this, and therefore will not be eligible as tier 1 capital. These PIBS will be 'grandfathered' and recognised as additional tier 1 capital on an amortising basis over 10 years from 1 January 2013, or to the call date if earlier. Of the Society's PIBS, £120m will no longer be eligible as tier 1 capital from their call date in June 2016.

Basel III requires tier 2 capital to absorb losses on a 'gone concern' basis when a business reaches a 'point of non-viability'. The Society's subordinated debt has no mechanism for recognising that point and so will be grandfathered as tier 2 capital in the same way as the Society's PIBS. The Society is monitoring market developments and may consider issuing Basel III compliant capital instruments should the market present favourable opportunities to do so. A number of rule changes were approved at the 2013 AGM that support the issuance of Basel III compliant instruments.

- **Capital Buffers**

To promote the conservation of capital and the build up of adequate buffers that can be drawn down in periods of stress, CRD IV requires the use of common equity capital buffers. A capital conservation buffer of 2.5% of RWAs is to be built up during times of positive growth. A countercyclical capital buffer of up to an additional 2.5% of RWAs is to be built up when credit growth exceeds GDP growth, thus allowing firms to use this additional buffer in times of stress. In addition, the prudential regulator is expected to identify globally and other systemically important institutions and set additional capital buffers on these bases. It may also determine the appropriateness of a macro-prudential systemic risk buffer applicable to subsets of the financial sector or the sector as a whole. According to the CRD IV text, these will come into force from 1 January 2016 and increase gradually until full implementation in 2019. However, the CRD IV text allows local regulators to impose a shorter transitional period. The extent to which these will overlap with current capital planning buffers is not yet determined.

- **Counterparty credit risk**

An additional capital charge for credit valuation adjustment risk will be required. The charge arises from the use of derivative instruments to manage interest rate and foreign exchange risk. The impact for the Group is expected to be immaterial.

- **Leverage**

CRD IV introduces a non-risk based leverage ratio that is calibrated to act as a supplementary measure to the risk based capital requirements and is intended as a backstop measure. The calculation determines a ratio based on the relationship between tier 1 capital and total on and off-balance sheet assets. The leverage ratio does not distinguish between unsecured and secured loans or recognise the ratio of loan to collateral value of secured lending. Consequently the leverage ratio has the potential to act as a primary constraint on low risk mortgage lenders even, as is the case for the Society, where strong underlying collateral exists. Basel III sets the minimum level of this ratio at 3%. However, this proposed measure does not come into effect until 2018. As at 1 January 2013 based on the Society's interpretation of the published CRR text, the leverage ratio was 3.3%, applying first year transitional provisions.

- **Harmonisation of national regulations**

Basel III is implemented in the EU via a regulation and a directive. The provisions of the regulation will apply directly to firms in the EU without further national discretion. Furthermore, CRD IV attempts to harmonise national regulation across the European Union via implementation of a single rule book. Local regulators will be able to apply stricter requirements only on macro-prudential grounds or because of a firm's specific risk profile.

Basel III had no effect in 2012, and the Society has considered the impact of the introduction of these rules on future levels of capitalisation, including under stress-testing within its capital plan. The directors consider that the Society will continue to remain well capitalised. A draft proforma presentation of the Society's capital on a Basel III basis reflecting the first year of transitional provision is presented overleaf. These have been updated since the publication of the 2012 Annual Report & Accounts, and are based upon the Society's interpretation of the final published CRR text:

	Notes	Basel II 31.12.2012 £m	Basel III Adjustments £m	Basel III 1.1.2013 £m
Common equity tier 1 capital				
General reserve		**811.4**	**-**	**811.4**
		811.4	**-**	**811.4**
Regulatory deductions				
Unrealised losses from Available-for-sale assets	1	**-**	**(2.5)**	**(2.5)**
Pension fund surplus adjustment	2	**(10.1)**	**2.3**	**(7.8)**
Intangible assets		**(9.2)**	**-**	**(9.2)**
Deferred tax assets	3	**-**	**(0.6)**	**(0.6)**
Deductions from tier 1 capital	4	**(9.6)**	**(2.9)**	**(12.5)**
Total common equity tier 1 capital		**782.5**	**(3.7)**	**778.8**
Additional tier 1 capital				
Permanent Interest Bearing Shares	5	**160.0**	**(32.0)**	**128.0**
Deductions from additional tier 1 capital	4,6	**-**	**(2.5)**	**(2.5)**
Total additional tier 1 capital		**160.0**	**(34.5)**	**125.5**
Total tier 1 capital		**942.5**	**(38.2)**	**904.3**
Tier 2				
Collective provisions for impairment		**0.4**	**-**	**0.4**
Subordinated debt	5	**55.5**	**(11.1)**	**44.4**
Deductions from tier 2 capital		**(9.6)**	**(0.4)**	**(10.0)**
Total tier 2 capital		**46.3**	**(11.5)**	**34.8**
Total capital		**988.8**	**(49.7)**	**939.1**
IRB approach				
Credit risk – Retail exposures		**2,034.0**	**-**	**2,034.0**
Standardised approach				
Credit risk – Retail exposures		**857.6**	**-**	**857.6**
Credit risk – Liquidity book	7	**201.2**	**0.8**	**202.0**
Credit risk – Other	8	**43.8**	**11.8**	**55.6**
Credit valuation adjustment risk	9	**-**	**125.0**	**125.0**
Operational risk		**230.6**	**-**	**230.6**
Risk-weighted assets		**3,367.2**	**137.6**	**3,504.8**
Common equity tier 1 (as a percentage of risk exposure amount)		**23.2%**		**22.2%**
Tier 1 (as a percentage of risk exposure amount)		**28.0%**		**25.8%**
Total capital (as a percentage of risk exposure amount)		**29.4%**		**26.8%**
Leverage ratio (applying first year transitional provisions)				**3.3%**

1. Under Basel III an adjustment for losses on assets held available-for-sale is required.
2. Under Basel III an adjustment for the associated deferred tax liability is required.
3. Under Basel III a transitional adjustment of 20% of deferred tax assets that rely on future profitability is required.
4. Under Basel III, an adjustment for the tax effect is no longer applicable.
5. Under Basel III a transitional deduction of 20% of the Society's Permanent Interest Bearing Shares and Subordinated debt is made.
6. Under the Basel III transitional rules, applicable on 1 Jan 2014, 20% of the expected losses adjusted for provisions is deducted from common equity tier 1 with the residual 80% split equally between other tier 1 capital and tier 2 capital. As the Society already provides for 50% of the expected losses adjusted for provisions in common equity tier 1 under Basel II, 10% of the expected losses is transferred from tier 2 to tier 1 under Basel III.
7. Adjustment for assets which carry a higher risk-weighting under Basel III.
8. Under Basel III where deferred tax assets arising from temporary differences are below the minimum level to be treated as a deduction from capital, they receive a risk weighting of 250%.
9. Basel III requires the inclusion of a capital charge relating to credit valuation adjustment risk.

4. Capital adequacy

4.1 Capital management

The Society's capital management objective is to maintain sufficient capital resources to ensure the financial security of the Society. In order to maintain this capital the Society needs to generate and retain profits that will add to the general reserves, the main source of capital.

4.2 Internal Capital Adequacy Assessment Process

The Society internally assesses its capital requirements through the Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP brings together the risk management framework and the financial disciplines of business planning and capital management in order to assess for the Society:

- the significant risks to which it is exposed;
- the adequacy of its risk assessment and management; and
- the capital resources it needs to address its risk exposures over its planning horizon.

4.3 Challenge and adoption of the ICAAP

The ICAAP document is prepared by the Society's finance team, working in conjunction with the credit risk, treasury, operational risk and compliance functions. The ICAAP is considered within the overall strategic planning process, which maintains a strong focus on the ability of the Society's Corporate Plan to generate sufficient capital to meet the requirements of balance sheet growth, making an accounting profit in each year and other factors.

The ICAAP is reviewed by senior members of ALCO to ensure that management are given the opportunity to challenge the scope of the risks within the ICAAP and confirm that the capital requirements are appropriate. The ICAAP is then reviewed by the Board Risk Committee prior to recommendation to, and approval by, the Board. The Society's internal audit function annually reviews the accuracy and consistency of the financial information included within the ICAAP document.

4.4 Minimum capital requirement – Pillar 1

The Society's minimum capital requirement under Pillar 1 is the sum of the credit risk capital requirement and the operational risk capital requirement.

The credit risk capital requirement is largely dependent upon residential mortgage capital calculated under the IRB approach. The remaining credit risk capital requirement is calculated using the standardised approach. The capital requirement under both the IRB and standardised approach is calculated as 8% of the risk weighted exposure amounts for each of the applicable credit risk exposure classes. The operational risk capital requirement is calculated using the standardised approach.

The following table shows the Society's assessment of its overall minimum capital requirement:

	As at 31 December 2012 £m	As at 31 December 2011 £m
IRB approach		
Credit risk – Retail exposures	**162.7**	153.7
Standardised approach		
Credit risk – Retail exposures	**68.6**	62.1
Credit risk – Liquidity book	**16.1**	15.9
Credit risk – Other	**3.5**	6.7
Operational risk	**18.5**	16.2
Total minimum capital requirement	**269.4**	254.6
Total capital resources	**988.8**	943.5
Total capital resources surplus over requirement	**719.4**	688.9

The increase in retail exposures assessed under the IRB approach are a result of the organic growth of the Society and Godiva Mortgages Limited. The increase in retail exposures under the standardised approach is due to the acquisition of a small UK mortgage book (£500m) during 2012 from the Bank of Ireland. There have been no other significant movements during the year.

5. Risks and their management

5.1 Overview

The Society seeks to understand and manage the various risks that arise from its operations. The principal risks facing the Society and the procedures put in place to manage them are described below.

The Society defines the significant risks it faces in a number of categories. These are:

- credit risk;
- market risk;
- liquidity risk;
- operational risk, including conduct risk;
- business risk;
- concentration risk; and
- pension obligation risk.

5.2 Credit risk

Credit risk is the risk that customers or counterparties will not be able to meet their financial obligations to the Society as they fall due. Credit risk is sub-divided into:

- credit risk for retail exposures; and
- credit risk for the treasury liquidity book and derivatives.

5.2.1 Credit risk exposures

The exposures below are stated before credit risk mitigation techniques have been employed.

The gross credit risk exposure and the average for the period is as follows:

	Notes	**Average 1 January 2012 - 31 December 2012 £m**	**As at 31 December 2012 £m**	Average 1 January 2011 - 31 December 2011 £m	As at 31 December 2011 £m
Residential mortgages	1	**20,557.3**	**21,951.1**	18,324.6	19,163.4
Unsecured and other lending	1, 2	**72.2**	**67.8**	82.3	76.6
Total		**20,629.5**	**22,018.9**	18,406.9	19,240.0
Treasury:					
Central banks and sovereigns	1	**3,470.3**	**3,316.7**	2,872.2	3,365.1
Multilateral development banks (supranational bonds)	3	**202.9**	**217.2**	148.6	188.7
Financial institutions	1,3	**766.6**	**738.0**	1,353.4	1,054.1
Residential Mortgage Backed Securities (RMBS)	3	**219.0**	**204.2**	297.4	233.7
Local authorities	1	**0.3**	**-**	15.4	0.5
Total		**4,659.1**	**4,476.1**	4,687.0	4,842.1
Total		**25,288.6**	**26,495.0**	23,093.9	24,082.1

The geographical distribution of credit exposures are as follows:

As at 31 December 2012	**Notes**	**United Kingdom £m**	**Rest of Europe £m**	**Rest of the World~ £m**	**Total £m**
Residential mortgages	1	**21,951.1**	**-**	**-**	**21,951.1**
Unsecured and other lending	1, 2	**67.8**	**-**	**-**	**67.8**
Total		**22,018.9**	**-**	**-**	**22,018.9**
Treasury:					
Central banks and sovereigns	1	**3,316.7**	**-**	**-**	**3,316.7**
Multilateral development banks (supranational bonds)	3	**-**	**217.2**	**-**	**217.2**
Financial institutions	1,3	**469.3**	**243.1**	**25.6**	**738.0**
Residential Mortgage Backed Securities (RMBS)	3	**204.2**	**-**	**-**	**204.2**
Total		**3,990.2**	**460.3**	**25.6**	**4,476.1**
Total		**26,009.1**	**460.3**	**25.6**	**26,495.0**

As at 31 December 2011	Notes	United Kingdom £m	Rest of Europe £m	Rest of the World £m	Total £m
Residential mortgages	1	19,163.4	-	-	19,163.4
Unsecured and other lending	1, 2	76.6	-	-	76.6
Total		19,240.0	-	-	19,240.0
Treasury:					
Central banks and sovereigns	1	3,365.1	-	-	3,365.1
Multilateral development banks (supranational bonds)	3	-	188.7	-	188.7
Financial institutions	1,3	539.2	466.8	48.1	1,054.1
Residential Mortgage Backed Securities (RMBS)	3	233.7	-	-	233.7
Local authorities	1	0.5	-	-	0.5
Total		4,138.5	655.5	48.1	4,842.1
Total		23,378.5	655.5	48.1	24,082.1

The residual maturity of the exposures are as follows:

As at 31 December 2012	Notes	**Up to 12 months £m**	**1-5 years £m**	**5-10 years £m**	**More than 10 years £m**	**Total £m**
Residential mortgages	1	**1,764.0**	**6,112.2**	**6,155.9**	**7,919.0**	**21,951.1**
Unsecured and other lending	1, 2	**4.1**	**13.7**	**15.8**	**34.2**	**67.8**
Total		**1,768.1**	**6,125.9**	**6,171.7**	**7,953.2**	**22,018.9**
Treasury:						
Central banks and sovereigns	1	**1,719.0**	**174.7**	**1,222.7**	**200.3**	**3,316.7**
Multilateral development banks (supranational bonds)	3	**30.0**	**168.8**	**18.4**	**-**	**217.2**
Financial institutions	1,3	**652.7**	**62.2**	**19.1**	**4.0**	**738.0**
Residential Mortgage Backed Securities (RMBS)	3	**-**	**32.3**	**21.0**	**150.9**	**204.2**
Total		**2,401.7**	**438.0**	**1,281.2**	**355.2**	**4,476.1**
Total		**4,169.8**	**6,563.9**	**7,452.9**	**8,308.4**	**26,495.0**

As at 31 December 2011	Notes	Up to 12 months 2011 £m	1-5 years 2011 £m	5-10 years 2011 £m	More than 10 years 2011 £m	Total 2011 £m
Residential mortgages	1	1,536.0	5,328.5	5,381.0	6,917.9	19,163.4
Unsecured and other lending	1, 2	5.0	14.9	17.2	39.5	76.6
Total		1,541.0	5,343.4	5,398.2	6,957.4	19,240.0
Treasury:						
Central banks and sovereigns	1	1,583.6	350.6	953.8	477.1	3,365.1
Multilateral development banks (supranational bonds)	3	-	138.4	50.3	-	188.7
Financial institutions	1,3	972.2	61.4	17.0	3.5	1,054.1
Residential Mortgage Backed Securities (RMBS)	3	-	31.2	20.6	181.9	233.7
Local authorities	1	0.5	-	-	-	0.5
Total		2,556.3	581.6	1,041.7	662.5	4,842.1
Total		4,097.3	5,925.0	6,439.9	7,619.9	24,082.1

Notes:
1. Held at amortised cost using the effective interest method and after deduction of impairment provisions where appropriate.
2. Other lending includes loans fully secured on land.
3. Held at fair value.

The maturity of exposures is shown on a contractual basis and does not take into account any instalments receivable over the life of the exposure.

5.2.2 Credit risk for retail exposures

- **Lending**

For a building society, this risk is most likely to present itself in the potential inability of borrowers to repay their mortgage. The Society's exposure to this risk is monitored by a specialist department that reports to the Chief Risk Officer, and is overseen by the Society's Retail Credit Risk Committee. The activities of, and decisions made in, the Retail Credit Risk Committee are overseen by the RMC and the Board Risk Committee.

The Retail Credit Risk Committee meets monthly, and is tasked with ensuring that the quality and mix of new lending and overall portfolio exposures are within the prudent limits and risk appetite set by the Board, and ensuring that adequate controls are in place to maintain the quality of lending. This includes setting, reviewing and monitoring lending policy, comprehensive credit risk management information and trend analysis on both new lending and the loan portfolio, including monitoring against available comparative data.

Retail credit risk is managed through a combination of an automated decision system and statistical modelling (including the use of credit scoring) that seeks to identify those customers who pose a greater risk of not repaying their mortgage, and the Society's underwriting process which seeks to ensure that customers only assume a debt that they can afford to repay, thereby safeguarding both themselves and the Society. This system assesses both the application and external credit bureau information against the Society's scorecard and lending policy rules, providing consistent lending decisions and ensuring that, where risk is higher, there is appropriate manual skilled underwriter intervention. There is a comprehensive quality assurance programme to monitor the quality of lending decisions and adherence to lending policy. Retail credit risk is further mitigated by the application of loan to value (LTV) policy rules, which form a key element of mortgage product design. This ensures the Society has prudent collateral levels, even in the event of a fall in property values.

The Society has a quantitative and qualitative retail credit risk appetite statement which is approved by the Board. Regular stress testing is undertaken which seeks to establish the extent to which losses may emerge under a range of macro-economic and specific stress scenarios and to ensure that the Society continues to remain within its retail credit risk appetite. These stress tests primarily consider the frequency and severity of default and house price movements as may be affected by economic events.

- **Arrears**

The Retail Credit Risk Committee monitors arrears and the policy and strategy for recoveries. A specialist team works with borrowers in financial hardship or difficulty to resolve matters and each case is reviewed on its own merit. The overarching aim is to collect arrears and to regularise payments, using possession as a last resort or where it is the only credible option. Reasonable and realistic arrangements will be accepted, based on what the customer can afford, provided in the longer term there is a high degree of confidence the debt will reduce. Repossession of a property is only sought where all reasonable efforts to regularise matters have failed or the mortgage is unsustainable in the longer term. Regular reviews of the Society's arrears management function and processes are independently undertaken to ensure that borrowers are being treated fairly, appropriately and sympathetically and in line with established policies and procedures and regulatory guidance.

All loans one or more months in arrears are considered as past due or impaired and the Society has an established methodology for calculating impairment and providing for potential losses on these cases. This includes an assessment of the likelihood of default and possession and an estimate of the collateral value that will be realised at a future possession date. The Society makes prudent assumptions for those values and does not assume any future recovery in house prices. All assumptions are regularly reviewed.

- **Forbearance and Impairment**

Forbearance occurs when, for reasons relating to the actual or apparent financial stress of a borrower the Society grants a concession, whether temporarily or permanently, to that borrower, provided it is satisfied that the mortgage can revert back to sustainable terms within a reasonable period.

Forbearance is most commonly associated with the treatment of arrears cases, which are looked at on an individual case by case basis. Should borrowers find themselves in financial difficulty resulting in arrears, the Society will seek to help and work with them to resolve matters subject to the mortgage being put back on to a sustainable footing in the longer term.

The principal forbearance measures provided by the Society on arrears cases are as follows:

- Arrangements, where larger monthly payments are maintained and the arrears are repaid over a period of time;
- Concessions, where it is agreed to accept the normal monthly payment, reduced payments, or in exceptional circumstances no repayments for a short period; and
- Mortgage term extensions to reduce the amount of the monthly payment may be considered as part of a longer term solution, provided that payments will be sustainable over the life of the mortgage.

Where appropriate the Society has provided for the likelihood of default for any loans subject to forbearance. In 2013 the Society has developed a forbearance strategy approved by the Board and additional management information to monitor loans which have been subject to a forbearance event.

Further information on forbearance can be found on pages 29 and 30 of the Annual Report & Accounts.

5.2.2.1 IRB rating system- retail exposures

The Society has obtained permission to use the retail IRB approach to determine the required level of capital to support the majority of its credit risk for retail exposures. All lending is covered by the IRB approach with the exception of the following, where capital is calculated using the standardised approach:

- unsecured personal loans;
- lifetime mortgages (equity release);
- housing association loans;
- credit impaired loans;
- mortgages acquired as a result of the merger with Stroud & Swindon; and
- mortgages acquired from Bank of Ireland.

The internal rating model and process

The Society has built a set of internal rating models, based on its own data, that assess the credit risk of over 90% of the residential mortgages on its book. Assets acquired as a result of the merger with Stroud & Swindon and acquired from the Bank of Ireland continue to be assessed under the standardised approach. The Society intends to assess mortgages acquired from Stroud & Swindon under the IRB approach in its 2013 disclosures.

The models that provide the rating of credit risk are split into two types:

- probability of default model; and
- loss given default model.

- **Probability of default model**

The Society uses a probability of default (PD) model to determine the risk of default of a mortgage within the retail IRB exposure class. The PD model is built on a default definition of six or more months in arrears in the next twelve months, or earlier if there is an indication that the borrower is unlikely to repay (e.g. if the borrower is less than six months in arrears but has been made bankrupt or has entered into an Individual Voluntary Arrangement). This definition complies with the provision in BIPRU.

The PD model uses internal data about the borrower and property, and external data in the form of regularly updated credit bureau information, to derive a credit score for each borrower within the IRB exposure class. The score is then calibrated to a PD prediction. The individual components of the PD model comprise an application model and a behavioural model.

The application model assesses the risk of default of new applications and is built using a combination of loan data and borrower credit details. The application model provides a point-of-application assessment (via the application credit score, which is calibrated to long run PD via a series of risk grades).

The behavioural model is built using a combination of internal mortgage performance data with regular updates of the borrower's credit behaviour. The behavioural model produces a behaviour credit score which is also calibrated to PD.

Either the application PD (for new accounts), behavioural PD (for seasoned accounts), or a blend of the two (for accounts that have been open for a short period but are not yet considered seasoned) is taken to be the overall PD rating for the mortgage.

- **Loss given default model**

The Society also uses a loss given default (LGD) model which is calibrated to downturn conditions.

There are a number of sub-models, built using internal data from the last downturn in the early 1990s, which contribute to the overall LGD model. These include models to assess the likelihood of repossession once an account defaults, the forced sale discount that is likely to be experienced in selling a property from possession (the 'haircut') and, if repossessed, the likelihood and amount of loss.

The combination of PD and LGD models is used to determine the expected loss and capital requirement for all mortgages within the retail IRB exposure class.

Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements (£20.9m) consistent with IFRS differs from the amount determined from the expected loss models (£45.7m) that are used for regulatory purposes.

- **Allocation of exposures to risk grades by the IRB rating system**

The exposure values relating to the Society's retail exposures, by risk grade (where 1 is the lowest risk grade), are as follows:

	Notes	**Outstanding loans 2012 £m**	**Undrawn loans 2012 £m**	Outstanding loans 2011 £m	Undrawn loans 2011 £m
Risk grades:					
1		**15,854.4**	**513.6**	13,386.6	528.5
2		**3,543.8**	**213.1**	3,280.1	59.8
3		**762.5**	**51.7**	826.1	6.6
4		**210.2**	**1.2**	210.9	2.4
5		**98.7**	**-**	113.7	-
Past due		**307.2**	**-**	299.9	-
Total IRB (Exposure At Default)		**20,776.8**	**779.6**	18,117.3	597.3
Standardised		**2,151.2**	**81.9**	1,897.9	91.9
Total retail exposures	1	**22,928.0**	**861.5**	20,015.2	689.2

1. Stated at values before applying the effective interest method and before deduction of impairment provisions.

The following table sets out the IRB capital calculation in more detail, providing an analysis of Exposure At Default (EAD), LGD, and risk weighted assets by PD bands:

PD bands up to:	**Exposure at default estimate 2012 £m**	**Average loss given default 2012 %**	**Average risk weight 2012 %**	**Exposure at default estimate 2011 £m**	**Average loss given default 2011 %**	**Average risk weight 2011 %**
0.30	**16,368**	**8.4**	**2.9**	13,918	8.0	2.8
1.00	**3,757**	**14.3**	**12.9**	3,340	14.5	12.8
3.00	**717**	**22.5**	**47.1**	724	23.8	48.3
10.00	**308**	**22.0**	**70.6**	319	22.4	71.8
100.00	**263**	**21.2**	**104.5**	269	21.0	104.5
In Default	**143**	**21.6**	**173.0**	144	21.7	171.3
Total	**21,556**			18,714		

- **Treatment of undrawn exposures**

The Society at any point has a number of undrawn exposures that it assigns ratings to using the IRB rating system. These undrawn exposures relate to mortgage applications that have reached the 'offer' stage, i.e. where we have agreed to advance the funds, but completion of the mortgage has not yet taken place. In theory, these offers are unconditionally cancellable by the Society; in practice, we would only cancel an offer if adverse information is received, for example via a late notification from a solicitor. In some cases, offers will not be taken up by the customer and will expire. We assume however that all offers will complete, and therefore, assign a conversion factor of 100% to these undrawn exposures.

At 31 December 2012, the value of undrawn exposures was £779.6m (2012: £597.3m). The value of undrawn exposures varies considerably at different points in time depending on whether the Society has actively sought to take large volumes of new mortgage business, for example via a market leading product, in accordance with its lending strategy. Undrawn exposures of £81.9m (2012: £91.9m) under the standardised approach relate to a draw down facility available on legacy Stroud & Swindon products, which is no longer available to new customers.

- **Credit risk mitigation**

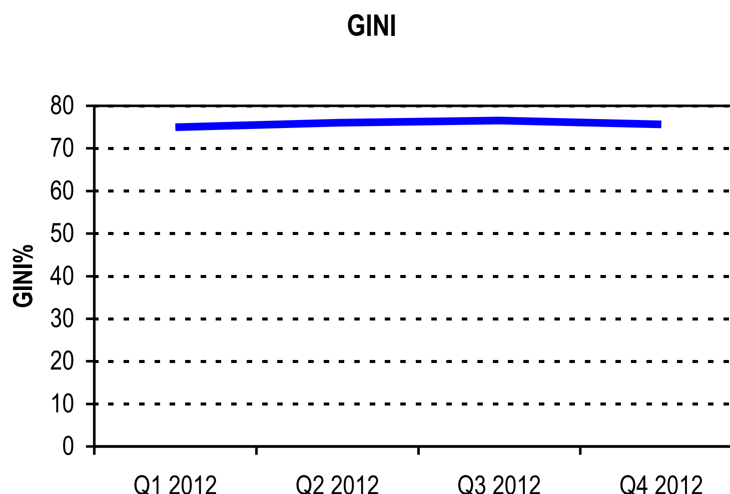
The Society does not employ credit risk mitigation techniques in relation to retail credit risk, apart from taking security for mortgage advances by placing a first legal charge on each property being offered as security for a mortgage.

- All properties being used as security are valued at the outset of the loan and, if a further advance is made during the lifetime of the loan, at the time of the further advance. With respect to the purchase of properties, the initial value of the security is established by way of an internal physical inspection of the property and written report by a qualified RICS surveyor. In limited circumstances we may use an Automated Valuation Model (AVM) or drive-by valuation as the basis for establishing the security value. AVMs are only used for low LTV (<50%) owner occupier remortgages and similarly low LTV further advances, and only where certain conditions are met, and drive-by valuations are only used with owner-occupier remortgages and further advances between 50% and 75% LTV. All buy-to-let properties are valued at the outset of the loan by a qualified RICS surveyor who makes a physical internal inspection of the property.
- Once the value of the property has been established, the Nationwide regional house price index is used to provide an updated estimate of the property's value, on a quarterly basis.
- Regularly updated assumptions regarding work-out costs, the time it takes to effect repossession and sale, and the effect of forced sale on estimated property values are used in the impairment model to determine the realistic value that could be achieved upon repossession and sale of the property.
- Conservative, stressed values for these parameters are used in the rating system for the purposes of inclusion within the calculation of the regulatory capital requirement.

- **Experience over time**

Over time, both the power of the PD model to discriminate between good and bad accounts across the score range (as measured by the GINI co-efficient) and the accuracy of predictions in terms of actual defaults against expected defaults, is monitored.

The chart below demonstrates the GINI measure of risk discrimination from the Society's PD model. Given the prolonged period of exceptionally low interest rates the Society is developing its models to provide even better risk differentiation, including separate portfolio-specific models, to further enhance its risk management capability. The GINI displayed is in relation to the Society's behavioural model which is used in the majority of cases.

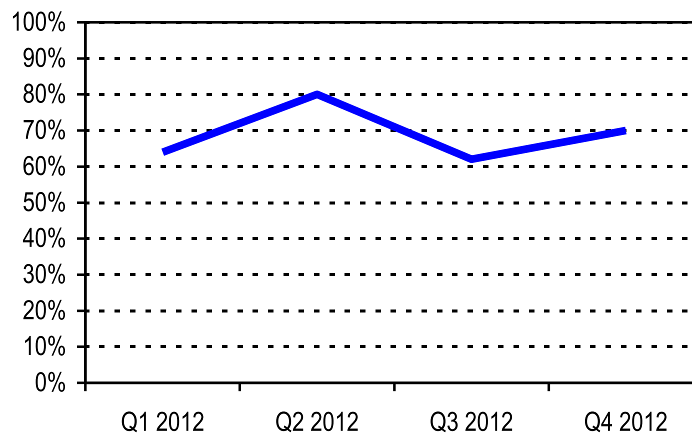


The correlation of recent experience of losses to predicted shortfalls is shown in the following graph. Predicted shortfalls in the capital calculation are made using the downturn LGD model, which are set to an assumed peak-to-trough fall in house prices that mirror a downturn in the housing market. Average actual losses are consistently below predictions.

On average over the course of 2012, 16 properties per month were sold from possession, resulting in a loss to the Society, which were within the remit of the IRB rating system (there were on average another 3 sales per month of cases that fell under the Standardised Approach).

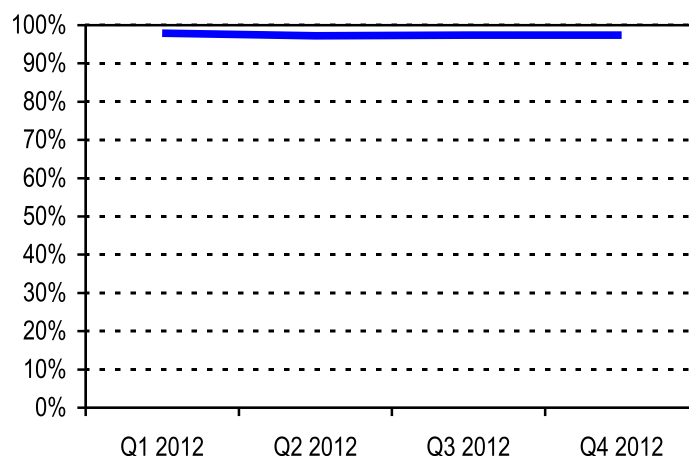
With such small numbers of sales, the loss experience can be impacted upon by individual unusual cases that give rise to losses that could not be reasonably predicted using a statistical model. The types of cases experienced in 2012 included properties that had been damaged by the occupant prior to repossession, issues with rights of access, and boundary disputes. In general however, the loss experience has been largely in line with predictions, which were generally conservative.

Actual losses as a percentage of predictions



For exposures that have defaulted over the past year, the EAD model has performed consistently, slightly over-predicting the value of the exposure at default, as demonstrated in the following chart:

Actual/Predicted EAD



A hybrid approach is utilised for the estimation of regulatory capital. Within the PD model, cases are assigned a risk grade based on their credit score and arrears status, and these accounts are then mapped to a long-run average PD estimated over a full economic cycle. The long-run average PD used for regulatory capital is significantly more conservative than the Point in Time (PiT) PD prediction and is in excess of the observed default rate across all risk grades.

As noted above the LGD models used in regulatory calculations are calibrated to reflect downturn conditions, for example via stresses to property prices. The downturn LGD estimates are greater than the point in time estimates shown.

Point in time PD and LGD predictions against actual results are shown below:

IRB retail mortgages	Actual %	Predicted %
PD	0.30	0.30
LGD	6.16	6.18

Note: The PD model predicts defaults from performing (up-to-date) accounts, with a separate roll-rate model used to predict default from accounts already in arrears. The PD predictions shown above relate to performing accounts.

- **Data integrity**

The models have been implemented on the Society's internal systems with no reliance on external systems. This gives the Society complete control over how the models are maintained, how data flows in and out of the models and provides a large degree of flexibility and reporting capability, allowing the risk team to drill into any aspect of model performance.

Controls and governance

- **Systems and change control**

Physical control of the IRB models resides within the Society's business systems function. Changes to the models (for example in terms of score to PD calibrations) can only be carried out by appropriately designated staff in this area who must follow an audited sign-off and change process.

The models are subject to the back-up and disaster recovery processes that govern all Society systems.

- **Monitoring and oversight**

Monitoring of the IRB models is the responsibility of the Society's risk model function. The risk models' function undertakes all monitoring required to properly assess the performance of the models, using various statistical techniques, and presents reports to the Models and Ratings Committee, a sub-committee of the Risk Management Committee.

Monitoring reports include an assessment of performance against trigger limits. If appropriate, the risk models' function will make recommendations for amendments or updates to the models. All significant amendments, updates and any new models are reviewed by external specialists. The Models and Ratings Committee, which is chaired by a non-executive director and comprises executive directors and senior management from the credit risk, finance and internal audit functions, is the designated committee through which authority for changes to models is obtained.

- **External verification**

An independent external expert has been appointed to provide the Models and Ratings Committee with an annual review of the work of the credit risk function.

The independent external expert:

- reviews the frequency, quality and appropriateness of the monitoring reports;
- reviews the appropriateness of the credit risk function's analysis and conclusions about model performance;
- provides comment and independent assessment on changes to models recommended by the credit risk function;
- comments on the documentation surrounding all aspects of the models; and
- provides an assessment of the use of the IRB models within the business.

- **Use of models**

The models are designed for use within the Society's operations in addition to providing the ratings required for the performance of regulatory capital calculations. Examples of use within the business include:

- the application PD model is integrated into the application decision making process – the same application model that provides the PD assessment of new applications is used to determine the credit risk, and hence the level of underwriter involvement (alongside lending policy considerations and valuations) of new mortgage applications;
- various aspects of the behavioural model contribute to the prioritisation of collections activity; and
- shortfall model outputs are also used to assist in impairment provision calculations.

5.2.3 Impairment provisions - Assets held at amortised cost

The Group assesses its loans and advances to customers for objective evidence of impairment at each balance sheet date. An impairment loss is recognised if, and only if, there is a loss event (or events) that has occurred after initial recognition, and before the balance sheet date, and has a reliably measurable impact on the estimated future cash flows of the loan amount.

Impairment is categorised as either individual impairment (where individual assets have been assessed for loss) or collective impairment (where losses are assessed as being present in a portfolio of loans, but they cannot be attributed to individual accounts). As well as loans that are individually or collectively identified as being impaired, recognition is also made of accounts where forbearance has been exercised and agreement has been reached with customers in financial difficulty to temporarily forego some element of the payment due or where other impairment indicators are present.

If there is objective evidence that an impairment loss on loans and advances to customers has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows (excluding future credit losses that have not been incurred).

Estimating future cash flows
Future cash flows are based upon prudent assumptions about the value of the property representing the underlying security for the mortgage, workout costs that might be incurred in realising the value of the property (i.e. following repossession and sale), the likelihood of repossession and the time it takes to repossess and sell properties:

- All properties being used as security are valued at the outset of the loan and, if a further advance is made during the lifetime of the loan, at the time of the further advance.
- Once the value of the property has been established, the Nationwide regional house price index is used to provide an updated estimate of the property's value, on a quarterly basis.
- Assumptions are continuously updated to reflect the time taken to sell a repossessed property and the likely discount to the latest property valuation. Typically, the forced sale discount averages at 27% of the property value.
- No assumptions are made as to the future value of properties, beyond the estimation of a discount for the forced sale that results from a repossession of a mortgaged property.

Individual assessment of impairment
The identification of loans for individual assessment of impairment is via a set days-past-due trigger being met or if, in the opinion of management, there is evidence that individually identifiable loans are impaired even if a set days-past-due trigger has not yet been met. For example, a small number of customers have been declared bankrupt but continue to make their mortgage repayments as scheduled. These customers can be individually identified and therefore an individual assessment can be made as to the level of impairment. Similarly loans subject to forbearance (See section 5.2.2).

The Group employs various models to assess the level of impairment. These include models to predict roll rates to default, the likelihood of possession given default, and shortfalls in property values over loan balances (after accounting for expected costs, the effects of forced sale, and updated valuations including via house price indexation). The assumptions in these models capture the differing experience of different mortgage types, and are updated regularly to reflect ongoing experience, with appropriate management overlays to ensure appropriate judgement is reflected in the final assessment of impairment.

Collective assessment of impairment
A variety of collective impairment assessments have been made against segments of the mortgage book where there is objective evidence of an impairment event impacting that segment, but which cannot be individually attributed, or more generally where there is evidence of an increased risk of credit losses but, again, where the risks cannot be individually attributed. Examples of segments where collective assessments of impairment have been conducted include provisions held to collectively address the risk that in a downturn issues will emerge that will adversely affect value and saleability of properties that would otherwise be masked in a growing housing market.

Forbearance impairment assessment
Assessment has also been made of customers who are undergoing some measure of forbearance. Since the previous measurement of forbearance impairment in 2011, significant additional analysis of the mortgage book has been undertaken with evidence based results being used to identify potential forbearance indicators, measure the performance of accounts with these indicators, and determine the level of impairment provision required.

Use of management overlays
Management overlays to assumptions are applied to ensure that an appropriate level of conservatism is employed. For instance, current point-in-time experience may be for an improvement in a particular roll rate, but if the longer term view is that the risk remains higher than the short term experience, an overlay may be applied to maintain a more conservative position. An example is in values applied in the

'probability of possession from default' assumption. The applied probabilities of possession are generally more conservative than the current experience to accommodate the fact that the likelihood of possession may increase in the event of a further economic downturn.

Recognition of post-impairment improvement

Impairment provisions are raised as the risk is recognised and measured. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the customer's credit rating), the previously recognised impairment loss is reversed by adjusting the impairment provision. The amount of the reversal is recognised in the income statement.

Write off policy and recognition of post-loss recoveries

When a loan is not collectable, it is written off against the related provision for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off are recorded in the income statement.

	Residential Mortgages £m	**Unsecured loans £m**	**Total £m**
At 1 January 2012			
Individual impairment	13.8	0.8	14.6
Collective impairment	6.1	0.4	6.5
Total	19.9	1.2	21.1
Charge for the year			
Individual impairment	7.6	2.2	9.8
Collective impairment	(0.2)	-	(0.2)
Total	7.4	2.2	9.6
Amounts written off individual impairment	(6.4)	(1.8)	(8.2)
At 31 December 2012			
Individual impairment	15.0	1.2	16.2
Collective impairment	5.9	0.4	6.3
Total	**20.9**	**1.6**	**22.5**

	Residential Mortgages £m	Unsecured loans £m	Total £m
At 1 January 2011			
Individual impairment	14.3	0.6	14.9
Collective impairment	5.4	0.8	6.2
Total	19.7	1.4	21.1
Charge for the year			
Individual impairment	7.8	1.8	9.6
Collective impairment	0.7	(0.4)	0.3
Total	8.5	1.4	9.9
Amounts written off individual impairment	(8.3)	(1.6)	(9.9)
At 31 December 2011			
Individual impairment	13.8	0.8	14.6
Collective impairment	6.1	0.4	6.5
Total	19.9	1.2	21.1

The distribution of loans on a 'past due' is set out below:

31 December 2012 Indexed loan to value	Not impaired		Impaired				
	Not past due £m	**Past due less than three months £m**	**Past due over three to six months £m**	**Past due over six months or in litigation £m**	**In possession £m**	**Impairment provision £m**	**Total[1] £m**
<50%	**5,978.0**	**101.9**	**14.5**	**13.7**	**0.2**	**(0.4)**	**6,107.9**
50% to 65%	**5,935.3**	**149.5**	**19.5**	**17.4**	**-**	**(1.8)**	**6,119.9**
65% to 75%	**3,948.9**	**148.0**	**25.0**	**15.1**	**0.2**	**(2.2)**	**4,135.0**
75% to 85%	**2,980.9**	**182.9**	**24.7**	**21.8**	**0.2**	**(3.1)**	**3,207.4**
85% to 95%	**1,333.4**	**84.2**	**23.0**	**24.8**	**0.1**	**(3.3)**	**1,462.2**
>95%	**792.6**	**62.1**	**34.0**	**40.1**	**10.1**	**(10.1)**	**928.8**
Unsecured	**53.8**	**4.2**	**0.7**	**0.6**	**-**	**(1.6)**	**57.7**
Total	**21,022.9**	**732.8**	**141.4**	**133.5**	**10.8**	**(22.5)**	**22,018.9**

1. The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due.

31 December 2011 Indexed loan to value	Not impaired		Impaired				
	Not past due £m	Past due less than three months £m	Past due over three to six months £m	Past due over six months or in litigation £m	In possession £m	Impairment provision £m	Total[1] £m
<50%	5,701.4	100.5	15.7	11.9	0.2	(0.2)	5,829.5
50% to 65%	4,927.5	130.5	19.1	15.3	0.1	(1.9)	5,090.6
65% to 75%	3,243.6	121.6	21.4	16.9	0.1	(2.1)	3,401.5
75% to 85%	2,413.9	123.9	21.6	20.0	0.3	(2.8)	2,576.9
85% to 95%	1,203.9	105.3	26.0	25.4	0.7	(3.2)	1,358.1
>95%	787.2	60.0	27.2	40.3	13.2	(9.7)	918.2
Unsecured	63.0	2.2	0.6	0.6	-	(1.2)	65.2
Total	18,340.5	644.0	131.6	130.4	14.6	(21.1)	19,240.0

1. The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due.

5.2.4 Credit risk for the treasury liquidity book

Credit risk within the treasury function (wholesale credit risk) arises from the portfolio of liquid assets held, and represents the risk that counterparties will fail to repay amounts when due. The Society has a low appetite for this form of risk. As such, exposures are restricted to good quality counterparties with a low risk of failure, and limits and exposures are set accordingly. Debt securities are generally unsecured with the exception of securitisation positions which are secured by pools of financial assets.

Treasury exposures and limits are focused in the main on strong UK institutions, with additional limits extended to a small number of highly rated banks in Europe and other developed economies such as Australia and Canada. Limits are set in line with a Board approved wholesale credit policy, which sets maximum limits taking into account internal analysis, external credit ratings, country of domicile and any other relevant factors. All credit limits require Board approval, and are subject to an initial assessment of the creditworthiness of the counterparty, with the approved limit then subject to at least an annual review. Exposures are reviewed on a daily basis to ensure that they remain within the approved limits.

Ongoing developments for Treasury counterparties are closely monitored by a specialist credit team and are reported to, and reviewed by, a dedicated Treasury Credit Committee. This Committee meets weekly and is chaired by the Chief Risk Officer. The Committee is empowered to take immediate action to reduce or suspend limits where this is warranted by adverse changes in the creditworthiness of counterparties or market or local developments. The Committee reports through ALCO to the Board Risk Committee.

The allocation of capital to the credit risk within the liquidity book is calculated using the standardised approach defined by BIPRU.

The exposure values relating to the Society's liquidity book are as follows:

	Exposure value by Moody's rating						
31 December 2012	**Aaa–Aa3 £m**	**A1–A3 £m**	**Baa1–Baa3 £m**	**Other £m**	**Unrated £m**	**Total £m**	**Capital requirement £m**
Central banks and sovereigns[1]	**3,316.7**	**-**	**-**	**-**	**-**	**3,316.7**	**-**
Multilateral development banks (supranational bonds)[1]	**217.2**	**-**	**-**	**-**	**-**	**217.2**	**-**
Financial institutions	**320.1**	**396.3**	**4.9**	**-**	**16.7**	**738.0**	**12.6**
Mortgage-backed securities	**198.9**	**5.3**	**-**	**-**	**-**	**204.2**	**3.5**
Total	**4,052.9**	**401.6**	**4.9**	**-**	**16.7**	**4,476.1**	**16.1**
Risk weight	**0/20%**	**20/50%**	**20/50%**	**-**	**20/50%**	**-**	**-**

1. Risk weighting for central banks and sovereigns, multilateral development banks (supranational banks) is 0%.

	Exposure value by Moody's rating						
31 December 2011	Aaa–Aa3 £m	A1–A3 £m	Baa1–Baa3 £m	Other[2] £m	Unrated[3] £m	Total £m	Capital requirement £m
Central banks and sovereigns[1]	3,365.1	-	-	-	-	3,365.1	-
Multilateral development banks (supranational bonds)[1]	188.7	-	-	-	-	188.7	-
Financial institutions	625.4	348.2	35.0	17.7	27.8	1,054.1	12.0
Mortgage-backed securities	228.7	5.0	-	-	-	233.7	4.1
Local authorities	-	-	-	-	0.5	0.5	-
Total	4,407.9	353.2	35.0	17.7	28.3	4,842.1	16.1
Risk weight	0/20%	20/50%	20/50%	50/150%	20/50%	-	-

1. Risk weighting for central banks and sovereigns, multilateral development banks (supranational banks) is 0%.
2. Exposures rated as 'Other', comprise Irish financial institutions and other UK building societies.
3. 'Unrated' institutions relate to smaller building societies and local authorities.

5.2.5 Impairment provisions - Available-for-sale-assets

Unrealised gains and losses arising from changes in the fair values are recognised directly in the Available-for-sale reserve, except for impairment losses and foreign exchange gains and losses, which are recognised in the income statement. Gains and losses arising on the sale of Available-for-sale assets, including any cumulative gains or losses previously recognised in the Available-for-sale reserve, are recognised in the income statement.

When a decline in the fair value of an Available-for-sale financial asset has been recognised directly in equity reserves and there is objective evidence that the asset is impaired, the cumulative loss recognised in equity reserves is removed and recognised in the income statement. As at 31 December 2012 no amounts in the treasury portfolio were either past due or impaired, and as such no provision had been made.

5.2.6 Securitisation

Purchased securitisation positions

The Society's exposure to purchased securitisation positions amounted to £204.2 million at 31 December 2012 and comprises senior tranches of residential mortgage-backed securities (RMBS). As at 31 December 2012, £198.9 million (2011: £228.7 million) had a Moody's credit grading of Aaa-Aa3, and £5.3 million (2011: £5.0 million) had a credit grading of A1-A3. Such purchased securitisation positions provide diversification for the Society's liquidity portfolio. Purchases and retention of RMBS are undertaken within a clearly defined credit risk policy. RMBS are held as 'Available-for-sale' at fair value on the Group's balance sheet. If the assets are sold before maturity, a gain or loss would be recognised in the Income Statement. RMBS are regularly reviewed inline with article 122a of the Capital Requirements Directive.

The exposure values relating to the Society's ownership of RMBS and their associating risk weightings for capital purposes are included in the table in Section 5.2.4.

As at 31 December 2012, no purchases securitisation positions were past due or impaired. The Society uses the standardised approach defined under BIPRU 9 for its purchased securitised positions.

Originated Securitisations

Certain debt securities in issue (funding) are secured against the Group's assets as part of the Group's asset backed funding programmes. The programmes have enabled the Group to obtain secured funding or to create additional collateral which could be used to source additional funding.

The table below illustrates the balances of external funding secured on the Group's loans and advances:

31 December 2012	Mortgages pledged £m	Held by third parties £m	Held by the Group drawn £m	Held by the Group undrawn £m	Total £m
Loans and advances to customers					
Securitisation programme – Leofric No.1 plc	**1,015.7**	**735.2**	**-**	**122.7**	**857.9**
Securitisation programme – Mercia No.1 plc	**1,571.3**	**-**	**-**	**1,436.4**	**1,436.4**
Total	**2,587.0**	**735.2**	**-**	**1,559.1**	**2,294.3**

Securitisation – Leofric No.1 plc

Leofric No.1 plc ('Leofric') was incorporated in November 2011. In May 2012, Leofric issued £933.5 million of listed debt securities secured against certain loans of the Society and its subsidiary Godiva Mortgages Limited, of which £133.5 million was retained by the Group. Under the terms of the Securitisation programme, the nominal amount of the debt securities is paid down to match the payment profile of the mortgages pledged to the programme. As at the 31 December 2012, listed debt securities in issue had fallen to £857.9 million of which £122.7 million was held by the Group.

Securitisation – Mercia No.1 plc

Mercia No.1 plc ('Mercia') was incorporated in October 2012. In December 2012, Mercia issued £1,436.4 million of listed debt securities in issue, all of which remain held by the Group. As at the 31 December 2012, listed debt securities totalled £1,436.4 million.

Coventry Building Society and Godiva Mortgages Limited are the originators and servicers. Other roles fulfilled by these firms are described in the prospectuses, which are available here. There are no assets that are currently in the process of being securitised.

Securities held by the Group reflect notes issued under securitisations programmes which have been retained to provide eligible collateral to access central government schemes such as the *Funding for Lending Scheme* (FLS). The Notes issued are rated by both Fitch and Moody's as AAA.

Mortgages have been pledged by the Society and its subsidiary, Godiva Mortgages Limited (Godiva) to special purpose entities (SPEs) in order to raise wholesale funding. The pledged mortgages remain on the balance sheet of the entity pledging the mortgages (the 'Originator'), as the Originator has retained substantially all the risks and rewards of ownership. These assets are held at amortised cost. The SPEs are fully consolidated into the Group accounts. The transfers of the mortgage loans to the SPEs are not treated as sales by the Originator, and therefore no gains are recognised.

As there is not considered to be a transfer of significant credit risk, the Society does not calculate risk weighted exposure amounts for any positions it holds in the securitisation and these continue to be calculated in line with BIPRU 3 requirements consistent with other mortgage assets. The risk relating to the underlying mortgage pool therefore remains with the Group and is included in the 'Residential mortgage' detailed throughout this document.

5.2.7 Counterparty credit risk - Derivatives

The Society uses derivative instruments to hedge its exposure to interest rate and foreign exchange risk. Counterparty credit risk is the risk of default of a counterparty to such a derivative instrument.

The Society uses International Swaps and Derivatives Association (ISDA) documentation for its derivative financial instruments (to hedge interest rate risk and foreign exchange rate risk).

The Group's legal documentation with its counterparties for derivative transactions also grants legal rights of set-off for those transactions respectively. Accordingly, under each type of agreement, negative market values will offset positive market values with the same counterparty in the calculation of credit risk, subject to an absolute exposure of zero by counterparty ('Netting benefits').

For the majority of derivatives, a Credit Support Annex (in the form of a cash deposit) is executed in conjunction with the ISDA agreement to set against derivative credit exposures in the event of counterparty default ('Collateral held'). Weekly rebalancing of the collateral reduces the potential increase in future credit exposures.

The Society only undertakes derivatives with highly rated counterparties and all counterparties are subject to credit assessments.

The Society measures derivative counterparty credit exposure values using the counterparty credit risk mark to market method.
The balance sheet exposure values of derivative instruments are given in the following table:

	31 December 2012 Exposure value £m	31 December 2011 Exposure value £m
Interest rate contracts	**279.6**	259.7
Gross positive fair value of contracts	**279.6**	259.7
Netting benefits	**(166.7)**	(186.1)
Net credit exposure	**112.9**	73.6
Collateral held	**(1.2)**	(3.1)
Net derivative credit exposure	**111.7**	70.5

As at 31 December 2012, all counterparties with whom the Society has a net derivative credit exposure have a Moody's credit rating of A3 or above.

The net exposure value of derivatives at 31 December 2012, which includes uplifts for Potential Future Credit Exposure (PFCE) under the mark to market method for assessing counterparty credit risk totalled £189.7 million (2011: £175.8 million).

Included within the 'Net derivative credit exposure' are amounts that relate to derivatives in respect of the Coventry Building Society Covered Bonds LLP which are subject to collateralisation when individual bank ratings fall below a certain threshold. This threshold has not yet been reached. The counterparty has a credit rating of Aa3.

Wrong way risk occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty. Specific wrong way credit risk can occur where transactions are collateralised by related party securities. General wrong way credit risk can arise where the credit quality of the counterparty may be correlated with a macroeconomic factor which affects the value of derivative transactions, such as the impact of interest rate movements on derivatives or on securities held as collateral. The Society mitigates wrong way risk by ensuring that exposures on derivatives are managed via CSA agreements, are regularly re-margined and are collateralised with cash.

5.2.8 Credit rating downgrades

If the Society experienced a downgrade in its credit rating it may be required to place additional collateral with its subsidiary undertakings Coventry Building Society Covered Bonds LLP, Leofric No.1 Plc and Mercia No.1 plc, to support its covered bond and UK residential mortgage-backed securities (RMBS) respectively. The value of this collateral would depend upon market conditions at the time.

5.3 Market risk

Market risk is the risk that the value of income derived from the Society's assets and liabilities may change adversely as a result of changes in interest rates, foreign exchange rates or house prices. The Society's policy is to manage these risks prudently, which is ensured through the setting of limits by the Board. The Society ensures compliance with these limits through a combination of matching assets and liabilities with off-setting interest rate or currency characteristics, by the use of derivative financial instruments such as interest rate swaps and caps, foreign exchange swaps and foreign exchange forward purchase contracts, and through restrictions on the amount of lending undertaken at higher LTV. Control of market risk exposure is overseen by ALCO, which reports to the RMC and the Board Risk Committee. The Society has strengthened its second line of defence for oversight and independent assessment of these market risks during 2012 through the establishment of a Balance Sheet Risk team reporting to the Chief Risk Officer. The most significant elements of market risk for the Society are interest rate risk, foreign currency risk and house price risk, each of which are described below.

5.3.1 Interest rate risk

Interest rate risk arises from the different interest rate characteristics of the Society's mortgages and savings products and from other financial instruments. Fixed and capped rate mortgages and fixed rate savings products expose an organisation, that principally operates within a variable rate environment (such as the Society) to the risk that interest rate fluctuations could cause either a reduction in interest income or an increase in interest expense relative to other interest flows.

Where the Society has issued fixed rate mortgages, the risk is that a general increase in interest rates would leave the Society facing higher interest expense, but without a compensating increase in interest income. In these circumstances, the Society would typically take out an interest rate swap with a counterparty bank under which the Society's fixed rate income is exchanged for one based on a variable rate which would be expected to follow the general pattern of interest rate movements and thereby reduce the Society's exposure. Similarly, in cases of issuing fixed rate savings products, the Society would typically take out an interest rate swap under which it receives a fixed rate of interest and pays a variable rate. With capped rate mortgages, the risk is that if the rates increase above a pre-determined level, the Society will be unable to increase its mortgage rate on these products to compensate. In these circumstances, the Society would typically purchase a rate cap that will pay a variable rate if an agreed index rate (for example, LIBOR) exceeds a certain level. The Society has a series of Board approved limits that ensure the impact of a change in general interest rates has limited effects on the net interest income generated. In addition, the Society regularly forecasts the impact of movements in the Bank of England Base Rate on the Society's balance sheet to

ensure any potential adverse impact can be anticipated. This information is reported to ALCO, RMC and the Board Risk Committee every month.

The Society does not trade or take speculative positions on derivatives. The following table shows the impact on net worth through the reporting period for a movement in interest rates:

	+100bps 2012 £m	**-100bps 2012 £m**	+100bps 2011 £m	-100bps 2011 £m
Impact on equity reserves	**(5.1)**	**5.0**	(13.7)	14.0
Impact on profit and loss	**19.2**	**(10.1)**	11.1	(6.4)

Exposure to the potential impact of such shifts in interest rates is maintained within an envelope of exposures over the next five years, consistent with the Corporate Plan approved by the Board. The sensitivity of equity is calculated by re-measuring the fair values of all Available-for-sale assets for the effects of the assumed changes in interest rates, and the impact on the income statement arises from the assumed changes in the interest rate relating to floating rate assets and liabilities. The total sensitivity is based on the assumption that there are parallel shifts in the yield curve. In the table above, the values represent the positive and negative impacts on equity and profit and loss faced by the Society due to the effect of a rate shock.

Variable rate instruments may also cause interest rate risk where the underlying basis of the rate differs from the prevailing variable rate of the balance sheet. The risk is driven from market influences on the different basis which may not operate in an equal manner, creating uneven changes in the rates (e.g. Bank Base Rate and LIBOR). This risk is characterised as basis risk and is subject to limits, regularly monitored, stress tested, and reported monthly to ALCO, RMC and the Board Risk Committee.

5.3.2 Foreign currency risk

Foreign currency risk arises as a result of the Society's activities in raising funds and making investments in foreign currencies. This is undertaken to ensure wholesale funds are obtained cost-effectively across a wide pool of potential providers, but exposes the Society to the risk of an appreciation in the value of foreign currency denominated liabilities or a deterioration in the value of the foreign currency denominated assets if exchange rates change.

The Society has a very low risk appetite for foreign currency risk and manages this through the use of currency swaps and foreign currency forward contracts and also, where appropriate, by the matching of foreign currency liabilities with assets denominated in the same currency.

Redenomination risk is risk that in the event that the euro ceases to be traded or a particular country leaves the euro, previously matched foreign exchange positions, designated in euros, become unmatched when these are exchanged for an alternative currency (valued against a local currency equivalent). The Society has very little redenomination risk with all euro denominated exposure held in highly rated UK, Dutch or German counterparties, the predominance being UK entities.

5.3.3 House price risk

Most significantly this risk arises from the value of the property forming the security for a mortgage being insufficient to repay the loan in the event of default and subsequent repossession. The Society manages this risk through a combination of prudent LTV limits at inception and ongoing monitoring to ensure that impairment provisions are sufficient to cover the potential losses that may arise in repossession situations.

With respect to 'lifetime mortgages', house price risk also arises from the 'no negative equity' guarantee, whereby the borrower is guaranteed that the amount recoverable by the Society at the end of the mortgage will not exceed the value of the property.

Under these loans, the borrower receives an advance but makes no payments of interest or principal until the loan is redeemed. The interest is added to the loan and recovered by the Society when the loan is redeemed. The 'no negative equity' guarantee therefore exposes the Society to the risk that the value of the property at the time of redemption is lower than the loan plus accumulated interest. The Society has managed this risk by granting loans only at relatively low LTV ratios, subject to the age of the borrower, and through the use of statistical modelling to stress potential exposures within acceptable prudent limits. Only 1.5% of the Society's outstanding mortgage balances have been advanced on this type of product. The Society does not currently offer these products to new applicants.

The risks presented by house price movements are evaluated through stress-testing and monitored by the Retail Credit Risk Committee and ALCO and, through these Committees, by the RMC and the Board Risk Committee.

5.4 Liquidity and funding risk

The essence of the Society's business is 'maturity transformation', whereby the Society borrows for relatively short terms, and lends on mortgages for much longer periods. This mismatch generates liquidity risk, the risk that the Society has insufficient funds to meet its immediate obligations and maintain day-to-day operations. The Society maintains liquidity resources at all times which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

Funding risk is the risk that the Society is unable to obtain funds which are sufficiently long dated and diverse, such that liquidity risks rise to unacceptable levels impeding its ability to operate economically. Funding risk is managed by ensuring that reliance on any single funding provider is minimised. This is principally achieved by limiting wholesale funding to a level lower than that imposed by both the building society nature limits and by the regulator. Concentration to retail customers is managed through having a broad customer base spread throughout the UK. The Society is predominantly funded through retail deposits, reflecting our long-term preference and nature as a building society. Wholesale funding is used to provide diversification and value to members. Funding is managed centrally enabling it to be used to fund assets throughout the business. In the event of a stress event the Society has a detailed Contingency Funding Plan which is approved by the Board annually and subject to regular testing.

Determining the appropriate amount of liquidity is a key decision for the Board. The Society recognises that it must remain a safe and attractive home for members' retail deposits. However, the more assets that are held in liquid form, the less that are available for the Society to lend to borrowing members. This conflicts with one of the core objectives of the Society which is to provide finance to help people purchase residential properties. The more liquidity that is held, the lower the profitability of the Society and the less capital it generates. If capital is reduced then the capacity for new mortgage lending is restricted. Therefore, it is in the best interests of the Society's members as a whole, for the Society to hold sufficient but not excessive levels of liquidity.

The Society's appetite for liquidity risk is set out in the Liquidity Risk Tolerance Statement which has been adopted by the Board following a recommendation from the Board Risk Committee. The Tolerance Statement is kept under regular review and revised in line with changes to the risk environment and regulatory context. The Tolerance Statement was last revised in September 2012 and is set with reference to the ability to meet all cash requirements throughout a 90 day stress.

The Board determines the level of liquidity resources required to support the Society's business objectives through undertaking an annual Individual Liquidity Adequacy Assessment (ILAA) as part of the development of the Corporate Plan. In this process the Society reviews its liquidity risk management framework, together with the financial projections developed for the Corporate Plan, in order to assess the significant risks to which it is exposed and the adequacy of its risk management and liquid resources. The Society's internal audit function annually reviews the accuracy and consistency of the financial information included within the ILAA.

The ILAA considers a range of time horizons, in particular intra-day, one day, two weeks, three months and five years. The ILAA is compliant with the BIPRU 12 regime that was introduced by the FSA in 2010. The main 'combination stress' assessed in the ILAA estimates the impact from a two week Society-specific stress combined with a three month market-wide stress.

The ILAA assesses the adequacy of the liquidity policies that are included in the Prudential and Treasury Policy Statement. These policies set out various minimum criteria for the amount and quality of liquidity that must be held at all times and the programme for testing the periodic realisation of the various liquidity types. In addition, the Policy Statement incorporates various triggers and target operating levels that guide appropriate management actions.

Liquidity is held for each of the principal drivers of liquidity risks:

- Withdrawal of on-demand and maturing retail deposits.
- Inability to issue or roll-over maturing wholesale funding.
- Funding concentration in particular markets or counterparties.
- Requirement to honour extant mortgage applications and maintain a lending franchise.
- Requirement to fund intra-day cashflows.
- Trapping of liquidity within covered bonds and RMBS programmes.
- Trapping of liquidity in particular currencies.
- Downgrade requirements associated with the covered bonds and RMBS programmes.
- Limits on the cash that can be generated from liquid assets in a liquidity event.
- Ability to use contingent liquidity (self-generated assets) to generate cash in a liquidity event.

With regard to the combination stress, the following key assumptions are made:

- The Society's credit ratings are downgraded by two long-term notches, from A3/P-2 to Baa2/P-3 for Moody's and from A/F1 to BBB+/F2 for Fitch.

- Long-term wholesale funding matures on its earliest call date and no additional issuance occurs.
- Severe retail outflows occur having regard to the mix of deposits, in particular those that are considered to be most sensitive to a stress event. Assumptions are informed by an analysis of the experience of, among others, Northern Rock, Icesave (an Icelandic bank that experienced a period of stress in 2008) and Bankia (a Spanish bank that experienced a period of stress in 2012).
- Mortgage applications that have been received by the date of the stress are honoured through to completion at the normal completion rate.

The ILAA is reviewed by the PRA through their Supervisory Liquidity Review Process (SLRP), an in-depth periodic review and assessment of a firm's quantitative and qualitative liquidity risk management processes and operations. Following the SLRP, the PRA provides 'Individual Liquidity Guidance' (ILG), which sets out the amount and composition of liquidity that the PRA requires the Society to hold. This measure uses the same time period of three months and assesses similar liquidity requirements. The Society is required to meet a set percentage of the calculated Liquidity Requirement through Liquid Assets Buffer (LAB) assets. The original intention was that the requirement would increase to 100% over time. However, this has now been suspended pending the replacement of the ILG regime with the Basel III equivalent, the Liquidity Coverage Ratio, which is based on a one month time period.

The requirement to meet this guidance primarily through a tightly defined LAB has resulted in a greater proportion of the liquidity book being represented by UK Government securities or invested with the Bank of England via a reserve account. Whilst these assets realise a relatively low yield, this reflects the very low credit risk represented by a highly rated sovereign entity, such as the UK Government, and ensures the assets can readily be converted into cash to meet liabilities, as they fall due.

Day-to-day management of the Society's liquidity position is the responsibility of the Liquidity Planning department working closely with the Treasury Front Office and overseen by the Society's Balance Sheet Risk department. Adequacy is assessed against a variety of limits and measures to ensure compliance with Board approved policy. The frequency of the assessments varies from daily to monthly dependent on the measure. Liquidity positions and the results of the combination stress and ILG are monitored regularly by ALCO and, through this committee, by the RMC, Board Risk Committee and the Board. All limits were in surplus as at the year end and throughout the year.

5.5 Operational risk

Operational risk is the risk of loss arising from inadequate internal processes, people and systems or from external events. These risks are managed as an integral part of the operation of each of the Society's business units. Management has a responsibility to understand how operational risk impacts the area of the business for which it is responsible, and for putting in place controls or mitigating activities, overseen and challenged by the Operational Risk team which acts as the second line of defence. This team also ensures co-ordination of the Society's operational risk assessment, risk event management process, operational risk stress testing, and other associated activities and is overseen by the Operational Risk Committee, RMC and the Board Risk Committee. The Society uses the standardised approach for the calculation of the operational risk capital requirement.

Key operational risks are regularly reviewed and considered more broadly in the context of potential linkages to reputational risk, regulatory and compliance risk, change risk, legal risks, information technology and systems risk, and business risk. Further resource has been dedicated to this area and it now includes specialist expertise in information technology.

The Society regularly stress tests such risks better to understand and manage the impact of their occurrence and quantification to support regulatory capital allocation. Over the last 18 months the Society has developed increasingly sophisticated scenario based stress testing to understand how an operational event may evolve and what degree of severity would be necessary to cause material loss or even 'break' the Society. For these more severe scenarios the Society has developed a Recovery and Resolution Plan that details options available to the Society and any obstacles to resolution.

Conduct Risk

Conduct risk, within financial services, refers to the way in which firms treat their customers, their behaviour towards each other and the way they operate in the market. The Society has articulated its commitment to its customers and its high business standards through its 'Putting Members First' principles. The principles have helped ensure the fair treatment of members. They provide a clear understanding and expression of the Society's purpose, which informs strategy, day-to-day decision-making and operations by all members of staff across the organisation. The Society has developed a Conduct Risk Framework through which it has identified potential conduct risks facing the Society and the measures of control to manage and monitor such risks.

The Society is committed to meeting its legal and regulatory responsibilities and has a team dedicated to developing business standards and policy, overseeing regulatory change and monitoring compliance. In particular the Society is focused on delivering fair customer outcomes in the development and distribution of its products and services.

Conduct Risk is overseen by the Compliance and Financial Crime Committee which is chaired by the Chief Risk Officer and reports to RMC and the Board Risk Committee.

Financial crime

Financial crime is managed by the Society's experienced Financial Crime team which is part of the risk management function, reporting directly to the Chief Risk Officer and overseen by the Society's Compliance and Financial Crime Committee.

This reflects the Society's focus on Financial Crime as a separate discipline with dedicated expertise to respond professionally to the evolving and substantial threat to the security and the safe operation of all financial institutions. Given the rapidly growing developments in technology, cyber-crime and communication and social media, the Society pays close attention to the source, likelihood and impact of financial crime generally and the various ways in which this could manifest itself. As such, the Society continues to increase investment in resourcing its Financial Crime team and its monitoring and control systems to prevent increasingly sophisticated criminal attacks.

Security and safety

The Society has a duty of care to its staff, members and visitors whilst present on Society premises. The Society has in place health and safety polices and a compliance regime which includes internal and external inspection. This work is overseen by the Security and Safety Committee which is chaired by an executive director and reports to the Operational Risk Committee, RMC and Board each month.

Business continuity

The Society has developed Business Continuity Plans to manage situations in which buildings, systems or significant staff are unavailable, for example in the event of a flu pandemic or the loss of utilities. The Society's Business Continuity Plan is overseen by the Business Continuity Committee which reports into the Operational Risk Committee and is subject to regular testing.

5.6 Business risk

Business risk encompasses those aspects of the external environment that have the potential to affect the Society's business model. This is particularly relevant in the context of the multiple major regulatory initiatives currently being proposed or implemented, including those covering the new regulatory regime, the Basel III driven capital and liquidity requirements which will form the basis of the capital requirements regulation and capital requirements directive, banking reforms following a turbulent year of operational events for the major UK banks, and proposed alignment of Building Society legislation with the outcomes from the Vickers report. The Society has invested in additional expertise in its compliance and business change areas to manage the implementation of any new initiatives.

5.7 Concentration risk

Concentration risk is the risk that accrues from a high degree of concentration in one particular business area. The Society operates within the UK mortgages and retail savings markets and as such accepts a degree of sectoral concentration risk. The Society's natural concentration in the UK mortgage market can be exacerbated by over exposure to one geographical location or counterparty, or reliance on particular product types within the mortgage portfolio. This risk is managed by having business strategies that aim to maintain a balance of lending across the UK and regularly monitoring the Society's exposures by region. The Society manages this risk by monitoring the geographic distribution of lending, the distribution of gross lending by channel of acquisition and by setting new lending risk limits on specific segments of the mortgage market.

5.8 Pension obligation risk

Pension obligation risk for the Society arises from the defined benefit pension scheme. This risk is generated by the potential liability of the Society for unexpected future contributions arising from variations in asset values and revised actuarial assessments of the liabilities. On 31 December 2011, the Coventry Building Society Superannuation Fund (the Fund) merged with Stroud & Swindon Building Society Retirement Benefit Plan. On 31 December 2012, the Coventry Building Society defined benefit scheme closed to future service accrual. As a result of Society contributions and the closure, a surplus of £10.1 million was presented for the defined benefit pension scheme in the 2012 Annual Report and Accounts. The assumptions used to evaluate the position of the pension fund are discussed with the Society's pension scheme advisors and are prudent. These assumptions are independently audited by the Society's external auditors.

The Society takes a prudent view of pension obligation risk and acts to ensure that any reported deficit is limited. Together with the Trustees of the Fund, management regularly review reports prepared by the Fund's independent actuaries to assess these risks and take appropriate actions which may, for example, include adjusting the investment strategy and / or contribution levels. Special contributions were made by the Society in 2002, 2004, 2006, 2011, 2012 and 2013.

6. Further information

Further information can be found in the 2012 Annual Report & Accounts (www.thecoventry.co.uk/accounts2012) in particular;

- the Risk Management Report on pages 25 to 35.
- the Directors' Report on Corporate Governance on pages 38 to 45.
- the Directors' Remuneration Report on pages 46 to 52.

Glossary

The following glossary defines terminology within the Pillar 3 disclosures to assist the reader and to facilitate comparison with publications by other institutions:

Term	Definition
Basel II	The recommendations on banking regulation made by the Basel Committee on Banking Supervision, and implemented in the EU via the Capital Requirements Directive, which came into force on 1 January 2007. The Basel II framework introduced the concept of three 'pillars' for regulation.
Basel III	The Basel Committee on Banking Supervision issued strengthened proposals in response to the recent financial crisis, which are referred to as Basel III. These standards will be introduced in Europe via the CRR (see below) and the CRD IV (see below), phased in gradually from 2013.
BIPRU	The Prudential sourcebook for Banks, Building Societies and Investment Firms, which sets out the PRA's and the FCA's (see below) rules regarding risk, capital and liquidity in particular.
Business risk	The risk that the external environment has the potential to affect the Society's business model.
Capital requirement	The minimum amount of capital resources that a financial institution must hold to cover the risk of losses, as set out in Basel II Pillar 1 rules.
Capital Requirements Directive IV (CRD IV)	CRD IV is European Union legislation which implements the parts of Basel III that require EU Member States to implement national laws. This includes capital buffer requirements.
Capital Requirements Regulation (CRR)	CRR is a European Union regulation that will apply directly to UK financial institutions. Broadly, it implements the Pillar 1 aspects of Basel III in relation to capital adequacy and new liquidity requirements.
Capital resources	Capital held, less all required regulatory adjustments and deductions. Capital comprises general reserve, Permanent Interest Bearing Shares, subordinated debt and collectively assessed impairment allowances.
Core Capital Deferred Shares (CCDS)	A proposed new form of core tier 1 capital instrument.
Core tier 1 capital	Core tier 1 capital comprising general reserves, less intangible assets, pension surplus and other regulatory deductions.
Core tier 1 ratio	Core tier 1 capital as a percentage of risk-weighted assets.
Counterparty credit risk	Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.
Covered bonds	Debt securities backed by a portfolio of mortgages that are segregated from the issuer's other assets solely for the benefit of the holders of the covered bonds. The Society issues covered bonds as part of its funding activities.
Credit risk	The risk that the customer or wholesale counterparty is unable to honour their obligations as they fall due.
Credit risk mitigation	Techniques used to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.
Derivative financial instrument	A contract or agreement, the value of which reflects changes in an underlying index such as an interest rate, foreign exchange rate or market index. The contract requires either no initial investment, or an initial investment that is smaller than would be required for other types of contracts with a similar response to market factors. The most common types of derivatives are interest rate swaps.
Expected loss (EL)	A Basel II calculation under the IRB approach to estimate the potential losses on current exposures due to potential defaults over a one year time period.
Exposure	The maximum loss that a financial institution might suffer if a borrower or wholesale counterparty fails to meet their obligations.
Exposure at Default (EAD)	A Basel II parameter used in IRB approaches to estimate the amount outstanding at the time of default.
Fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
Financial Conduct Authority (FCA)	The statutory body responsible for conduct of business regulation and supervision of UK authorised firms from 1 April 2013. The FCA also has responsibility for the prudential regulation of firms that do not fall within the PRA's scope.
Foreign currency risk	The risk of loss arising as a result of adverse movements in exchange rates on investments in foreign currencies.
Funding for Lending Scheme (FLS)	An initiative by the Bank of England and HM Treasury to incentivise banks and building societies to boost their lending to UK households and non-financial companies, by providing funding to banks and building societies for an extended period.
General reserve	The general reserve is the accumulation of historic and current year profits and includes actuarial gains and losses on the defined benefit pension plan (net of tax).

Impaired loans	A loan is impaired if there is objective evidence that an impairment event has occurred, and that the event has an impact on the estimated future cash flows of the loan which can be reliably estimated. Impairment may be caused by a single event, or a combination of events.
Impairment losses	The reduction in value that arises following an impairment review of an asset that determines that the recoverable amount is less than its carrying value.
Impairment provision	Provisions held against impaired assets on the balance sheet. The provisions represent management's best estimate of losses incurred in the loan portfolio at the balance sheet date.
Indexed LTV (Loan to Value)	Loan to value (see below) calculated on an indexed basis. The property value is regularly updated to reflect changes in the house price index.
Individual liquidity adequacy assessment (ILAA)	The Society's own assessment of the liquidity resources it requires in order to remain within the risk tolerances it has set. This will include an evaluation of potential stresses based on regulatory benchmarks and on Society specific tests.
Individual liquidity guidance (ILG)	Guidance from the PRA on a firm's required quantity of liquidity resources and funding profile.
Individual/collectively assessed loan impairment provisions	Impairment is measured individually for assets that are individually identified as at the balance sheet date as being impaired, and collectively for homogenous asset classes where there is evidence of impairment event(s) but these have not yet manifested themselves as individually identified impaired accounts.
Interest rate risk	The risk that income received or paid is adversely affected by interest rate fluctuations on the Society mortgage and savings products.
Interest rate swap	A contract under which two counterparties agree to exchange periodic interest payments based on a predetermined notional principal amount.
Internal capital adequacy assessment process (ICAAP)	The Society's own assessment of the amount of capital that it needs to hold in respect of its regulatory requirements (for credit, market and operational risks) and for other risks. This assessment includes determination of a capital buffer to be held in case of potential economic stress.
Internal ratings-based approach (IRB)	An advanced approach to measuring capital requirements in respect of credit risk under Pillar 1 of Basel II. The IRB approach may only be used only with permission from the PRA.
ISDA	International Swaps and Derivatives Association is the global trade association for over-the-counter (OTC) derivatives, and providers of the industry-standard ISDA documentation.
Leverage ratio	The ratio of tier 1 capital (see below) to total non-risk weighted assets. This includes on and off balance sheet items (after netting derivatives).
Liquid assets	An amount as defined by The Building Societies (Accounts and Related Provisions) Regulations 1998. This comprises cash in hand, balances with the Bank of England, debt securities (including gilts), loans to credit institutions and other liquid assets.
Liquidity and funding risk	Liquidity risk is the risk that the Society cannot meet its financial obligations as they fall due or can secure them only at excessive cost. Funding risk is the risk of an inability to raise new wholesale funding or to replace existing funding as it matures, or a loss of member confidence that causes a 'run' on retail funds.
Liquidity coverage ratio (LCR)	A Basel III measure which aims to ensure that an entity maintains an adequate level of liquidity to meet its needs for a 30 day period under severe stress conditions.
Loan to Value (LTV)	LTV is the amount of mortgage loan as a percentage of the value of the property.
Loss given default (LGD)	A Basel II parameter used to estimate the difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.
Market risk	The potential losses or decrease in value of the Group balance sheet as a result of adverse market movements. Specific types of market risk include interest rate risk, foreign exchange risk and house price risk.
Netting	The ability to reduce credit risk exposures by offsetting the value of any deposits against loans to the same counterparty.
Net stable funding ratio (NSFR)	A Basel III liquidity ratio which calculates the proportion of long term assets that are funded by stable, long term funding sources (customer deposits and long term wholesale funding).
Operational risk	The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.
Past due	A financial asset such as a loan is past due when the counterparty has failed to make a payment when contractually due.
Pension fund surplus	The assets in a pension fund that are in excess of its liabilities.
Permanent Interest Bearing Shares (PIBS)	Unsecured, perpetual deferred shares of the Society offering a fixed coupon. These are a form of tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, or creditors of the Society. PIBS are also known as subscribed capital.
Pillar 1	The part of the Basel II Framework which sets out the regulatory minimum capital requirements for credit, market and operational risk.

Pillar 2	The part of the Basel II Framework which sets out the processes by which financial institutions review their overall capital adequacy. Supervisors then evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments. This includes all risks (including Pillar 1 risks) – ICG (see above) is an outcome of Pillar 2.
Pillar 3	The part of the Basel II Framework which sets out the disclosure requirements for firms to publish details of their risks, capital and risk management. The aims are greater transparency and strengthening market discipline.
Probability of Default (PD)	A Basel II parameter used in IRB approaches to estimate the probability that a borrower will default on their credit obligations in the next 12 months.
Prudential Regulation Authority (PRA)	The statutory body responsible for the prudential supervision of banks, building societies, insurers and a small number of significant investment firms in the UK from 1 April 2013. The PRA is a subsidiary of the Bank of England.
Redenomination risk	Redenomination risk is risk that in the event that the euro ceases to trade, or a particular country leaves the euro, previously matched foreign exchange positions, designated in euros, become unmatched when these are exchanged for an alternative currency (valued against a local currency equivalent).
Residential mortgage backed securities (RMBS)	Asset backed securities that represent interests in a group of residential mortgages, which give the investor the right to cash received from future mortgage payments both principal and interest.
Risk appetite	The articulation of the level of risk that the Society is willing to take (or not take) in order to safeguard the interests of the Society's members, whilst also achieving business objectives.
Risk-weighted assets (RWA)	The value of assets, after adjustment to reflect the degree of risk they represent in accordance with the relevant Basel II rules.
Sale and repurchase agreement (repo)	An agreement to sell a financial security together with a commitment by the seller to repurchase the asset at a specified price on a given date. In substance this forms a secured loan, the difference between the purchase price and repurchase price being the interest rate.
Securitisation	A process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose entity (SPE) (see below) which then issues securities backed by the assets. The Group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool (retained securitisation). In addition, the Group invests in various securitisation structures in its Treasury portfolio (purchased securitisation).
Special purpose entities (SPEs)	Entities that are created to accomplish a narrow and well defined objective. The Group uses SPEs to facilitate securitisation and covered bond programmes. Where the Group has control of these entities or retains risks and rewards relating to them they are consolidated within the Group results.
Standardised approach	The basic method used to calculate capital requirements for credit risk under Basel II. In this approach the risk weighting used in the capital calculation are determined by specified percentages.
Subordinated liabilities	Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer.
Subscribed capital	See Permanent Interest Bearing Shares (PIBS).
Tier 1 capital	A component of regulatory capital comprising core tier 1 capital and Permanent Interest Bearing Shares (PIBS).
Tier 2 capital	A component of regulatory capital comprising qualifying subordinated debt and eligible collective impairment allowances, less certain regulatory deductions.