Coventry Building Society

Pillar 3 Disclosures
31 December 2013

the
COVENTRY
TLC not PLC

CONTENTS

1. OVERVIEW 5

1.1 Background 5
1.2 Basis and frequency of disclosures 5
1.3 Location and verification 5
1.4 Remuneration 6
1.5 Scope of disclosures 6
1.6 Change in disclosure requirements 6

2. RISK MANAGEMENT POLICIES AND OBJECTIVES 7

2.1 Overview 7
2.2 Risk governance and control 7
2.2.1 Risk categorisation 7
2.2.2 Three lines of defence and risk governance structure 7
2.3 Risk strategy 9
2.4 Stress testing and planning 9
2.5 Coverage of risk 10

3. CAPITAL RESOURCES 11

3.1 Compliance with capital requirements 11
3.2 Impact of the Capital Requirements Regulation and Capital Requirements Directive (Basel III) 13

4. CAPITAL ADEQUACY 16

4.1 Capital management 16
4.2 Minimum capital requirement – Pillar 1 17
4.3 Minimum capital requirement: credit risk 17
4.4 Movement in credit risk - Risk Weighted Assets (RWAs) 18

5. CREDIT RISK 19

5.1 Overview 19
5.1.1 Credit risk overview and exposures 19
5.1.2 Credit risk exposures 19
5.2 Retail credit risk 21
5.2.1 Management of retail credit risk 21
5.2.2 IRB rating system 24
5.2.3 Controls and governance 27
5.2.4 IRB model performance over time 27
5.2.5 Credit risk mitigation 30
5.2.6 Impairment provisions - Assets held at amortised cost 30
5.3 Treasury credit risk 34
5.3.1 Management of treasury credit risk 34
5.3.2 Credit risk mitigation 35
5.3.3 Impairment provisions - Available-for-sale-assets 35
5.3.4 Securitisation 35
5.3.5 Counterparty credit risk - Derivatives 37

6. MARKET RISK 38

6.1 Management of market risk 38
6.2 Interest rate risk 38
6.3 Foreign currency risk 40

7. LIQUIDITY AND FUNDING RISK 41

7.1 Management of liquidity and funding risk 41
7.2 Liquidity adequacy 41

8. OPERATIONAL RISK 43

8.1 Overview 43

8.2 Management of operational risk 43
8.3 Operational risk capital calculation approach 45

9. BUSINESS RISK 46

9.1 Business risk overview 46
9.2 Regulatory risk 46
9.3 Reputational risk 46
9.4 Pension obligation risk 46

10. FURTHER INFORMATION 47

GLOSSARY 48

Tables

Table 1 Scope of disclosure
Table 2 Capital available
Table 3 Regulatory capital flow statement
Table 4 Tier 1 capital - Permanent Interest Bearing Shares (PIBS)
Table 5 Tier 2 capital - Subordinated debt
Table 6 Reconciliation of leverage ratio exposure to accounting balance sheet
Table 7 Basel III impact
Table 8 Minimum capital requirement – Pillar 1
Table 9 Minimum capital requirement for credit risk
Table 10 Risk Weighted Assets (RWA) flow statement
Table 11 Credit risk exposure
Table 12 Geographical distribution of credit risk 2013 (Table 12a) and 2012 (Table 12b)
Table 13 Residual maturity of credit risk 2013 (table 13a) and 2012 (Table 13b)
Table 14 Credit risk profile
Table 15 Geographical distribution of residential mortgages
Table 16 Residential mortgages Loan to Value (number of accounts)
Table 17 Residential mortgages new business profile
Table 18 Forbearance
Table 19 Allocation of exposures to IRB risk grade
Table 20 IRB Probability of Default (PD), Exposure at Default (EAD), Loss Given Default (LGD) and Average Risk Weight
Table 21 Probability of Default (PD) model
Table 22 Actual losses as percentage of predictions
Table 23 Actual Exposure at Default (EAD) against predicted EAD
Table 24 Actual Probability of Default (PD) and Loss Given Default (LGD) against predicted
Table 25 Movement in impairment provisions
Table 26 Past due and impaired loans by Loan to Value (LTV) 2013 (Table 26a) and 2012 (Table 26b)
Table 27 Not impaired and impaired loans by segment 2013 (Table 27a) and 2013 (Table 27b)
Table 28 Movement in impaired loans
Table 29 Treasury assets exposure values by rating 2013 (Table 29a) and 2012 (Table 29b)
Table 30 Balance of funding secured on loans and advances 2013 (Table 30a) and 2012 (Table 30b)
Table 31 Derivative counterparty credit exposure
Table 32 PV200 interest rate risk sensitivity
Table 33 Net interest income - 100bp sensitivity
Table 34 Foreign exchange risk exposure

1. Overview

1.1 Background

The European Union Capital Requirements Directive II (CRD II) 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.

The European Parliament and Council have now approved new capital reforms which implement Basel III into Europe from 1 January 2014 (herein referred to as CRD IV). 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 wider economy.

The key elements of CRD IV are explained in section 3.2 of this document including an estimate of the impact on the Society. From 2014, this document will be prepared under CRD IV.

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 and this was extended by the PRA in July 2013 to include the majority of mortgages transferred from the merger with the Stroud & Swindon Building Society in 2010. This allows the Society to calculate capital requirements for prime and self –certified owner occupied and buy-to-let mortgage exposures (excluding as at 31 December 2013, the £0,5 billion mortgage book acquired from Bank of Ireland in 2012) using internally developed models that reflect the credit quality of the Society's and its subsidiaries' mortgage books. As at 31 December 2013, this covered 96% 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 IRB approach allows the Society to set capital levels using internally developed models rather than through standardised percentages defined within 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 2013 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 & Accounts 2013 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 2013, the Society's year end, unless otherwise stated.

Pillar 3 Disclosures are published on an annual basis. Consideration was given to more frequent disclosures, but given the relatively static nature of the Society's balance sheet and the limited scope of the Society's lending and treasury activity, it was not considered necessary.

1.3 Location and verification

These disclosures have been reviewed by the Society's Board Audit Committee on behalf of the Board, and by Ernst & Young but have not been, and are not required to be, subject to independent external review, and do not constitute any part of the Group's financial statements. They are published on the Society's website www.thecoventry.co.uk/accounts2013.

1.4 Remuneration

In order to comply with the disclosure requirements of the Capital Requirements Directive III and IV (CRD III and IV) 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 2013 Annual Report & Accounts on pages 77 to 82. The 2013 Annual Report & Accounts are published on the Society's website www.thecoventry.co.uk/accounts2013.

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. 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:

Table 1: Scope of disclosures

Subsidiary undertakings	PRA Registered number	Total assets £m	Total reserves £m	Principal activity
Godiva Mortgages Limited	457622	7,089	89	Mortgage lending
ITL Mortgages Limited	302608	849	25	Mortgage lending and mortgage acquisition vehicle
Five Valleys Property Company Limited (unaudited)	n/a	5	(2)	Investment properties holding company

All funding for the subsidiaries is primarily 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.

The term 'Society' is used in this Pillar 3 document to refer to the activities of the Society and its subsidiaries, except where the context indicates otherwise.

1.6 Change in disclosure requirements

The Society continually aims to improve the quality and transparency of its disclosures to ensure they are as clear and informative as possible. In particular this year we have considered the recommendations of the Enhanced Disclosure Task Force (EDTF).

The Financial Stability Board (FSB) established the EDTF with a remit to broaden and deepen the risk disclosures of financial institutions in a number of areas including risk management, liquidity and funding risk, credit risk and market risk. We have developed our disclosures consistent with the principles and recommendations set out by the EDTF in their report in so far as they are relevant to an organisation of the size and complexity of the Society. These additional disclosures can be found in this document and in the Annual Report & Accounts.

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 governance and control

2.2.1 Risk categorisation

The risks of the organisation are managed on a group basis.

Risks generally crystallise as an impact to cashflow or capital of an organisation in the form of a loss event. However the Society's Board recognises the importance of reputation and considers this carefully when considering its risk profile.

The risks to the Society are defined across five broad categories detailed below:

Risk category	Brief definition
Credit risk	Credit risk is the risk that borrowers or counterparties do not meet their financial obligations to the Society as they fall due.
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 or foreign exchange rates.
Liquidity & funding risk	Liquidity risk is the risk the Society has insufficient funds to meet its obligations as and when they fall due. Funding risk is the inability to access funding markets or to only do so at excessive cost and/or liquidity risk.
Operational risk	Operational risk is the risk of loss arising from inadequate internal processes, systems, people, or from external events. Operational risk includes conduct risk.
Business risk	Business risk is the risk arising from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geopolitical, regulatory or other factors.

2.2.2 Three lines of defence and risk governance structure

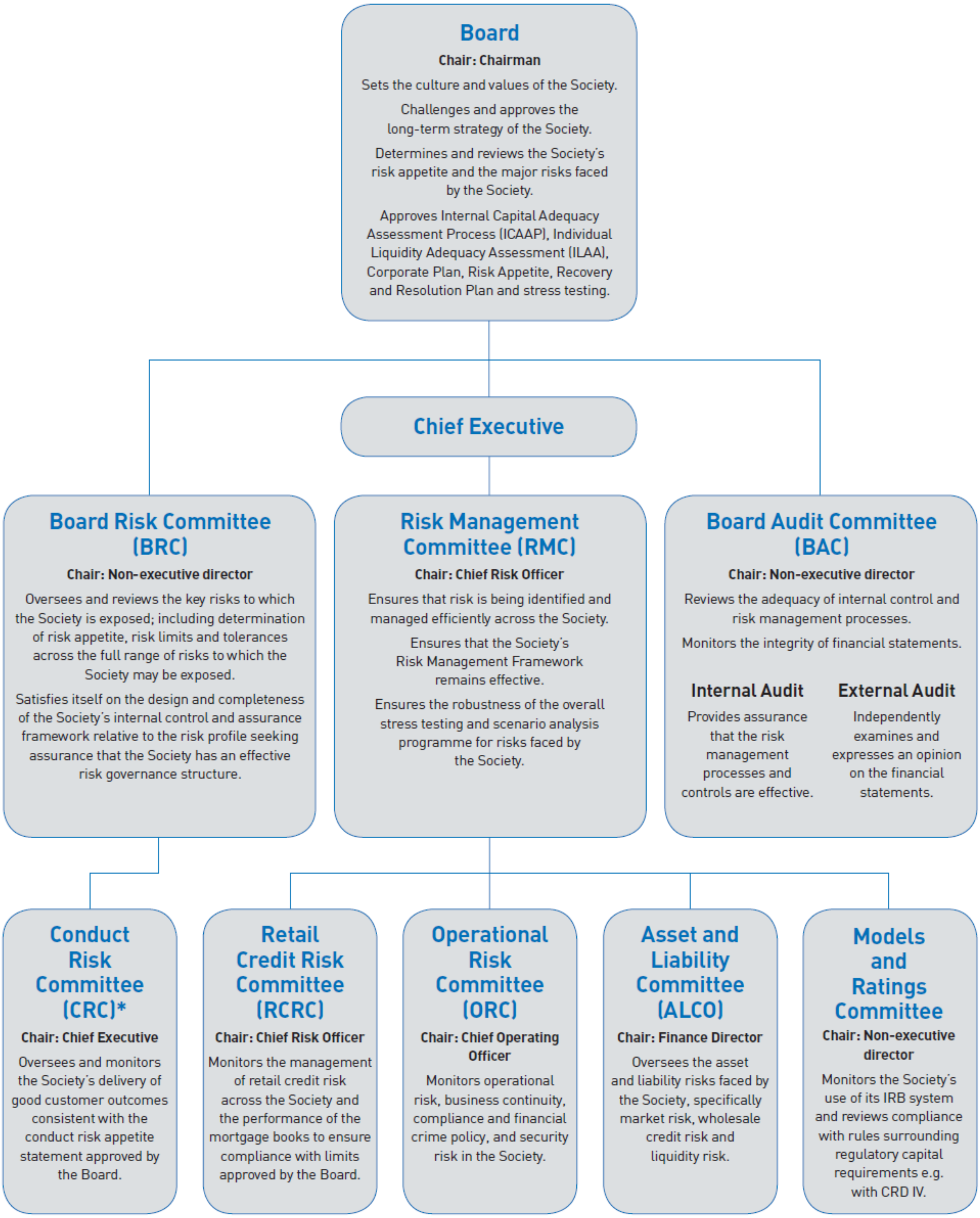
The Society's risk management framework is structured along the 'three lines of defence model' which is recognised as an industry standard for risk management.

- **First line of defence** – risk management is primarily the responsibility of all managers and staff of the Society. Management has 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 Board Risk Committee (BRC).

- **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 has an independent reporting line directly to the Chairman of Board Audit Committee (BAC), and reports to the Chief Executive for day to day management. BAC 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 overleaf:



Board

Chair: Chairman

Sets the culture and values of the Society.

Challenges and approves the long-term strategy of the Society.

Determines and reviews the Society's risk appetite and the major risks faced by the Society.

Approves Internal Capital Adequacy Assessment Process (ICAAP), Individual Liquidity Adequacy Assessment (ILAA), Corporate Plan, Risk Appetite, Recovery and Resolution Plan and stress testing.

Chief Executive

Board Risk Committee (BRC)

Chair: Non-executive director

Oversees and reviews the key risks to which the Society is exposed; including determination of risk appetite, risk limits and tolerances across the full 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 risk profile seeking assurance that the Society has an effective risk governance structure.

Risk Management Committee (RMC)

Chair: Chief Risk Officer

Ensures that risk is being identified and managed efficiently across the Society.

Ensures that the Society's Risk Management Framework remains effective.

Ensures the robustness of the overall stress testing and scenario analysis programme for risks faced by the Society.

Board Audit Committee (BAC)

Chair: Non-executive director

Reviews the adequacy of internal control and risk management processes.

Monitors the integrity of financial statements.

Internal Audit

Provides assurance that the risk management processes and controls are effective.

External Audit

Independently examines and expresses an opinion on the financial statements.

Conduct Risk Committee (CRC)*

Chair: Chief Executive

Oversees and monitors the Society's delivery of good customer outcomes consistent with the conduct risk appetite statement approved by the Board.

Retail Credit Risk Committee (RCRC)

Chair: Chief Risk Officer

Monitors the management of retail credit risk across the Society and the performance of the mortgage books to ensure compliance with limits approved by the Board.

Operational Risk Committee (ORC)

Chair: Chief Operating Officer

Monitors operational risk, business continuity, compliance and financial crime policy, and security risk in the Society.

Asset and Liability Committee (ALCO)

Chair: Finance Director

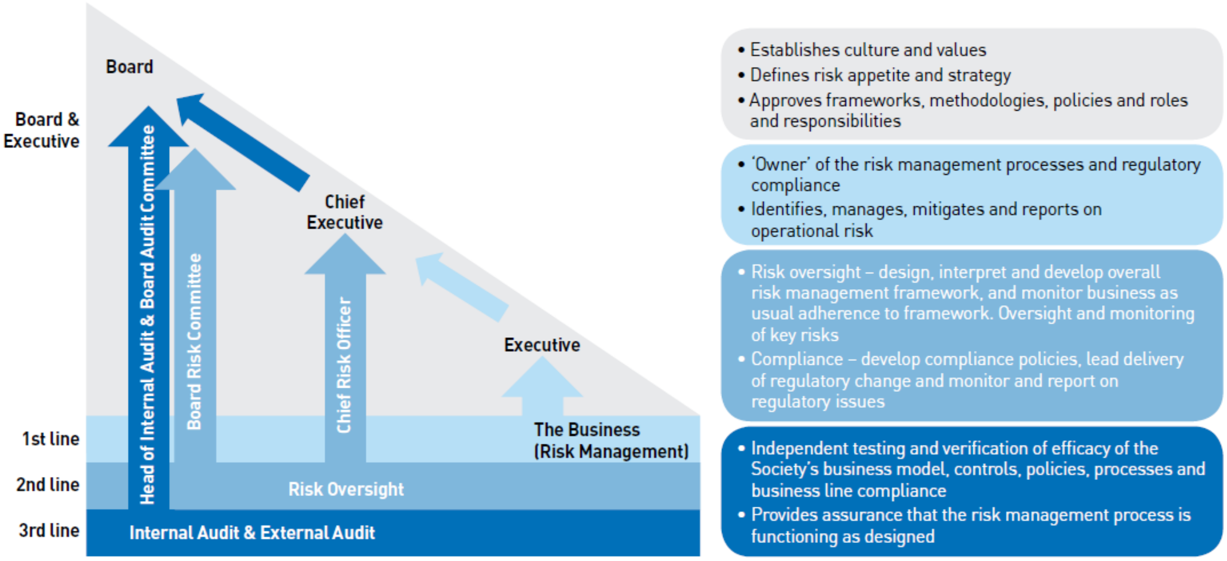
Oversees the asset and liability risks faced by the Society, specifically market risk, wholesale credit risk and liquidity risk.

Models and Ratings Committee

Chair: Non-executive director

Monitors the Society's use of its IRB system and reviews compliance with rules surrounding regulatory capital requirements e.g. with CRD IV.

* Committee formed with effect from 1 January 2014



- Establishes culture and values
- Defines risk appetite and strategy
- Approves frameworks, methodologies, policies and roles and responsibilities

- 'Owner' of the risk management processes and regulatory compliance
- Identifies, manages, mitigates and reports on operational risk

- Risk oversight – design, interpret and develop overall risk management framework, and monitor business as usual adherence to framework. Oversight and monitoring of key risks
- Compliance – develop compliance policies, lead delivery of regulatory change and monitor and report on regulatory issues

- Independent testing and verification of efficacy of the Society's business model, controls, policies, processes and business line compliance
- Provides assurance that the risk management process is functioning as designed

Reporting of key risk measures occurs through the distribution of reports on Risk and Capital to BRC and RMC on a monthly basis

2.3 Risk strategy

Risk appetite

The Society has an umbrella risk appetite statement to be a 'below median risk lender'. This over-arching statement provides a check and balance against underlying appetite statements and limits for the previously categorised risks.

For each of the key risks, appetite is set either qualitatively or through limits. The Society's overall risk appetite is to be able to withstand a severe but plausible stress and still report an accounting profit. The Society will tend to operate with a lower level of risk than its stated appetite or boundary condition, if it is possible to do so and still meet its Corporate Plan targets.

The Society's performance against limits, which together with the qualitative aspects create the articulation of the Board's risk appetite, are reviewed monthly as part of a consolidated risk report by both the Risk Management Committee (RMC) and BRC.

Risk culture

The Society operates a very simple business model and there is a high level of engagement between individual business functions and between staff at all levels of the organisation. A key element of the Society's risk culture is a genuine emphasis on putting members first and this is supported by the absence of sales incentives for any staff. In addition, the business model and strategy does not depend on fee or commission income earned from cross selling additional products to new or existing members.

2.4 Stress testing and planning

The Society uses stress testing as a key risk management tool to gain a better understanding of its risk profile and its resilience to internal and external shocks. In addition, stress testing provides a key input to the Society's capital and liquidity assessments and related tests of risk management and measurement assumptions.

The stress testing that the Society undertakes is designed to:

- Confirm the Society has sufficient capital and liquid resources.
- Ensure the Society remains within its risk appetite.
- Ensure the alignment between the Society's risk management framework and senior management decision making.
- Provide sufficiently severe and forward looking scenarios.

ICAAP

The ICAAP (Internal Capital Adequacy Assessment Process) is the Society's evaluation of its capital position and requirements, assessed under the CRD IV framework. The ICAAP provides details of the current approaches used to manage risk across the Society. As part of that assessment the ICAAP has to assess capital requirements both against its current position and during severe but plausible stresses.

The Society bases its capital requirements on a stressed scenario specified by the regulator overlaid with further adverse second order effects. In addition a range of other more severe stresses are considered. For example, the Society stresses its capital requirements to include scenarios in which the worst house price deflation ever observed is compounded by the worst arrears observed to date. The stresses also reflect both low rate and high rate Bank Base Rate scenarios.

ILAA

The ILAA (Individual Liquidity Adequacy Assessment) is the Society's documentation of its liquidity position and requirements, assessed against regulatory requirements and risk tolerance. An integral component of the approach to liquidity risk management is stress testing; some of which is mechanical using the very detailed rules and guidance issued within Prudential regulations and contained within regulatory returns. In addition to the regulatory prescribed stress testing the Society undertakes its own stress tests and sets limits on these which tend to be more onerous than those of the regulator. The Society stress tests and the regulatory returns are completed weekly, alongside a monthly operational stress and six monthly alternative stress tests.

Reverse stress testing

The Reverse Stress Testing (RST) informs, enhances and integrates with the Society's existing stress testing framework by considering extreme events that could 'break' the Society. As such it complements the existing ICAAP and ILAA processes, helping to improve risk identification and risk management more generally.

The application of RST follows two basic approaches: a qualitative approach which begins with executive workshops to provide an opportunity to explore the threats and issues which may sit outside routine risk reporting. The threats identified are amalgamated with risks identified in a parallel process incorporating operational risks. The combined threats and risks are then explored to see what additional events would be required to 'break' the Society and determine the feasibility of all these events occurring together. This qualitative approach is supplemented with a quantitative assessment of the risks which explores the level of capital or liquidity failure needed to 'break' the Society. A key outcome from the process is to consider whether any of the scenarios considered are sufficiently plausible to necessitate a change to the Society's strategy.

The analysis is formally undertaken every 12 months and reviewed and approved by the Board although the scenarios are considered more frequently.

2.5 Coverage of risk

Pillar 3 disclosures in this document cover credit risk (section 5), market risk (section 6), liquidity and funding risk (section 7), operational risk (section 8) and business risk (section 9). Additional information on risk can also be found in the Annual Report & Accounts.

3. Capital resources

3.1 Compliance with capital requirements

Throughout 2013 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 2013 under CRD II.

Table 2: Capital available

	Notes	**2013** **£m**	2012 £m
Tier 1			
General reserve		**914.6**	822.1
Pension fund surplus adjustment	1	**(5.1)**	(10.1)
Intangible assets	2	**(12.2)**	(9.2)
Deductions from Tier 1 capital	3	**(11.1)**	(9.6)
Core Tier 1 capital		**886.2**	793.2
Permanent Interest Bearing Shares (PIBS)	4	**160.0**	160.0
Total Tier 1 capital		**1,046.2**	953.2
Tier 2			
Collective provisions for impairment	5	**2.0**	0.4
Subordinated debt	6	**54.1**	55.5
Deductions from Tier 2 capital	3	**(11.1)**	(9.6)
Total Tier 2 capital		**45.0**	46.3
Total capital		**1,091.2**	999.5
IRB approach			
Credit risk – Retail exposures		**2,787.5**	2,034.0
Standardised approach			
Credit risk – Retail exposures		**387.4**	857.6
Credit risk – Liquidity book		**185.7**	201.2
Credit risk – Other		**42.0**	43.8
Operational risk		**250.8**	230.6
Risk weighted assets		**3,653.4**	3,367.2
Core Tier 1 ratio (%)		**24.3**	23.6

1. Pension fund surplus does not qualify as capital for regulatory purposes.
2. Intangible assets do not qualify as capital for regulatory purposes.
3. 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 is allocated 50% to Tier 1 and 50% to Tier 2 capital.
4. PIBS - principal amount outstanding only.
5. 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.
6. Subordinated debt – principal amount outstanding only, and if in the last five years to maturity, the subordinated debt is amortised on a straight line basis.

The table below shows the movement in capital during 2013.

Table 3: Regulatory capital flow statement	£m
Core Tier 1 capital at 1 January 2013	793.2
Profit for the period	101.3
Other comprehensive income recognised directly in the general reserve	(8.8)
Pension surplus adjustment	5.0
Intangible assets	(3.0)
Excess of expected loss over impairment	(1.5)
Core Tier 1 capital at 31 December 2013	886.2
Other Tier 1 capital (PIBS) at 1 January and 31 December 2013	160.0
Total Tier 1 capital at 31 December 2013	1,046.2
Tier 2 capital at 1 January 2013	46.3
Collective provision for impairment	1.6
Subordinated debt amortisation	(1.4)
Excess of expected loss over impairment	(1.5)
Tier 2 capital at 31 December 2013	45.0
Total regulatory capital at 31 December 2013	**1,091.2**

The increase in Core Tier 1, total Tier 1 and total capital is predominantly driven by profit in the year with only very small changes in the other components of capital.

Tier 1 capital

Tier 1 capital comprises the general reserve, PIBS, adjustments for the defined benefit pension fund surplus and 50% of the expected loss over impairment calculated on an IRB basis over accounting provisions. Intangible assets do not qualify as capital for regulatory purposes and are also deducted from capital. The Society's Available-for-sale and cash flow hedge reserves are excluded from Tier 1 capital. The Society has £160 million of PIBS which is made up of the following:

Table 4: Tier 1 capital - Permanent Interest Bearing Shares (PIBS)

	Call date	2013 £m	2012 £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 PIBS at the rate of 12 1/8% per annum in half-yearly instalments, and on £120 million PIBS 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 PIBS 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 PIBS 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, the collective impairment provisions for loans and advances to customers calculated on a standardised basis and 50% of the expected loss over impairment calculated on an IRB basis over accounting provisions. As at 31 December 2013 the Society has £54.1 million of subordinated debt that qualifies as Tier 2 capital the make up of which is shown in Table 5 below.

Table 5: Tier 2 capital - Subordinated debt

Subordinated note	Maturity date	Option to call date	Step up date	Type	2013 £m	2012 £m
Fixed rate subordinated notes 2016	4 December 2016	No option	n/a	Fixed 12.25%	**4.1**	5.5
Fixed rate subordinated notes 2021	8 November 2021	8 November 2016	8 November 2016	Fixed 6.12%	**10.0**	10.0
Fixed rate subordinated notes 2022	25 June 2022	23 June 2017	23 June 2017	Fixed 6.469%	**15.0**	15.0
Fixed rate subordinated notes 2026	29 August 2026	29 August 2021	29 August 2021	Fixed 6.33%	**10.0**	10.0
Fixed rate subordinated notes 2032	23 August 2032	23 August 2027	23 August 2027	Fixed 7.54%	**15.0**	15.0
Total					**54.1**	55.5

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 the Capital Requirements Regulation and Capital Requirements Directive (Basel III)

The European Parliament and Council have approved new capital reforms, which implement Basel III in the EU. Some provisions of Basel III are implemented in the EU via a regulation in which case the provisions will apply directly to firms in the EU without further national discretion. In contrast some provisions of Basel III implemented via a directive require local regulator adoption and interpretation. Both the regulation (CRR) and directive (CRD) are referred to as CRD IV. 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 contagion from the financial sector into the wider economy. CRD IV legislation came into force on 1 January 2014. The key elements of CRD IV are as follows:

Quality of capital

The regulations bring more stringent requirements for the eligibility of capital instruments with a focus on common equity (which includes reserves) as the principal component of regulatory Tier 1 capital, and changes to the regulatory deductions from Common Equity. The regulations set 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 must be a minimum of 8% of RWAs.

CRD IV applies the principle that Tier 1 capital is available to absorb losses of the business on a 'going concern' basis. The Society's PIBS are not able 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 9 years from 1 January 2014, or to the call date if earlier. Of the Society's PIBS, £120 million will no longer be eligible as Tier 1 capital from their call date in June 2016.

CRD IV requires Tier 2 instruments to be free of any incentive to redeem. The Society's subordinated debt fails to meet this requirement and will be grandfathered as Tier 2 capital in the same way as the Society's PIBS.

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 implements the use of common equity capital buffers; a capital conservation buffer of 2.5% of RWAs to be built up from 2016 to 2019; a systemic risk buffer applied to institutions judged to be systemically important; sectorial capital requirements (SCR); and a countercyclical capital buffer (CCB) of up to an additional 2.5% of RWAs. The Financial Policy Committee published a Policy Statement in January 2014 explaining the circumstances in which the SCR and CCB may be applied. A PRA buffer will also be set, and will replace the current Pillar2B requirement.

Counterparty credit risk and prudent valuation

A capital charge for credit valuation adjustment risk is required. The charge arises from the use of derivative instruments to manage interest rate and foreign exchange risk. The impact for the Society as at 31 December 2013 is immaterial, due to the vast majority of derivative instruments being collateralised. A further capital charge is made to cover any uncertainty of valuation where assets or derivative instruments held at 'fair value' are considered to be relatively illiquid. This charge is also minimal for the Society given the simple nature of the assets and instruments it uses and the fact that it does not trade in such assets or instruments.

Leverage

CRD IV introduces a non-risk based leverage ratio that is supplementary 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 balance sheet exposures (see table 6). 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. The CRD IV requirement is for the minimum level of this ratio to be 3%. This measure does not come into effect until 2018. At 1 January 2014 the leverage ratio of the Society is 3.4% reflecting transitional provisions under CRD IV, and 3.0% on an end-point basis i.e. assuming no transitional provisions. This ratio is expected to improve further during 2014. In considering a target for this ratio the Society recognises the importance of continuing to originate high quality assets and the risk of targeting a higher ratio by originating higher yielding assets, or a lower growth strategy that could dilute operational efficiency. The Society will therefore operate at a leverage ratio that meets regulatory requirements with a buffer appropriate to the nature of its business model.

The Board's preferred measure is a risk weighted asset measure and this shows a Core Tier 1 ratio of 24.3%. Whilst no absolute target has been set for this measure, based on current methodology this ratio is expected to be maintained at, or close to current levels.

Whilst CRD IV was not in force during 2013, 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 adequately capitalised.

The table overleaf sets out estimated CRD IV ratios as at 31 December 2013, based upon the Society's current understanding of the regulations and reconciles the accounting capital to both transitional and full impact capital positions as if 2013 is 'year 1' of the transitional period. The table shows how these items are represented for regulatory purposes. The transitional measure is based on the PRA policy statement PS7/13 which has no transitional provisions for the deductions from capital. The actual capital ratios under CRD IV may differ as related technical standards are finalised and other guidance is issued by the relevant regulatory bodies.

A reconciliation of total assets as disclosed in the accounting balance sheet to the leverage ratio exposure is given in the following table:

Table 6: Reconciliation of leverage ratio exposure to accounting balance sheet

	£m
Total balance sheet assets	**28,253.3**
Mortgage pipeline[1]	**477.4**
Other committed facilities (undrawn lending) [1]	**38.9**
Repurchase agreements	**8.9**
Netted derivative adjustment	**(32.4)**
Common equity and Tier 1 deductions	**(50.1)**
Leverage ratio exposure	**28,696.0**

1. 50 % weighting applied as per Basel III leverage ratio framework issued by the Basel Committee on Banking Supervision in January 2014.

Table 7: Basel III impact

	Notes	Current rules 31 Dec 2013 £m	Transitional rules 1 Jan 2014 £m	Post-transitional end-point 1 Jan 2014 £m
Common Equity Tier 1 capital: reserves				
General reserve		**914.6**	**914.6**	**914.6**
Accumulated other comprehensive income		**-**	**(19.6)**	**(19.6)**
Common Equity Tier 1 prior to regulatory adjustments		**914.6**	**895.0**	**895.0**
Common Equity Tier 1 regulatory adjustments				
Prudent additional valuation adjustment	1	**-**	**(1.7)**	**(1.7)**
Intangible assets		**(12.2)**	**(12.2)**	**(12.2)**
Deferred tax assets	2	**-**	**(1.4)**	**(1.4)**
Cash flow hedge reserve	3	**-**	**7.5**	**7.5**
Excess of expected loss over impairments	4	**(11.1)**	**(27.9)**	**(27.9)**
Pension fund surplus adjustment	5	**(5.1)**	**(4.1)**	**(4.1)**
Common Equity Tier 1 (CET 1) capital		**886.2**	**855.2**	**855.2**
Additional Tier 1 capital				
Permanent Interest Bearing Shares	6	**160.0**	**128.0**	**-**
Total Additional Tier 1 (AT1) capital		**160.0**	**128.0**	**-**
Total Tier 1 capital		**1,046.2**	**983.2**	**855.2**
Tier 2				
Collective provisions for impairment		**2.0**	**2.0**	**2.0**
Subordinated debt	6	**54.1**	**44.4**	**-**
Total Tier 2 prior to regulatory adjustments		**56.1**	**46.4**	**2.0**
Tier 2 regulatory adjustments				
Excess of expected loss over impairments	4	**(11.1)**	**-**	**-**
Total Tier 2 capital		**45.0**	**46.4**	**2.0**
Total capital		**1,091.2**	**1,029.6**	**857.2**
IRB approach				
Credit risk – Retail exposures		**2,787.5**	**2,787.5**	**2,787.5**
Standardised approach				
Credit risk – Retail exposures		**387.4**	**387.4**	**387.4**
Credit risk – Liquidity book		**185.7**	**185.7**	**185.7**
Credit risk – Other	7	**42.0**	**56.8**	**56.8**
Credit valuation adjustment risk	8	**-**	**82.0**	**82.0**
Operational risk		**250.8**	**250.8**	**250.8**
Risk weighted assets		**3,653.4**	**3,750.2**	**3,750.2**
Total exposure for leverage ratio		**28,696.0**	**28,696.0**	**28,696.0**
Common Equity Tier 1 (as a percentage of risk weighted assets)		**24.3**	**22.8**	**22.8**
Tier 1 (as a percentage of risk weighted assets)		**28.6**	**26.2**	**22.8**
Total capital (as a percentage of risk weighted assets)		**29.9**	**27.5**	**22.9**
Leverage ratio		**3.6**	**3.4**	**3.0**

1. Under transitional and end-point calculations, an adjustment is required to move instruments shown at fair value from an accounting to a prudent valuation. Since the publication of the Annual Report & Accounts 2013, the EBA has published its final draft regulatory technical standards on prudent valuation adjustments, which provided further clarity on the calculation. As such, this has been recalculated to reflect the most current guidance reducing the adjustment from £4.5 million to £1.7 million.
2. Under transitional and end-point calculations, an adjustment for deferred tax assets that rely on future profitability is required.
3. Under transitional and end-point calculations, the cash flow hedge reserve does not form part of regulatory capital.
4. Under transitional and end-point calculations, expected losses adjusted for provisions is deducted in full from Common Equity Tier 1 capital, and the adjustment for the tax effect is no longer applicable.
5. Under transitional and end-point calculations, an adjustment for the associated deferred tax liability is required.
6. Under transitional calculations a deduction of 20% of the Society's PIBS and Subordinated debt is made. The end-point calculations result in full amortisation of both capital instruments to nil.
7. Deferred tax assets attract a risk weighting of 250% (when arising from temporary differences) where they are below a minimum level.
8. CRD IV requires the inclusion of a capital charge relating to credit valuation adjustment risk.

4. Capital adequacy

4.1 Capital management

The primary purpose of capital is to absorb any losses that might arise from credit losses on lending, trading losses due to pressure on net interest income or expenses and losses from other adverse events such as operational incidents. The Board determines the level of capital required to support the Society's business objectives through undertaking an annual Internal Capital Adequacy Assessment Process (ICAAP) as part of the development of the Corporate Plan. In this process the Society reviews its 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, the adequacy of its risk management, and the capital resources it needs to support the risk exposures over the planning horizon. An allocation of capital is made for each of the following risks facing the Society:

- Credit risk from mortgages and other retail lending.
- Credit risk from treasury assets and derivatives.
- Concentration risk (which can exacerbate credit exposures).
- Interest rate risk.
- Liquidity risk.
- Operational risk.
- Pension obligation risk.

This allocation is based on regulatory requirements for credit risk and operational risk (Pillar 1) with additional allocations to reflect the degree of residual risk that remains after allowing for the effect of the risk controls operated by the Society (Pillar 2A).

This initial level of capital allocation is based on a 'point in time' assessment. A further capital allocation is made (Pillar 2B) which is a 'capital planning buffer' giving assurance that the Society can meet capital requirements under stressed conditions. The calculation of the capital planning buffer is a forward looking projection and examines the Society's business plans in detail, subjecting them to economic and operational stresses over a five year planning horizon. The severity and duration of the stress scenarios used is determined by reference to the 'anchor stress scenarios' published by the PRA. In addition the Society incorporates additional second order stresses to make the capital stress even greater than that prescribed by the regulator.

These additional stresses include:

- A compression of the spread between mortgage rates and Bank Base Rate when interest rates rise significantly from their current level.
- Increased retail funding costs arising from stresses driven by the end of all FLS funding.
- The impact of a two notch rating downgrade on the Society, on top of the economic stresses.

This stress testing enables the Society to estimate the magnitude of losses that may be incurred, determine the impact of these losses on the stock of capital available to the Society, and compare this with the additional capital requirements that may be needed in a stressed environment.

The impact of the stress testing is compared with the ability of the Society to react to stressed conditions by modifying its business plans. The Society retains the ability to control the rate of asset growth and therefore has the flexibility necessary to react to stressed conditions by reducing the overall capital requirement, and so maintain adequate capitalisation. Furthermore, the Society maintains a significant proportion of the mortgages and retail savings on the balance sheet at administered interest rates. This provides the Society with the option of realigning the interest margin if necessary in order to maintain an adequate level of capital generation.

The capital planning buffer is set having regard to both the impact of the stress tests and the ability of the Society to undertake a credible scale of management action in response to the stress scenarios. The ICAAP is used by the PRA in its Supervisory Review and Evaluation Process (SREP) through which it sets the Society's capital requirements, expressed as Individual Capital Guidance (ICG). The PRA adds a capital planning buffer to the ICG to ensure that the requirements may be met throughout the planning horizon.

The output from the ICAAP financial model, including stress results, is reviewed in detail by ALCO prior to finalisation. The ICAAP is then reviewed by BRC before submission to the Board for formal approval as part of the corporate planning process. The Society's Internal Audit function reviews the accuracy and consistency of the financial information included within the ICAAP document. Capital levels for the Society are reported to and monitored by the Board on a monthly basis. The Society continues to be strongly capitalised and maintains its capital substantially above current regulatory requirements. The Society's Core Tier 1 ratio is the highest reported by any top 10 building society and the Board believes this reflects the low risk profile of the Society's assets. Consequently it is anticipated the Society's level of regulatory surplus will tend to be driven by non risk based measures such as the CRD IV leverage ratio.

4.2 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:

Table 8: Minimum capital requirement – Pillar 1

	As at 31 December 2013 £m	As at 31 December 2012 £m
IRB approach		
Credit risk – Retail exposures	**223.0**	162.7
Standardised approach		
Credit risk – Retail exposures	**31.0**	68.6
Credit risk – Liquidity book	**14.9**	16.1
Credit risk – Other	**3.4**	3.5
Operational risk	**20.0**	18.5
Total minimum capital requirement	**292.3**	269.4
Total capital resources	**1,091.2**	999.5
Total capital resources surplus over requirement	**798.9**	730.1

4.3 Minimum capital requirement: credit risk

The following table shows the composition of the minimum capital required for credit risk at 31 December 2013.

Table 9: Minimum capital requirement for credit risk

	As at 31 December 2013 £m	As at 31 December 2012 £m
Internal Ratings Based (IRB) exposure classes		
Retail mortgages (prime secured against residential property)	**223.0**	162.7
Standardised exposure classes		
Institutions	**9.4**	12.6
Securitisation positions	**5.5**	3.5
Corporates (commercial lending)	**0.6**	0.8
Retail mortgages (secured against residential property)	**24.7**	58.7
Other retail (unsecured loans)	**3.1**	3.4
Non-credit obligation assets (fixed assets and other)	**3.4**	3.5
Past due	**2.6**	5.7
Total minimum capital requirement standardised	**49.3**	88.2
Total minimum capital requirement IRB and standardised	**272.3**	250.9

The overall capital requirement for credit risk has increased by 8.5% over the year. Capital requirements calculated under the IRB approach have increased by £60.3 million. This has been offset by a £38.9 million reduction in standardised requirements. For further information see 4.4 below.

4.4 Movement in credit risk - Risk Weighted Assets (RWAs)

The following table shows the movement in credit risk RWAs over 2013. Movements reflect changes in book size, book quality and model updates.

Table 10: Risk Weighted Asset (RWA) flow statement

	IRB mortgages £m	Standardised mortgages and loans £m	Treasury £m	Other £m	Total £m
RWAs at 1 January 2013	2,034.0	857.6	201.2	43.8	**3,136.6**
Book size increase/ (decrease)	251.6	(101.2)	(14.9)	(1.8)	**133.7**
Book quality improvement	(89.4)	(31.9)	(0.6)	-	**(121.9)**
Model updates	591.3	(337.1)	-	-	**254.2**
RWAs at 31 December 2013	**2,787.5**	**387.4**	**185.7**	**42.0**	**3,402.6**

The increase in IRB RWAs attributable to book size is driven by growth of the Society's residential lending. No new lending is now being undertaken that would be rated under the standardised approach.

The book quality improvement primarily reflects decreasing loan to value ratios due to house price increases and general improving performance of the underlying mortgages.

The increase in IRB RWAs, attributable to model updates, reflects both the migration of the former Stroud & Swindon mortgages from standardised and also an increase in the discount rate applied in the IRB capital calculation to more accurately reflect an expected long term cost of funding. The decrease in standardised RWAs reflects the migration to IRB of the former Stroud & Swindon mortgages already referred to above.

5. Credit risk

5.1 Overview

5.1.1 Credit risk overview and exposures

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 (covered in section 5.2); and
- credit risk for the treasury liquidity book and derivatives (covered in section 5.3).

5.1.2 Credit risk exposures

The exposures below are stated before credit risk mitigation techniques have been employed and are in respect of on balance sheet exposures only.

Table 11: Credit risk exposure

	Notes	**Average 1 January 2013 - 31 December 2013 £m**	**As at 31 December 2013 £m**	Average 1 January 2012 - 31 December 2012 £m	As at 31 December 2012 £m
Residential mortgages	1	**23,003.0**	**24,054.2**	20,557.3	21,951.9
Unsecured and other lending	1, 2	**65.0**	**62.9**	72.2	67.0
Total		**23,068.0**	**24,117.1**	20,629.5	22,018.9
Treasury:					
Central banks and sovereigns	1,3	**3,252.8**	**3,188.9**	3,470.3	3,316.7
Multilateral development banks (supranational bonds)	3	**156.4**	**95.7**	202.9	217.2
Financial institutions	1,3	**579.0**	**420.0**	766.6	738.0
Residential Mortgage Backed Securities (RMBS)	3	**193.5**	**182.8**	219.0	204.2
Local authorities	1	**-**	**-**	0.3	-
Total		**4,181.7**	**3,887.4**	4,659.1	4,476.1
Total		**27,249.7**	**28,004.5**	25,288.6	26,495.0

Table 12a: Geographical distribution of credit risk 2013

As at 31 December 2013	Notes	**United Kingdom £m**	**Rest of Europe £m**	**Rest of the World £m**	**Total £m**
Residential mortgages	1	**24,054.2**	**-**	**-**	**24,054.2**
Unsecured and other lending	1, 2	**62.9**	**-**	**-**	**62.9**
Total		**24,117.1**	**-**	**-**	**24,117.1**
Treasury:					
Central banks and sovereigns	1,3	**3,188.9**	**-**	**-**	**3,188.9**
Multilateral development banks (supranational bonds)	3	**-**	**95.7**	**-**	**95.7**
Financial institutions	1,3	**310.6**	**14.3**	**95.1**	**420.0**
Residential Mortgage Backed Securities (RMBS)	3	**182.8**	**-**	**-**	**182.8**
Total		**3,682.3**	**110.0**	**95.1**	**3,887.4**
Total		**27,799.4**	**110.0**	**95.1**	**28,004.5**

Notes:
1. Held at amortised cost using the effective interest method and after deduction of impairment provisions where appropriate.
2. Other lending includes a closed commercial loan book.
3. Held at fair value.

Table 12b: Geographical distribution of credit risk 2012

As at 31 December 2012	Notes	United Kingdom £m	Rest of Europe £m	Rest of the World £m	Total £m
Residential mortgages	1	21,951.9	-	-	21,951.9
Unsecured and other lending	1, 2	67.0	-	-	67.0
Total		22,018.9	-	-	22,018.9
Treasury:					
Central banks and sovereigns	1,3	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

Table 13a: Residual maturity of credit risk 2013

As at 31 December 2013	Notes	**Up to 12 months £m**	**1-5 years £m**	**5-10 years £m**	**More than 10 years £m**	**Total £m**
Residential mortgages	1	**1,935.4**	**6,596.6**	**6,528.6**	**8,993.6**	**24,054.2**
Unsecured and other lending	1, 2	**4.3**	**13.2**	**14.0**	**31.4**	**62.9**
Total		**1,939.7**	**6,609.8**	**6,542.6**	**9.025.0**	**24,117.1**
Treasury:						
Central banks and sovereigns	1,3	**1,889.4**	**250.3**	**873.5**	**175.7**	**3,188.9**
Multilateral development banks (supranational bonds)	3	**25.4**	**70.3**	**-**	**-**	**95.7**
Financial institutions	1,3	**379.0**	**32.0**	**5.5**	**3.5**	**420.0**
Residential Mortgage Backed Securities (RMBS)	3	**32.2**	**-**	**-**	**150.6**	**182.8**
Total		**2,326.0**	**352.6**	**879.0**	**329.8**	**3,887.4**
Total		**4,265.1**	**6,962.4**	**7,421.6**	**9,354.8**	**28,004.5**

Table 13b: Residual maturity of credit risk 2012

As at 31 December 2012	Notes	Up to 12 months 2012 £m	1-5 years 2012 £m	5-10 years 2012 £m	More than 10 years 2012 £m	Total 2012 £m
Residential mortgages	1,3	1,774.3	6,109.7	6,010.1	8,057.8	21,951.9
Unsecured and other lending	1,2	8.4	12.1	15.0	31.5	67.0
Total		1,782.7	6,121.8	6,025.1	8,089.3	22,018.9
Treasury:						
Central banks and sovereigns	1,3	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		4,184.4	6,559.8	7,306.3	8,444.5	26,495.0

Notes:
1. Held at amortised cost using the effective interest method and after deduction of impairment provisions where appropriate.
2. Other lending includes a closed commercial loan book.
3. Held at fair value.

The maturity of exposures is shown on a contractual basis.

5.2 Retail credit risk

5.2.1 Management of retail credit risk

The Society operates a simple business model, focusing on its principal objective, to meet its current and future members' needs for residential mortgages. Credit risk for the Society is therefore most likely to present itself in the potential inability of borrowers to repay their mortgage.

Exposure to this risk is monitored and managed by a specialist department that reports to the Chief Risk Officer, and overseen by the Retail Credit Risk Committee (RCRC). RCRC's activities and decisions are overseen by RMC and BRC.

RCRC 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.

With respect to controlling the quality and mix of new lending and ensuring that it is within limits and the risk appetite set by the Board, the Society operates a combination of statistical modelling (credit scoring) and assessment of applications against lending policy criteria which are embedded as rules within the Society's automated decision system. This system uses information from the statistical modelling and assessment against policy rules to provide consistent lending decisions, and helps determine when manual intervention is required by skilled underwriters.

There is also a comprehensive quality assurance programme to monitor the quality of lending decisions and adherence to lending policy.

The Society's retail mortgage lending is only secured against properties in the UK. The Society's natural concentration in the UK market could then be exacerbated by over exposure to one geographical location or counterparty, or reliance on particular product types within the portfolio. The Society manages this risk by monitoring the geographical distribution of lending, the distribution of gross lending by channel of acquisition and by setting new lending risk limits in specific segments of the mortgage market.

Regular stress testing is undertaken on the mortgage book 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 impact of economic events on the probability of default and on house price movements.

RCRC monitors arrears and the policy and strategy for managing members in payment difficulties. 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. Additional information on the extent and use of forbearance is set out later in this section.

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.

Retail credit risk profile

The nature of the Society's lending has remained focused on low risk residential mortgage business, including buy-to-let. Limited non-traditional lending in the form of near-prime mortgages and self-certification was discontinued in 2008 and 2009 respectively and these portfolios are reducing over time. Commercial loans in the Stroud & Swindon portfolio were added to the Society's assets upon merger of the two Societies in 2010. These balances also continue to reduce over time, with no new lending activity being undertaken in this portfolio. There has been no new unsecured lending since 2009.

The Society acquired around £1.9 billion of mortgages on its merger with the Stroud & Swindon Building Society in 2010 and a further £0.5 billion through the acquisition of a Bank of Ireland portfolio in 2012. The performance of both of these books has been strong with only £4.2 million written off on the Stroud & Swindon mortgages to date, and only three Bank of Ireland mortgages more than three months in arrears. Loans and advances to customers, gross of impairment provisions, are shown overleaf:

Table 14: Credit risk profile

Loans and advances to customers	2013 £m	2013 %	2012 £m	2012 %
Residential mortgages: owner-occupier	**15,161.1**	**62.8**	14,185.2	64.3
Residential mortgages: buy-to-let	**8,419.8**	**34.9**	7,174.9	32.6
Total traditional residential mortgages	**23,580.9**	**97.7**	21,360.1	96.9
Residential near-prime mortgages	**116.0**	**0.5**	142.7	0.6
Residential self-certification mortgages	**382.6**	**1.6**	474.9	2.2
Commercial mortgages[1]	**8.3**	**-**	10.1	-
Total non-traditional mortgages	**506.9**	**2.1**	627.7	2.8
Unsecured personal loans[1]	**56.7**	**0.2**	58.7	0.3
Total gross balance	**24,144.5**	**100.0**	22,046.5	100.0

1. Legacy books of unsecured personal loans and commercial mortgages exist. The credit risks from these are immaterial and are not considered further within the report.

Owner-occupier

Residential mortgages: owner-occupier includes £330.0 million (1.4% of total gross balances) (2012: £341.5 million and 1.5%) of 'equity-release mortgages', where 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. The Society is therefore exposed to the risk that the value of the property at the time of redemption is lower than the loan including accumulated interest. The Society manages this risk by granting loans at a relativity low loan to value, subject to the age of the borrower, and through the use of statistical modelling to stress potential exposures within acceptable prudent limits. The Society has not offered these mortgages since 2009.

Buy-to-let

The Society undertakes low risk, low loan to value business, and the amount of equity each borrower consequently retains within the property means that even in the event of default, credit losses are low. Along with assessing rental income and stipulating conservative minima that are acceptable, which helps protect the mortgage repayments independently of the borrower's circumstances, the Society also limits the number of properties it will consider in lending to individual landlords. Additionally, the Society considers the value of the property on the basis of whether it can be resold into the owner-occupier market. This therefore gives recourse to two markets (buy-to-let and owner-occupier) in the event that the property was to move into Society ownership. For these reasons the risks from the Society's buy-to-let portfolio are in many respects comparable to standard owner-occupier mortgages.

Geographic concentration

The residential mortgage portfolio is well diversified and reflects the national coverage of the Society's lending operations. The geographical split of residential mortgages by balance, gross of impairment provisions is shown below:

Table 15 Geographical distribution of residential mortgages

Region	2013 %	2012 %
East of England	**12.4**	12.1
London	**14.2**	13.1
Midlands	**16.0**	17.0
North East	**9.1**	9.2
North West	**8.6**	8.7
Scotland & Northern Ireland	**4.6**	4.6
South Central	**12.6**	12.7
South East	**10.6**	10.3
South West & Wales	**11.9**	12.3
Total	**100.0**	100.0

Loan to value

The Society's low risk approach to lending is reflected in the loan to value profile of the residential mortgage book. The estimated value of the residential mortgage portfolio is updated on a quarterly basis using the Nationwide regional house price index.

The residential mortgage book as at 31 December 2013 is analysed on the next page, together with an analysis of gross new lending in the year. The following tables are by number of accounts unless stated otherwise:

Table 16: Residential mortgages LTV (number of accounts)

Book analysis	2013 %	2012 %
Indexed loan to value:		
< 50%	**45.0**	43.3
50% to 65%	**26.6**	22.3
65% to 75%	**13.7**	14.5
75% to 85%	**9.1**	10.8
85% to 95%	**4.1**	5.5
> 95%	**1.5**	3.6
Total	**100.0**	100.0
Average indexed loan to value of stock (simple average)	**50.0**	52.1
Average indexed loan to value of stock (balance weighted)	**57.7**	60.9

Table 17: Residential mortgages new business profile

New business profile (Gross lending)[1]	2013 %	2012 %
Owner-occupier purchase	**36.7**	32.0
Owner-occupier remortgages	**24.0**	23.9
Buy-to-let	**39.3**	44.1
Total	**100.0**	100.0
Average loan to value (simple average)	**63.6**	60.6
Average loan to value (balance weighted)	**66.5**	64.1

1. New business and average loan to value of new business excludes further advances (2013: £141.7 million, 2012: £129.0 million).

Extent and use of forbearance

Forbearance occurs when, for reasons relating to the actual or apparent financial stress of a borrower, the Society grants a concession to that borrower, but only where the Society 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 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.
- 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.

With regard to cases that are not past due, forbearance may be granted to members as a means of helping them overcome temporary financial difficulties. The vast majority of cases of this type are payment holidays granted by the Collections department. Payment holidays are a contractual feature on most of the mortgage products offered by the Society, but where a customer requests a payment holiday and it has been determined that financial difficulties are the reason for the request, the action is recorded as being a forbearance measure.

In rare cases, the Society may also capitalise arrears and schedule repayment of the balance over the remaining term of the loan when the period of financial difficulty has ended, provided that the customer has made at least six consecutive monthly payments and payments will be sustainable over the remaining life of the mortgage. Capitalisation will only be allowed once on each loan. In 2013 the Society capitalised arrears on 13 accounts (2012: 12) in total, of which 10 are currently performing and up to date (2012: 10).

The Society no longer lends on an interest-only basis for owner-occupier mortgages, and the option to transfer members on to temporary interest-only payments has been curtailed accordingly and is only used in very rare situations. During 2013 only four mortgages were put on to a temporary interest-only basis (2012: 37) of which three are currently performing and up to date (2012: 35).

Table 18: Forbearance

	2013 No of accounts	**2013 Carrying value £m**	2012 No of accounts	2012 Carrying value £m
Forbearance: Accounts past due				
Arrangements	**2,789**	**323.4**	3,099	360.9
Concessions	**208**	**22.2**	242	28.7
Term extensions[1]	**41**	**4.6**	122	12.4
Capitalisation of arrears[1]	**3**	**0.4**	2	0.3
Temporary transfer to interest-only[1,2]	**1**	**0.1**	2	0.2
Forbearance indicators: Accounts not past due				
Payment holidays granted by Collections department[1]	**1,605**	**197.5**	1,213	137.1
Term extensions[1]	**61**	**7.0**	50	5.2
Capitalisation of arrears[1]	**10**	**1.1**	10	1.2
Temporary transfer to interest-only[1,2]	**3**	**0.3**	35	4.7

1. Granted in the last 12 months.
2. The option to transfer members on to temporary interest-only payments is only used in very rare situations.

The Society holds £9.9 million provision (2012: £11.8 million) in total for all cases in these forbearance categories. The provision balance has fallen despite the overall increase in the number of cases since last year because of the reduction in the number of accounts with forbearance indicators that are also past due and have a greater propensity to default.

With regard to the increase in payment holidays granted by the Collections department, in 2013 a new automated process was introduced whereby an increased number of requests were referred to the department to determine if there was any indication of financial difficulty. This increase therefore reflects a more robust process for identifying cases for treatment within the appropriate business area, and does not in itself represent an increase in forbearance.

Whilst accounts not past due are not considered to be individually impaired it is recognised that collectively impairment exists. Provisions have therefore been raised against accounts subject to a forbearance measure. In addition the Society has identified the following situations as indicating potential impairment amongst members whose mortgages are nonetheless not past due.

- Accounts where direct debits had been cancelled or returned but payment was subsequently made.
- Payments were being made by the Department for Work and Pensions.
- The Society has paid ground rent on behalf of members living in leasehold properties.

Members whose mortgage accounts display these potential impairment indicators have a higher than expected propensity to go into arrears, but the increased propensity is not so high as to consider these loans as being impaired.

The analysis of these potential impairment indicators assesses the performance of any mortgage that has had one of these situations arise in the previous 12 months. As at 31 December 2013 there were 3,661 members with such potential impairment indicators, to the value of £365.4 million (1.5% of the mortgage book). A collective provision of £0.5 million is being held, which reflects the low probabilities of default (since 31 December 2012, only 45 cases in these categories had gone into arrears by six or more months) and high collateral values (the average simple loan to value is 50.4 % and less than 4% are above 95% loan to value) of these cases.

5.2.2 IRB rating system

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; and
- mortgages acquired from Bank of Ireland in 2012.

The majority of loan assets that were added to the balance sheet via the merger with Stroud & Swindon Building Society were migrated on to the IRB approach at June 2013. The exceptions were those that fell within the portfolio types listed above. Across the Group, 96% of balances outstanding as at December 2013 are on the IRB approach to calculating capital.

The internal rating model and process

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).

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 including 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 (£27.4 million at December 2013, £27.6 million December 2012) consistent with IFRS differs from the amount determined from the expected loss models (£53.1 million at December 2013, £45.7 million December 2012) that are used for regulatory purposes.

The LGD model used for expected losses is calibrated to downturn conditions (e.g. a peak-to-trough fall in house prices is assumed in the expected loss calculation). In the impairment model, current prices are used with no future house price movements being assumed.

In addition, impairment models also use current (point-in-time) roll rates as the basis of estimating likelihood to default. The expected loss model uses long run average PD estimates and, in the current environment, the long run PD estimate is higher than point-in-time default rates. For example, the point-in-time one year default rate is 0.51% whilst the portfolio average long run PD is 0.78% (December 2012 to December 2013 period).

The increase in expected loss amounts for mortgages rated under the IRB approach is attributable to the prudent increase to the discount rate in the LGD model that was applied in 2013 rather than as a result of any underlying deterioration in performance (section 4.4). Without this adjustment, the performance of the mortgage book has improved since the end of 2012, with fewer loans in arrears or default.

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:

Table 19: Allocation of exposures to IRB risk band

	Notes	**Outstanding loans 2013 £m**	**Undrawn loans 2013 £m**	Outstanding loans 2012 £m	Undrawn loans 2012 £m
Risk grades:					
1		**18,698.2**	**911.5**	15,854.4	513.6
2		**4,043.6**	**87.1**	3,543.8	213.1
3		**794.7**	**6.5**	762.5	51.7
4		**230.5**	**0.1**	210.2	1.2
5		**108.0**	**-**	98.7	-
Past due		**320.0**	**-**	307.2	-
Total IRB (balances outstanding)		**24,195.0**	**1,005.2**	20,776.8	779.6
Standardised		**950.1**	**-**	2,151.2	81.9
Total retail exposures	1	**25,145.1**	**1,005.2**	22,928.0	861.5

1. The outstanding loans above are shown on an EAD basis.

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 2013, the value of undrawn exposures being rated under the IRB approach was £1,005.2 million (2012: £779.6 million). 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.

There are no longer any undrawn exposures under the standardised approach (2012: £81.9 million). The previous exposures related to a draw down facility available on legacy Stroud & Swindon products, which is no longer available to new customers and which was migrated on to the IRB approach in June 2013. No new lending is being conducted on exposures that are rated under the standardised approach.

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:

Table 20: IRB Probability of Default (PD), Exposure at Default (EAD), Loss Given Default (LGD) and Average Risk Weight

PD bands up to:	**Exposure at default estimate 2013 £m**	**Average loss given default 2013 %**	**Average risk weight 2013 %**	Exposure at default estimate 2012 £m	Average loss given default 2012 %	Average risk weight 2012 %
0.30	**19,581**	**13.3**	**4.4**	16,368	8.4	2.9
1.00	**4,155**	**18.1**	**15.6**	3,757	14.3	12.9
3.00	**695**	**25.8**	**52.5**	717	22.5	47.1
10.00	**341**	**25.6**	**81.3**	308	22.0	70.6
100.00	**287**	**23.7**	**118.7**	263	21.2	104.5
In Default	**141**	**23.5**	**210.1**	143	21.6	173.0
Total	**25,200**			21,556		

The increase in the observed average LGD% and risk weights between the 2012 figures and the current values arises because of modelling changes, via the application of the increase to the discount rate in the LGD model noted above, rather than as a result of deterioration in performance of the underlying mortgage book.

5.2.3 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 models department. This team 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 and finance functions, is the designated committee through which authority for changes to models is obtained. The Head of Internal Audit also attends the Committee.

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 risk models function.

The independent external expert:

- reviews the frequency, quality and appropriateness of the monitoring reports;
- reviews the appropriateness of the risk models function's analysis and conclusions about model performance;
- provides comment and independent assessment on changes to models recommended by the risk models 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:

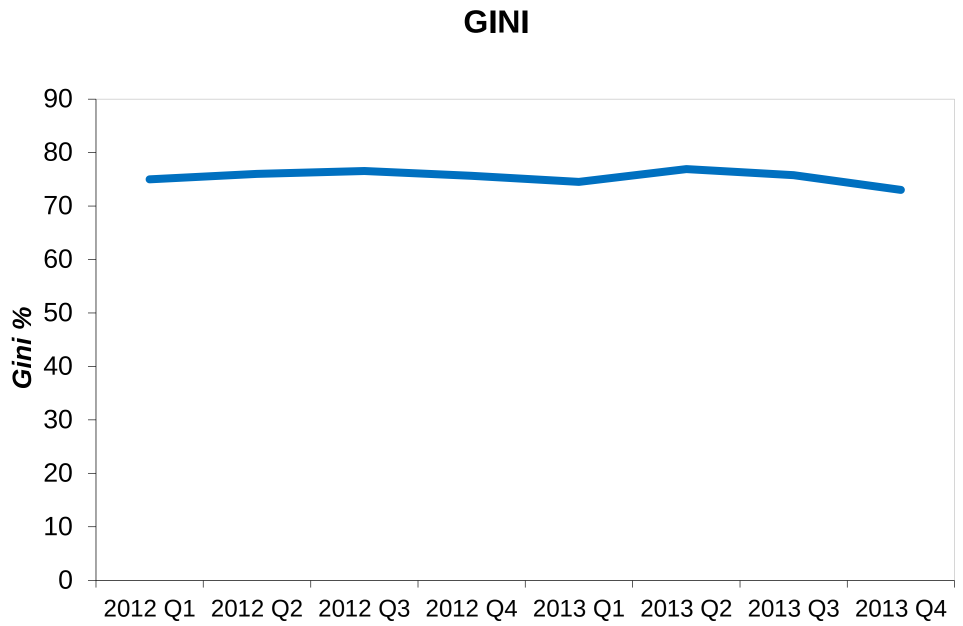
- the application PD model is integrated into the application decision making process – the same application model that provides the PD assessment of new applications is used to determine the credit risk, and hence the level of underwriter involvement (alongside lending policy considerations and valuations) of new mortgage applications;
- various aspects of the behavioural model contribute to the prioritisation of collections activity;
- shortfall model outputs are also used to assist in impairment provision calculations;
- for limit setting with regard to the quality of new business taken on; and
- within corporate and capital planning, to determine projected capital and impairment requirements in various forward looking scenarios and stresses.

5.2.4 IRB model performance 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.

Table 21: Probability of Default (PD) model

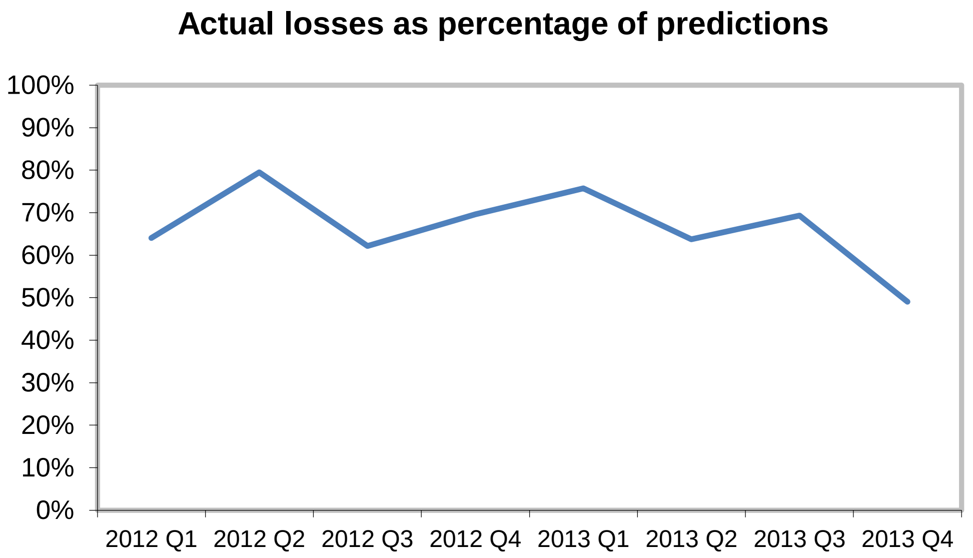


The correlation of recent experience of losses to predicted shortfalls is shown in the following graph. Predicted shortfalls in the capital calculation are made using the downturn LGD model, which are set to an assumed peak-to-trough fall in house prices that mirror a downturn in the housing market.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

On average over the course of 2013, 18 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 was on average another 1 sale per month of cases that fell under the Standardised Approach).

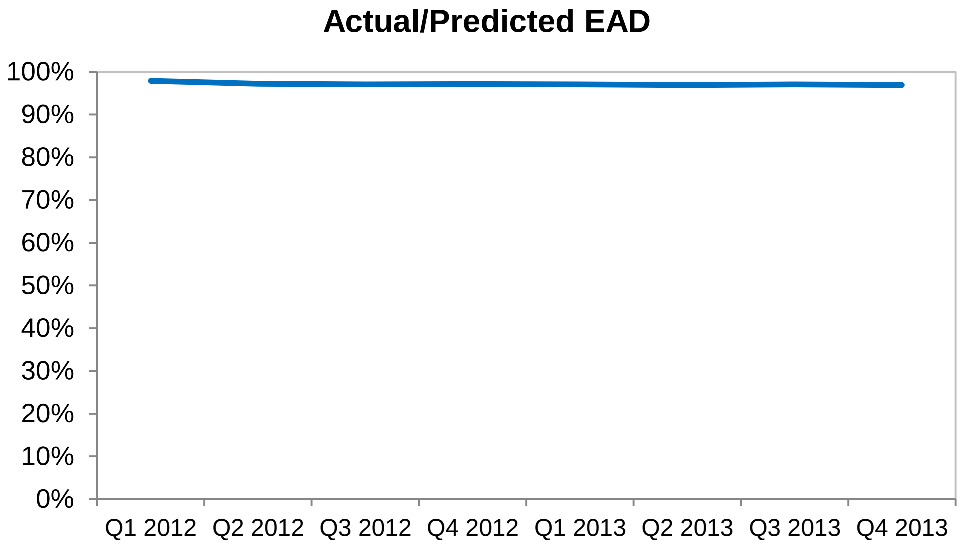
With such small numbers of sales, the loss experience can be affected by individual unusual cases that give rise to losses that could not be reasonably predicted using a statistical model. The types of cases experienced in 2013 included properties that had been damaged by the occupant prior to repossession, issues with rights of access, and boundary disputes. However, the loss experience has been in line with predictions, which were generally conservative. In particular in Q4 2013, the performance of sales from properties in possession was stronger than predicted reflecting improvement in the housing market.

Table 22: Actual losses as 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:

Table 23: Actual Exposure at Default (EAD) against 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:

Table 24: Actual Probability of Default (PD) and Loss Given Default (LGD) against predicted

IRB retail mortgages	**Actual 2013 %**	Predicted 2012 %	Actual 2012 %	Predicted 2011 %
PD	**0.24**	0.27	0.30	0.30
LGD	**5.71**	6.09	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. To enable a consistent and like-for-like comparison to be made, the analysis above excludes ex-Stroud & Swindon mortgages, which were migrated on to IRB in June 2013.

Data integrity and quality

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.

Regular reconciliations and reviews of data quality and accuracy are conducted by the risk models function, which as part of its monitoring role seeks to identify and investigate outliers and correct inaccuracies in the data underpinning the rating system.

5.2.5 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 Royal Institution of Chartered Surveyors (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. 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.
- Regular reviews of the appropriateness and accuracy of the various valuation methods used by the Society are undertaken, to satisfy ourselves that these remain appropriate and accurate for the purposes of establishing the security value.
- Once the value of the property has been established, the Nationwide Building Society regional house price index is used to provide an updated estimate of the property's value, on a quarterly basis. Monitoring of the accuracy of the Nationwide Building Society index is undertaken on a regular basis, the results of which inform the Society's IRB models.
- 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.

5.2.6 Impairment provisions - Assets held at amortised cost

The Group assesses its loans and advances to customers for objective evidence of impairment at each statement of financial position 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 statement of financial position date and has a reliably measurable impact on the estimated future cash flows.

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, work out 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 26% 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 potential impairment.

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 being present 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, 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, 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.

The following table shows the movement in the year in impairment provisions. The incurred loss element of the fair value adjustments arising from the merger with the Stroud & Swindon Building Society, have been included within the table.

Table 25: Movements in impairment provisions

Group	**Loans fully secured on residential property 2013 £m**	**Other loans 2013 £m**	**Total 2013 £m**	Loans fully secured on residential property 2012 £m	Other loans 2012 £m	Total 2012 £m
At 1 January						
Individual impairment	**18.8**	**1.4**	**20.2**	17.6	0.8	18.4
Collective impairment	**7.0**	**0.4**	**7.4**	7.2	0.4	7.6
	25.8	**1.8**	**27.6**	24.8	1.2	26.0
Charge for the year						
Individual impairment	**4.4**	**0.4**	**4.8**	7.6	2.2	9.8
Collective impairment	**1.6**	**(0.1)**	**1.5**	(0.2)	-	(0.2)
	6.0	**0.3**	**6.3**	7.4	2.2	9.6
Charge covered by fair value adjustment*	**0.8**	**0.8**	**1.6**	1.7	0.2	1.9
Amounts written off	**(7.3)**	**(0.8)**	**(8.1)**	(8.1)	(1.8)	(9.9)
At 31 December						
Individual impairment	**16.2**	**1.3**	**17.5**	18.8	1.4	20.2
Collective impairment	**9.1**	**0.8**	**9.9**	7.0	0.4	7.4
Total	**25.3**	**2.1**	**27.4**	25.8	1.8	27.6

*Utilisation of fair value adjustment arising from the merger with Stroud & Swindon Building Society in 2010.

An analysis of past due and impaired loans by loan to value is shown below:

Table 26a: Past due and impaired loans by loan to value (LTV) 2013

As at 31 December 2013	**Not impaired**		**Impaired**				
Indexed loan to value:	**Not past due £m**	**Past due up to 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 £m**
< 50%	**7,297.0**	**135.1**	**17.2**	**15.2**	**0.2**	**(2.2)**	**7,462.5**
50% to 65%	**7,712.5**	**189.4**	**26.3**	**17.8**	**-**	**(4.0)**	**7,942.0**
65% to 75%	**4,113.8**	**136.6**	**21.1**	**21.0**	**0.2**	**(3.5)**	**4,289.2**
75% to 85%	**2,620.5**	**113.0**	**22.2**	**18.9**	**0.3**	**(3.0)**	**2,771.9**
85% to 95%	**1,016.7**	**134.4**	**20.1**	**19.8**	**0.7**	**(4.0)**	**1,187.7**
> 95%	**338.7**	**31.0**	**16.8**	**21.7**	**9.6**	**(9.6)**	**408.2**
Unsecured	**51.7**	**4.0**	**0.6**	**0.4**	**-**	**(1.1)**	**55.6**
Total	**23,150.9**	**743.5**	**124.3**	**114.8**	**11.0**	**(27.4)**	**24,117.1**

Table 26b: Past due and impaired loans by loan to value (LTV) 2012

As at 31 December 2012	Not impaired		Impaired				
Indexed loan to value:	Not past due £m	Past due up to 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 £m
< 50%	5,980.0	101.8	14.6	13.8	0.2	(0.9)	6,109.5
50% to 65%	5,936.0	149.6	19.5	17.4	-	(2.1)	6,120.4
65% to 75%	3,949.6	148.1	25.0	15.1	0.2	(2.7)	4,135.3
75% to 85%	2,981.8	183.0	24.7	21.8	0.2	(3.9)	3,207.6
85% to 95%	1,333.8	84.3	23.1	24.8	0.1	(4.3)	1,461.8
> 95%	792.8	62.2	34.0	40.2	10.1	(12.1)	927.2
Unsecured	53.2	4.2	0.7	0.6	-	(1.6)	57.1
Total	21,027.2	733.2	141.6	133.7	10.8	(27.6)	22,018.9

The Society held properties valued at £9.1 million (2012: £8.4 million) pending their sale against balances of £8.2 million (net of provisions) (2012: £7.5 million). Shortfalls between expected sale proceeds (less anticipated costs) and the balance outstanding are fully provided.

The table below provides further information regarding the impaired status of retail mortgages and loans. Balances are shown gross of impairment provisions.

Table 27a: Not impaired and impaired loans by segment 2013

As at 31 December 2013	Not impaired		Impaired				
	Not past due £m	Past due up to 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 £m
Traditional residential mortgages							
Owner-occupier	14,505.6	490.9	89.2	69.5	5.9	(11.9)	15,149.2
Buy-to-let	8,201.3	187.4	12.3	15.9	2.9	(9.4)	8,410.4
Non-traditional mortgages							
Residential near-prime	62.0	25.7	10.8	16.7	0.8	(1.9)	114.1
Residential self-certified	322.9	34.6	11.4	12.3	1.4	(2.1)	380.5
Commercial lending	7.4	0.9	-	-	-	(1.0)	7.3
Unsecured	51.7	4.0	0.6	0.4	-	(1.1)	55.6
Total	**23,150.9**	**743.5**	**124.3**	**114.8**	**11.0**	**(27.4)**	**24,117.1**

Table 27b: Not impaired and impaired loans by segment 2012

As at 31 December 2012	Not impaired		Impaired				
	Not past due £m	Past due up to 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 £m
Traditional residential mortgages							
Owner-occupier	13,597.8	412.8	87.8	80.7	6.1	(11.6)	14,173.6
Buy-to-let	6,892.2	243.9	18.6	17.5	2.7	(8.8)	7,166.1
Non-traditional mortgages							
Residential near-prime	74.7	29.2	18.7	19.7	0.4	(2.8)	139.9
Residential self-certified	400.1	42.3	15.8	15.1	1.6	(2.6)	472.3
Commercial lending	9.2	0.8	-	0.1	-	(0.2)	9.9
Unsecured	53.2	4.2	0.7	0.6	-	(1.6)	57.1
Total	21,027.2	733.2	141.6	133.7	10.8	(27.6)	22,018.9

Movement in impaired loans

The table below reconciles the movements in impaired loans in the year.

Table 28: Movement in impaired loans

	Traditional residential mortgages		Non-traditional mortgages				
	Owner-occupier £m	Buy-to-let £m	Residential near-prime £m	Residential self-certified £m	Commercial lending £m	Unsecured £m	Total £m
Impaired at 1 January 2013	174.6	38.8	38.8	32.5	0.1	1.3	286.1
Classified as impaired during the year	141.6	39.7	21.8	32.8	0.2	1.7	237.8
Transferred from impaired to unimpaired	(135.6)	(42.3)	(26.4)	(32.5)	(0.3)	(0.6)	(237.7)
Amounts written off	(4.3)	(1.5)	(0.3)	(0.7)	-	(1.3)	(8.1)
Charged to impaired loans	3.0	1.1	0.6	0.4	-	-	5.1
Repayments and other movements	(14.7)	(4.7)	(6.2)	(7.4)	-	(0.1)	(33.1)
Impaired at 31 December 2013	**164.6**	**31.1**	**28.3**	**25.1**	**-**	**1.0**	**250.1**

Loan balances are shown gross of provisions. The balances are of impaired loans at the start and end of the year. Amounts written off reflect losses on loans sold from possession where the balances on these loans were in excess of the sale proceeds. Repayments and other movements include disposals (where the balances of loans sold from possession where sale proceeds were sufficient to settle the loan), repayments (from customers reducing the outstanding balances) and transfers between categories. Amounts charged to impaired loans includes interest accrued and charges.

5.3 Treasury credit risk

5.3.1 Management of treasury credit risk

Credit risk within the treasury function (wholesale credit risk) arises from the portfolio of liquid and other financial 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.

Treasury exposures and limits are focused in the main on 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.

Derivatives are only executed with organisations that have been subject to review by the Treasury Credit Committee and the vast majority include collateral agreements primarily reducing the risk to the extent valuations may move within a week. The Society has no exposure to emerging markets, hedge funds, non-UK RMBS or credit default swaps and 99.9% of exposures have an investment grade rating.

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 the Assets and Liabilities Committee (ALCO) to RMC and BRC.

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:

Table 29a: Treasury asset exposure value by rating 2013

	Exposure value by Moody's rating					
31 December 2013	**Aaa–Aa3 £m**	**A1–A3 £m**	**Baa1–Baa3 £m**	**Unrated[2] £m**	**Total £m**	**Capital requirement £m**
Central banks and sovereigns[1]	**3,188.9**	**-**	**-**	**-**	**3,188.9**	**-**
Multilateral development banks (supranational bonds)[1]	**95.7**	**-**	**-**	**-**	**95.7**	**-**
Financial institutions	**323.6**	**90.7**	**4.1**	**1.6**	**420.0**	**5.8**
Residential mortgage-backed securities	**177.9**	**4.9**	**-**	**-**	**182.8**	**5.5**
Total	**3,786.1**	**95.6**	**4.1**	**1.6**	**3,887.4**	**11.3**
Risk weight	**0/20%**	**20/50%**	**20/50%**	**20/50%**	**-**	**-**

Table 29b Treasury asset exposure value by rating 2012

	Exposure value by Moody's rating					
31 December 2012	Aaa–Aa3 £m	A1–A3 £m	Baa1–Baa3 £m	Unrated[2] £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	8.7
Residential mortgage-backed securities	198.9	5.3	-	-	204.2	3.5
Total	64,052.9	401.6	4.9	16.7	4,476.1	12.2
Risk weight	0/20%	20/50%	20/50%	20/50%	-	-

1. Risk weighting for central banks and sovereigns and multilateral development banks (supranational banks) is 0%.
2. Unrated institutions comprise smaller building societies and local authorities.

5.3.2 Credit risk mitigation

Debt securities are generally unsecured with the exception of securitisation and covered bond positions which are secured by pools of financial assets.

The Society has entered into International Swaps and Derivatives Association (ISDA) master netting agreements for all of its derivatives (other than derivatives held by the Coventry Building Society Covered Bonds LLP), whereby outstanding transactions with the same counterparty can be settled net following a default or other predetermined event. Credit Support Annexes (CSAs) are executed in conjunction with these ISDA master agreements which typically provide for the exchange of collateral on a weekly basis to mitigate net mark to market credit exposure.

The Coventry Building Society Covered Bonds LLP does not enter into a master netting agreement due to the structure of the transaction but a CSA has been entered into which provides for full collateralisation by the counterparty should its rating fall below a certain threshold. Substantially all of the net derivative credit exposure in table 31 relates to this arrangement. The counterparty has a credit rating of Aa3.

5.3.3 Impairment provisions - Available-for-sale-assets

Unrealised gains and losses arising from changes in fair values are recognised directly in the Available-for-sale (AFS) 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 AFS assets, including any cumulative gains or losses previously recognised in the AFS reserve, are recognised in the income statement.

When a decline in the fair value of an AFS 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. In assessing impairment, the Society considers the credit ratings of the counterparties, current market valuations (such as negative fair value adjustment) as well as the extent to which coupon payments have been made on a timely basis. As at 31 December 2013 no amounts in the treasury portfolio were either past due or impaired, and as such no provision had been made.

5.3.4 Securitisation

Purchased securitisation positions
The exposure values relating to the Society's ownership of Residential Mortgage Backed Securities (RMBS) and their associated risk weightings for capital purposes are included in the table 29 in Section 5.3.1. All exposures comprise senior tranche RMBS.

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 in line with article 122a of the Capital Requirements Directive.

As at 31 December 2013, no purchased 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:

Table 30a: Balance of funding secured on the loans and advances 2013

		Notes in issue			
31 December 2013	**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	**694.1**	**470.9**	**-**	**78.7**	**549.6**
Securitisation programme – Mercia No.1 plc	**1,535.0**	**-**	**-**	**1,436.4**	**1,436.4**
Total	**2,229.1**	**470.9**	**-**	**1,515.1**	**1,986.0**

Table 30b: Balance of funding secured on loans and advances 2012

		Notes in issue			
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 2013, the nominal value of listed debt securities in issue had fallen to £550.1 million of which £78.7 million was held by the Group.

Securitisation – Mercia No.1 plc

Mercia No.1 plc (Mercia) was incorporated in October 2012 and in December 2012 Mercia issued £1,436.4 million of listed debt securities all of which were retained by the Group. As at the 31 December 2013, 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 undrawn 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 'Residential mortgages' detailed throughout this document.

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.

5.3.5 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.

All of the Society's derivatives are over-the-counter (OTC) and none are as yet settled by central counterparties.

The mitigation of counterparty credit risk by entering into ISDA master netting agreements is covered in 5.3.2 Credit risk mitigation.

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:

Table 31: Derivative counterparty credit exposure

	31 December 2013 Exposure value £m	31 December 2012 Exposure value £m
Gross positive fair value of contracts	**191.2**	279.6
Netting benefits	**(102.8)**	(166.7)
Net credit exposure	**88.4**	112.9
Collateral held	**(46.4)**	(1.2)
Net derivative credit exposure	**42.0**	111.7

As at 31 December 2013, 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 2013, which includes uplifts for Potential Future Credit Exposure (PFCE) under the mark to market method for assessing counterparty credit risk totalled £111.0 million (2012: £189.7 million).

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.

6. Market risk

6.1 Management of 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, or foreign exchange rates.

The Society's policy is to manage its exposure to these risks within prudent limits. The hedging undertaken to mitigate interest rate and foreign exchange rate movements is via a combination of matching assets and liabilities with offsetting interest rate or exchange rate characteristics and by the use of derivative financial instruments such as interest rate swaps, interest rate options and cross currency interest rate swaps.

The Society does not trade or take speculative positions on derivatives.

Control of market risk exposure is overseen by the Asset and Liability Committee (ALCO), which reports to the Risk Management Committee (RMC) and Board Risk Committee (BRC). The accounting policy for derivatives and hedge accounting is described in the Annual Report & Accounts Accounting Policies in note 1.

The most significant elements of market risk for the Society are interest rate risk and foreign currency each of which is described below.

6.2 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. The Society is subject to the risk that changes in interest rates will cause material variations in earnings because of different interest rates charged for the mortgages and paid for the funding that comprise the bulk of the balance sheet.

For example, 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. Where the opportunity exists, the Society will offset assets and liabilities with similar interest profiles. Alternatively the Society may 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. This risk increases with the duration of the asset and is particularly relevant for equity release mortgages (£330.0 million) held by the Society, however as at 31 December 2013 approximately £150 million of this balance was hedged. Similarly, in cases of issuing fixed rate savings products, the Society may take out an interest rate swap under which it receives a fixed rate of interest and pays a variable rate.

The Society also continues to ensure that it has a significant proportion of administered rate savings and mortgages on its balance sheet, giving it flexibility to manage a prolonged low interest rate environment, or the impacts from a Bank Base Rate rise.

The Society has a series of Board approved limits that ensure the impact of a change in general interest rates has limited effects on both the net interest income generated and present value (PV) of its balance sheet repricing gaps. In addition, the Society forecasts monthly the impact of movements in the Bank Base Rate on the Society's net interest income to ensure any potential adverse impact can be anticipated. This information is reported to ALCO, RMC and BRC every month.

The following tables show the impact of a 200bps parallel shock to interest rates on the value of the assets and liabilities (PV200) and net interest income (100bps) throughout the reporting period:

Table 32: PV200 interest rate sensitivity shock

Shock applied	**+200bps** **31 Dec 2013** **£m**	-200bps 31 Dec 2012 £m
PV200 results	**(5.4)**	(4.5)

Table 33: Net interest income – 100bp sensitivity

	+100bps 2013 £m	**-100bps 2013 £m**	+100bps 2012 £m	-100bps 2012 £m
Impact on profit and loss	**13.1**	**(7.6)**	19.2	(10.1)

The PV200 measures the impact of a rate change on the value of the assets and liabilities and incorporates a Board approved duration for the investment of reserves. The impact on profit and loss reflects the changes in interest income on the assets and liabilities and the expected consequential effects that would occur, such as changes in customer behaviour, over the accounting period following a rate shock. In a low interest rate environment, interest rates are floored at zero. The reported sensitivity will vary over time due to strategic changes to the balance sheet mix and general market conditions and should not be considered predictive of future sensitivity.

In line with the Society's policy to manage interest risk management within prudent limits, the balance sheet is positioned to be relatively insensitive to adverse interest rate movements.

Basis risk

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, LIBOR and SONIA). This risk is characterised as basis risk and is subject to limits, regularly monitored, stress tested, and reported monthly to ALCO, RMC and BRC.

The risk is measured by applying a basis spread shock to the financial forecasts which includes behavioural assumptions and current business plans but excludes the impact of any consequential response, and assessing the impact of that shock on the prevailing net interest income.

The Board has defined limits for the level of reduction in net interest income each quarter that arises from the basis shock applied. These limits are reviewed monthly by ALCO, RMC and BRC to ensure compliance.

Swap spread risk

In order to diversify its liquidity holdings the Society holds a part of its liquidity portfolio in gilts, which have associated derivatives (swaps) in order to hedge the interest rate risk. The hedging undertaken to mitigate interest rate movements (which follow the swap curve), will provide some protection against offsetting movements in the value of the gilts (which follow the government securities curve). However, the credit element of gilt value movements arising from perceptions of Sovereign quality, remain unprotected and it is this which creates 'swap spread risk'. This risk only crystallises if the gilts are sold, generally they are held to term as part of the Society's liquidity resources; however under CRD IV the net difference is deducted from capital as part of the Available-for-sale reserve. Swap spread risk is monitored through a Board limit.

Product option risk

Prepayment risk is a category of product option risk, sometimes referred to as a behavioural risk, which arises from product features available to the Society's members.

Members have the option, albeit sometimes with penalties, to redeem their mortgage loan (prepayment) or withdraw their savings (access) at their discretion, representing prepayment or repayment risk to the Society.

These risks are managed through a combination of the following:

- Redemption charges on mortgage products and repayment charges on savings products to reflect the risk.
- Offering products whose behaviour may be more predictable under the anticipated future interest rate outcomes.
- Monitoring past trends and stress testing future forecasts.
- Matching hedging to the expected attrition profile of the product.
- Balance tracking hedges for equity release mortgages.

Product option risk also includes pipeline risk, the risk that between the point of application for a product and completion, customers choose not to take the product potentially during a period in which interest rate expectations may have moved. This could leave the Society with an imbalance of funding or hedging that is no longer at prevailing interest rates.

The risk is managed by only allocating specific tranches to individual products and undertaking hedging activity whilst applications are received. The risk is further mitigated by keeping the pipeline small compared to the overall balance sheet and through close monitoring during early product stages.

6.3 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 primarily 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. The Society has also in the past, offset foreign currency liabilities with foreign currency assets.

After taking into account the effects of cross currency swaps, the Society has no material net exposure to foreign exchange risk fluctuations or changes in foreign currency interest rates. Consequently the foreign exchange position risk requirement is minimal and is not considered further for the purposes of capital. Foreign currency repricing risk is assessed as the effect of a 3% parallel rate shift on repricing mismatches within any foreign currency and the results are set out below. ALCO sets limits on the level of exposure by currency which is monitored daily.

Table 34: Foreign exchange risk exposure

	31 Dec 2013 **£m**	31 Dec 2012 £m
Foreign currency repricing	**0.08**	0.20

The Society net exposure to foreign exchange position is immaterial,

Redenomination risk

Redenomination risk is the 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 minimal redenomination risk, as all euro denominated asset exposures are held with UK institutions.

7. Liquidity and funding risk

7.1 Management of 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. This could manifest itself in an inability to raise new wholesale funding and replace existing funding as it matures, due to a severe liquidity crisis in the money markets or in a loss of member confidence that causes a 'run' on retail funds. The Society maintains at all times liquidity resources 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 inability to access funding markets or to only do so at excessive cost and/or liquidity risk. 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 Societies Act and by the PRA. Diversifying the source of retail deposits is achieved by having a broad customer base spread throughout the UK. The Society is predominantly funded through retail deposits reflecting the long-term strategy. Wholesale funding is used to provide diversification and lower the overall cost of funding. Funding is managed centrally enabling it to be used to fund assets throughout the Society.

Determining the appropriate mix and amount of liquidity to hold 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 secure 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 approved by the Board following a recommendation from BRC. 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 2013 and is set with reference to the ability to meet all cash requirements throughout a prolonged combination stress as detailed later in this section.

7.2 Liquidity adequacy

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 assessment, management and liquid resources. The Society's Internal Audit function 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 Chapter 12 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) 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 Treasury and Prudential 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 risk:

- 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 cash flows.
- Trapping of liquidity within covered bonds and RMBS programmes.

- Trapping of liquidity in particular currencies.
- Downgrade requirements associated with the covered bond and RMBS programmes.
- Limits on the cash that can be generated from liquid assets in a liquidity event.
- Ability to use contingent liquidity 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 eligible liquidity that the PRA requires the Society to hold. This measure uses a three month time period and assesses similar liquidity requirements. The Society is required to meet a set percentage of the calculated liquidity requirement through eligible Liquid Asset Buffer (LAB) assets (the first and second categories of liquidity set out on in the 2013 Annual Report & Accounts page 18). Following the initial expansion of eligible liquidity to include pre-positioned mortgage assets and self issued covered bonds, the PRA has extended the amount of off-balance sheet collateral that can be used to meet the ILG assessment. 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 CRD IV 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 liquidity 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 assessment 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 RMC, BRC and the Board. All limits were in surplus as at the year end and throughout the year.

A Recovery and Resolution Plan is in place which sets out a range of options available to the Society in the event of a severe liquidity or capital stress. As part of this Recovery and Resolution Plan, there are a number of contingent funding options designed to deal with a liquidity or funding stress which are evaluated on a regular basis through the Society's periodic realisation programme, and through an annual full scale exercise.

8. Operational risk

8.1 Overview

Operational risk is the risk of loss arising from inadequate internal processes, people and systems or from external events impacting these. During the year, conduct risk was managed as part of the overall operational risk management framework but from early 2014 it will be managed by a dedicated Conduct Risk Committee to provide oversight of conduct risk matters and developments.

Operational risks are managed as an integral part of the Society's operations. 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. Key operational risk activities are detailed below:

Risk category	Brief definition
Business continuity	The risk to the Society arising from its incapacity to continue its business operations in the event of significant operational disruption or arising from loss or damage to physical assets or staff from a natural disaster or other events.
Change	The risk to the Society arising from the failure to successfully manage key projects.
Conduct	The risk to the Society arising from a loss or a failure to deliver fair customer outcomes.
Financial reporting	The risk to the Society as a result of a loss or a failure arising from the operational risks associated with the publication of financial statements, adherence to accounting standards, compliance with tax laws and codes, maintenance of the general ledger and publication of documentation for funding programmes.
Financial crime	The risk of loss to the Society arising from a failure to prevent fraud.
Information management and security	The risk of loss arising from its failure to ensure the security, accuracy and completeness of data and information.
Model	The risk of loss arising from the inaccurate implementation and/or use of models and model outputs.
People	The risk of loss arising from the inability to recruit, develop or retain the appropriate people resources.
Premises and physical security	The risk arising from injury or loss as a consequence of a failure to ensure that premises and physical assets are fully compliant with regulations, effectively maintained, secured and protected.
Technology	The risk of damage to the Society as a result of the failure of its technology assets.

In addition to the direct loss attributable to these risk categories, the reputational impact of such an event may damage the business franchise leading to secondary impacts.

The Society regularly stress tests such risks to better 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, the impact of a loss of confidence caused by reputational risk is often material to these scenarios. 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.

8.2 Management of operational risk

Business continuity

The Society has developed Business Continuity Plans to manage situations in which buildings, systems or key staff are unavailable, for example in the event of a flu pandemic or the loss of utilities. The Society's Business Continuity Plan is approved annually and regularly tested and overseen by the Business Continuity Committee which reports into Operational Risk Committee (ORC).

Change

Change programmes are carefully managed to ensure that they are achievable and can be managed to agreed timescales with limited reliance on external support. The Society has undertaken significant investment in its change resources and has a strong track record of successful delivery. All key projects have a dedicated steering committee chaired by an executive director which reports regularly to the Board.

The risks arising from mergers and acquisitions, which have highlighted the fragility of some firms, have been shown to be well managed by the Society as illustrated by previous successful integrations and these transactions are not a key feature of the business model.

Conduct

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 members and its high business standards through its 'Putting Members First' principles. These 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 the potential conduct risks applicable to the products, services and documentation it provides to its members 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 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 was overseen by ORC and reported to Risk Management Committee (RMC) and Board Risk Committee (BRC). During 2014, the Society implemented a dedicated Conduct Risk Committee, which reports to BRC, and provides oversight of conduct risk matters and developments.

Financial reporting

Increased reporting requirements and disclosures highlights the need for robust systems and controls in the preparation of these documents. The Society undertakes a number of reviews provided by its Internal Audit function and by external auditors as part of its ongoing assurance to assess the accuracy of its published material. Development of accounting standards and areas of reporting subject to judgement are regularly reviewed by the Board Audit Committee (BAC).

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 ORC. 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, cybercrime 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.

Following substantial investments by financial institutions in technological solutions to combat the more sophisticated financial crime threats, recent years have seen an increasing trend of deception crimes targeting the customer directly. The Society is firmly committed to developing its defences further to protect those who are most likely to be vulnerable to financial abuse. 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.

Information management and security

The Society recognises the importance of information management and security for the protection of the Society and its members and regularly commissions attack and penetration tests by a number of different third parties as part of validating the strength of its defences.

The Society is determined to ensure that its defences remain as robust as possible, implementing industry leading practices, and has adopted a defence in depth approach to its control mechanisms. In this rapidly changing world, the Society remains vigilant and will continue to evaluate and enhance its controls to ensure that appropriate protection is provided. This includes the continual measurement against industry best practices and use of tools and practices aligned to the environment in which it operates, and to its low risk appetite.

To demonstrate its stance in addressing the Information Security challenge, and to bolster its knowledge, skills and capabilities, the Society has employed a Chief Information Security Officer to be the advocate for information security standards.

Model risk

Models are employed in two key aspects of Society activity, in the assessment of net interest income, and in the determination of retail credit risk. Modified assumptions and detailed outputs from the model used to determine net interest income are reviewed monthly by Finance, Risk and Treasury functions. The Society's Models and Ratings Committee meets six times a year to review the retail credit risk models and is chaired by a non-executive member of the Board. The credit risk models are also subject to independent external scrutiny. Locally built models are required to comply with the Society's policy on end user computing.

People

The Society manages its people risk by having rigorous recruitment selection processes, providing an induction program before new staff commence work, and providing courses and other opportunities for staff to develop their skills and experience throughout their time with the Society.

The Society benchmarks its reward strategy against others in the financial services sector, and offers a range of support services under the Society's Wellbeing Programme and Policy. More generally, procedures and policies are designed to minimise employee dissatisfaction with the objective of attracting and retaining high performing staff. The Society periodically undertakes a survey of staff satisfaction and engagement with the Society's values and responds positively to any issues revealed.

Premises and physical security

The Society has a duty of care to its staff, members and visitors whilst present on Society premises. The Society has in place comprehensive health and safety policies and a compliance regime which includes internal and external inspection. This work is overseen by the Health & Safety and Security Committees, which are both chaired by executive directors and report to RMC and the Board each month.

Technology

The Society recognises the risks associated with not keeping pace with technology and invests significant resources in ensuring the robustness of its systems and controls and ongoing monitoring. Key to establishing a low risk environment is the maintenance of a single core system. During 2013 the Society appointed a specialist third party to undertake an independent review of its IT resources. This confirmed the resilience of the Society's system and strength of its people resources. Progress on implementing recommendations made is being overseen by the Board.

To the extent that the above risks arise from the actions of third parties, the Society continues to enhance its management of third party relationships through the appointment of a procurement and supply specialist.

8.3 Operational risk capital calculation approach

The Society adopts the standardised approach (TSA) for the purposes of calculating the operational risk capital requirement. The capital requirement can be found in Table 8. The results of the calculation are well in excess of actual experienced losses, suggesting this approach is prudent.

9. Business risk

9.1 Business risk overview

The Society defines business risk as the risk arising from changes to its business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geopolitical, regulatory or other factors. These risks are controlled through the Society's continual assessment of its policies (including risk appetite and limits) and strategy (through the Corporate Plan) which are regularly reviewed by the Board. Performance against the Corporate Plan is assessed via defined checkpoints that are reviewed quarterly by the Board.

9.2 Regulatory risk

The financial services industry is undergoing transformational reforms. The general objective of regulatory bodies is to improve consumer protection and promote more stable and transparent financial markets.

This exposes financial institutions to regulatory risk. The Society defines this as the risk that a change in law or regulation will adversely impact the Society's economic prospects and may lead to regulatory non-compliance. It includes the risk that complex regulation will prove overly burdensome and impede the ability of a low risk lender to compete successfully.

The Society's simple business model and members first principles mitigate some of these risks and the Society's compliance function supports business line management in ensuring appropriate policies are in place and providing challenge where necessary. The function is organised to recognise the different objectives of the Society's regulators. Compliance Policy & Change focuses on retail conduct, consumer and product regulation. Balance Sheet Risk concentrates on prudential and wholesale conduct regulation. Both units review government and regulatory proposals for reform, and engage with the Society's trade associations on initiatives that impact the building society sector as a whole. The compliance function also supports business change projects that have a regulatory dimension.

The complexity and burden of regulation is increasingly difficult to manage but the investment in second line functions, and recruitment of a permanent Chief Risk Officer has helped to relieve some of the pressure from operational focused functions. Increasing capital requirements and in particular the focus on non-risk based measures pose challenges to low risk business models particularly mutual lenders who have less well established routes to raise new capital from external sources than publicly quoted companies.

The Society maintains an open and co-operative relationship with its regulators.

9.3 Reputational risk

Reputational risk is the risk of loss arising from the degradation of the Society's reputation even if events which create the reputational impact do not have a direct financial consequence.

It is clear from 2013 that in periods of stress the media attention and reputational impact of operational events or corporate failings is heightened. The Society recognises this and invests significant resources in ensuring the robustness of its systems and controls, governance, product set, and ongoing monitoring. Key to establishing a low risk environment is a focus on member outcomes, simple low risk product offerings and the maintenance of a single core system.

9.4 Pension obligation risk

The Society is the sponsor of a defined benefit pension scheme. As the sponsor, the Society is exposed to adverse movements in the actuarial valuation of the scheme. Following the closure of the fund to new entrants at the end of 2001, the Society closed the fund to future service accrual in 2013. Further contributions are to be provided by the Society to the fund in accordance with the schedule of contributions agreed with the trustees of the fund and are subject to future scheme valuations.

To mitigate pension risk, the trustees of the fund review regular reports prepared by the fund's independent actuaries and investment consultants to assess risks and take appropriate actions which may, for example, include adjusting the investment strategy, hedging inflation risks and/or hedging interest rate risks (see further details in 2013 Annual Report and Accounts note 21).

10. Further information

Further information can be found in the 2013 Annual Report & Accounts (www.thecoventry.co.uk/accounts2013) in particular;

- the Risk Management Report on pages 44 to76.
- the Directors' Report on Corporate Governance on pages 30 to 39.
- The Board Audit Committee Report on pages 40 to 43.
- the Directors' Remuneration Report on pages 77 to 82.

Glossary

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

Arrears	The financial value of unpaid obligations, which arise when contractual payments are not paid as they fall due.
Available-for-sale reserve (AFS)	The Available-for-sale reserve contains unrealised gains and losses arising from changes in the fair values of non-derivative financial assets that are categorised as Available-for-sale.
Average loan to value (LTV)	The average of individual loan to values (simple average). The average loan to value of the residential mortgage book, weighted by balance (balance weighted). For indexed loan to value – see 'Indexed LTV'
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 II, which came into force on 1 January 2007. The Basel II framework introduced the concept of three 'pillars' for regulation. Pillar 1 sets out the minimum capital requirements for firms, and under Pillar 2 firms will take a view of whether additional capital is required for risks not covered in Pillar 1. Pillar 3 improves market information by requiring firms to publish details of risks and capital management.
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 implemented in the EU via CRD IV, which came into force on 1 January 2014.
Basis point	One hundredth of a percent (0.01 percent). 100 basis points is one percent. Used when quoting movements in interest rates and yields on securities.
BIPRU	The Prudential sourcebook for Banks, Building Societies and Investment Firms, which sets out detailed prudential requirements applicable to the Society. This has largely been superseded by CRD IV.
Business risk	Business risk is the risk arising from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geopolitical, regulatory or other factors.
Buy-to-let (BTL) mortgage	A mortgage secured on a residential property that is rented out to tenants.
Capital requirements	Amount to be held by the Group to cover the risk of losses set by regulators and firms own assessment of its risk profile
Capital Requirements Regulation and Capital Requirements Directive IV (CRD IV)	CRD IV is the European Union legislation (part regulation and part directive) which came into force from 1 January 2014 to implement Basel III, revising the capital requirements framework and introducing liquidity requirements, which regulators use when supervising firms.
Capital resources	Capital comprising the general reserve, Permanent Interest Bearing Shares (PIBS), subordinated debt and collectively assessed impairment allowances, less all required regulatory adjustments. Under Basel II the PIBS and subordinated debt were allowable as capital resources for regulatory purposes, and the Available-for-sale (AFS) reserve was excluded. Under CRD IV PIBs and subordinated debt do not meet the requirements for capital reserves and so their eligibility for capital requirements is adjusted by transitional rules, furthermore the AFS reserve is included in capital resources.
Common Equity Tier 1 capital (CET1)	Common Equity Tier 1 capital comprises general reserves and the negative balance on the Available-for-sale reserve, less intangible assets, pension surplus and other regulatory deductions.
Common Equity Tier 1 ratio	Common Equity Tier 1 capital as a percentage of risk-weighted assets.
Contractual maturity	The date in the terms of a financial instrument on which the last payment or receipt under the contract is due for settlement.
Core Tier 1 capital	Core Tier 1 capital comprises 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.
Council of Mortgage Lenders (CML)	A trade association for the residential mortgage lending industry.
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 that are backed by both the resources of the issuer and 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	Credit risk is the risk that borrowers or counterparties do not meet their financial obligations to the Society 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, set off or netting.
Currency swap	An arrangement in which two parties exchange equivalent principal amounts of different currencies at inception and subsequently exchange interest payments on the principal amounts. At the maturity of the swap, the principal amounts are re-exchanged at the original rates, protecting the participants from changes in exchange rates.
Debt securities	Transferable instruments creating or acknowledging indebtedness. They include bonds, certificates of deposit and loan notes. The holder of a debt security is typically entitled to the payment of principal and interest, together with other contractual rights under the terms of the issue. Debt securities are generally issued for a fixed term and redeemable by the issuer at the end of that term. Debt securities can be secured on other assets or unsecured.
Debt securities in issue	Transferable certificates of indebtedness of the Group to the bearer of the certificates. These are liabilities of the Group and include certificates of deposit.
Deferred tax asset/(liability)	Corporation tax recoverable (or payable) in future periods resulting from temporary or timing differences, between the accounting value of assets and liabilities and the tax base of those assets and liabilities.
Defined benefit obligation	The present value of expected future payments required to settle the obligations of a defined benefit pension plan resulting from past employee service.
Defined benefit plan	Pension or other post-retirement benefit plan offering guaranteed benefits usually as a fraction of the final salary.
Defined contribution plan	Pension or other post-retirement benefit plan where the employer’s obligation is limited to its contributions to the fund.
Derivative financial instrument	A contract or agreement which derives its value or cash flows from changes in an underlying index such as an interest rate, foreign exchange rate or market index. The most common type of derivative instruments are interest rate swaps.
Enhanced Disclosure Task Force (EDTF)	Body established by the Financial Stability Board with a remit to broaden and deepen the risk disclosures of financial institutions in a number of areas of risk management.
Effective interest rate (EIR)	The effective interest rate is the rate of interest income or expense that produces a level yield, either to maturity or to the next re-pricing date, equivalent to the projected cash flows on an instrument.
Eurozone	An economic and monetary union (EMU) of EU member states that have adopted the euro (€) as their common currency and sole legal tender.
Expected loss (EL)	A Basel II and Basel III calculation under the IRB approach to estimate the potential losses on current exposures due to expected 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	Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or, in its absence, the most advantageous market to which the Group has access at that date.
Final salary pension arrangements	A defined benefit pension arrangement where the pension payable is based on the employee's final pensionable salary.
Financial Conduct Authority (FCA)	A statutory body responsible for the conduct of business regulation and supervision of UK financial institutions in the UK from 1 April 2013.
Financial Services Authority (FSA)	Financial Services Authority (UK) was an independent non-governmental supervisory body superseded by the PRA and the FCA on 1 April 2013.
Financial Stability Board (FSB)	Body established at the international level to coordinate the work of national financial authorities and international standard setting bodies to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability.
Fitch Ratings	Fitch Ratings is a credit rating agency which provides credit ratings and research covering financial institutions and governments and their debt instruments and securities.
Forbearance	Forbearance takes place when a concession is made on the contractual terms of a loan in response to the borrower's financial difficulties.
Foreign currency risk	The risk of loss arising as a result of movements in exchange rates on investments or obligations 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 small and medium sized enterprises, 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 remeasurements of the defined benefit pension plan (net of tax).
Gilts	Gilts is the name given to long term fixed income debt securities (bonds) issued by the UK Government.
GINI	The GINI co-efficient, as used by the Society, measures how well the IRB probability of default model performs in discriminating between high and low risks as determined by the credit score.
Gross mortgage lending	The total of mortgage lending advanced during the year.
IFRS/IAS	International Financial Reporting Standards/ International Accounting Standards. A set of international accounting standards stating how particular types of transactions and other disclosures should be reported in financial statements.
Impaired loans	Impaired loans are defined as those which are more than three months in arrears or in possession. However other indicators of impairment may result in provisioning for losses.
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 assets on the statement of financial position. The provisions represent management's best estimate of losses incurred in the loan portfolio at the statement of financial position date.
Indexed LTV (Loan to value)	Loan to value (see below) calculated on the basis of the latest property valuation being adjusted by the relevant house price index movement since that date.
Individual Capital Guidance (ICG)	Guidance from the PRA on the levels of capital to be held by the Society to meet its minimum regulatory capital requirements.
Individual Liquidity Adequacy Assessment (ILAA)	The Society's own assessment of the liquidity resources that are required 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 company's required quantity of liquidity resources and funding profile.

Individual/collectively assessed loan impairment provisions Impairment is measured specifically for assets that are individually identified as being impaired at the statement of financial position date, 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 Interest rate risk arises from the different interest rate characteristics of the Society's mortgages and savings products and from other financial instruments. The Society is subject to the risk that changes in interest rates will cause material variations in earnings because of different interest rates charged for the mortgages and paid for the funding that comprise the bulk of the balance sheet.

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 and Basel III. The IRB approach may only be used 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 documentation for derivative transactions.

Leverage ratio The ratio of Tier 1 capital (see below) to total exposures. Where total exposures include on and off-balance sheet items (after netting derivatives).

LIBOR London Inter-Bank Offer Rate. The interest rate at which banks can borrow funds from other banks. The LIBOR is derived from a filtered average of the interbank deposit rates for large loans with maturities between overnight and one full year. Administration of LIBOR rates has recently been transferred from the BBA to the ICE Benchmark Administration Ltd.

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.

Liquid assets buffer (LAB) The liquid assets that the PRA currently allow in their liquidity measures, which shall be replaced by LCR liquid assets from 1 January 2015.

Liquidity and funding risk Liquidity risk is the risk the Society has insufficient funds to meet its obligations as and when they fall due. Funding risk is the inability to access funding markets or to only do so at excessive cost and/or liquidity risk.

Liquidity coverage ratio (LCR) A measure brought in as part of Basel III 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. A binding minimum LCR of 80% will apply to the Society from 1 January 2015.

Liquidity resources Assets held in order to manage liquidity risk. Liquidity resources comprises cash and balances with the Bank of England, UK Government Securities and multi-lateral development banks, other securities and bank deposits and self issued covered bonds, RMBS and Bank of England approved mortgage portfolios.

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 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 or foreign exchange rates.

Member A person who has a share investment or a mortgage loan with the Society.

Moody's Investor Services Moody's Investor Services is a credit rating agency which provides credit ratings and research covering financial institutions and governments and their debt instruments and securities.

Mortgage backed securities (MBS)	Asset backed securities that represent interests in a group of mortgages which give the investor the right to cash received from future mortgage payments of both principal and interest.
Near-prime	Loans to borrowers with marginally weakened credit histories such as County Court Judgements (CCJ) or default less than or equal to £1,000 or with one missed mortgage payment in the last 12 months.
Netting	The ability to reduce credit risk exposures through entering into ISDA master netting agreements (whereby outstanding transactions with the same party can be settled net following a default or other predetermined event) and the receipt of financial collateral..
Operational risk	Operational risk is the risk of loss arising from inadequate internal processes, systems, people, or from external events.
Over the counter (OTC)	Contracts that are traded (and privately negotiated) directly between two parties without going through an exchange or other intermediary. They offer flexibility because, unlike standardised exchange-traded products, they can be tailored to fit specific needs.
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 under Basel II. PIBS rank behind the claims of all subordinated debt holders, depositors, or creditors of the Society. PIBS are also known as subscribed capital. Under Basel III PIBS are included as Tier 1 under transitional rules only.
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.
Point in Time (PiT)	A modelling approach which assesses the credit risk of an exposure at a single point in time.
Probability of Default (PD)	Point-in-Time. A modelling approach which assesses the credit risk of an exposure at a single point in time.
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.
PV200	Present Value 200. A calculation of the theoretical change in the net present value (NPV) of financial instruments for a 200 basis point (2%) parallel shift in interest rates.
Redenomination risk	The 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).
Residential mortgage backed securitisation (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 of both principal and interest.
Retail deposits	See Shares.
Risk appetite	The articulation of the level of risk that the Society is willing to accept 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 rules under Basel II and Basel III.
Securitisation	A pool of loans used to back the issuance of new securities. The loans are transferred to a special purpose entity (SPE) which then issues securities (RMBS) backed by the assets. The Society has used retail mortgages as the loan pool for securitisation purposes.
Senior unsecured funding	Bonds issued by corporate bodies and financial institutions, which are not secured by any collateral and are not subordinated to any other liabilities of the issuer.
Shares	Funds deposited by a person in a retail savings account with the Society. Such funds are recorded as liabilities of the Society.
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 and Basel III. In this approach the risk weighting used in the capital calculation are determined by specified percentages.
Stress testing	Various techniques that are used to gauge the potential vulnerability of the Society to stressed conditions.
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 (Common Equity Tier 1 under CRD IV) and Permanent Interest Bearing Shares (PIBS). Common Equity Tier 1 must absorb losses on a going concern basis but only contains PIBS under transitional rules.
Tier 2 capital	A component of regulatory capital comprising qualifying subordinated debt and eligible collective impairment allowances, less certain regulatory deductions.
Trading book	A regulatory classification consisting of positions in financial instruments or commodities held by a bank with intention to trade. The Society does not have a trading book.
The Standardised Approach: operational risk	The standardised approach to operational risk, calculated using three year historical net income multiplied by a percentage factor depending on the underlying business being considered.
Wrong-way risk	Defined by the PRA as a situation where there is an adverse correlation between the counterparty's probability of default and the mark-to market value of the underlying transaction