Coventry Building Society

Pillar 3 Disclosures
31 December 2011

Contents

1. Overview

1.1 Background

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

In the UK, implementation of the Directive has been through rules introduced by the Financial Services Authority ('the FSA'). 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.

In January 2008 the FSA granted Coventry Building Society and its subsidiary Godiva Mortgages Limited, permission to use the Basel II Internal Ratings Based ('IRB') approach to retail credit risk and capital management from 1 January 2008. This permission reflects the Society's detailed understanding of its customer base and control of its credit risk profile. It allows the Society to set capital levels using internally developed models rather than through standardised percentages set by the FSA.

In 2010, Coventry Building Society merged with the Stroud & Swindon Building Society, which used the standardised approach to retail credit risk management in respect to Stroud & Swindon Building Society originated assets, and the mortgages originated and acquired by its subsidiary ITL Mortgages Limited. The Society intends to adopt the IRB approach for mortgages acquired during the merger in due course. The Society uses the standardised approach in calculating the capital requirements for other risk types – for example, operational risk.

1.2 Scope of disclosures

The Pillar 3 disclosures in this document relate to Coventry Building Society (FSA registered number 150892) and its subsidiary undertakings (together referred to as 'the Society'). The Society also includes the business combination that occurred in 2010 from the merger with the Stroud & Swindon Building Society. The subsidiary undertakings included within these disclosures are Godiva Mortgages Limited (FSA registered number 457622), ITL Mortgages Limited (FSA registered number 302608), Stroud and Swindon Funding Company, Stroud and Swindon Funding Company (No. 2) Limited and Five Valleys Property Company Limited.

Godiva Mortgages Limited and ITL Mortgages Limited distribute products solely through mortgage intermediaries. All funding comes from the Society. Stroud and Swindon Funding Company and Stroud and Swindon Funding Company (No.2) Limited previously provided funding for the acquisition of mortgage books. Five Valleys Property Company Limited undertakes investment in residential property for letting purposes.

This consolidated treatment reflects the scope of the Society's solo consolidation waiver approval from the FSA. 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.

1.3 Basis and frequency of disclosures

This document sets out the 2011 Pillar 3 disclosures for the Society. These disclosures have been prepared solely to give information on the basis of calculating Basel II requirements and on the management of risks faced by the Society in accordance with the rules laid out in BIPRU Chapter 11. The disclosures may differ from similar information in the Annual Report and Accounts 2011 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 2011, the Society's year end, unless otherwise stated.

Future disclosures will be issued on an annual basis and published as soon as practicable after the publication of the Annual Report and Accounts.

1.4 Location and verification

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

1.5 Remuneration

In order to comply with the disclosure requirements of the Capital Requirements Directive (CRD) 3 and the FSA'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 2011 Annual Report & Accounts on page 32. The 2011 Annual Report & Accounts are published on the Society's website http://www.coventrybuildingsociety.co.uk/pdfs/RepAcc_11.pdf.

2. Scope of IRB permission granted

On the 1 January 2008 the FSA granted approval for the Society to use the IRB approach for prime owner occupied and buy-to-let mortgage exposures, for assets included within Coventry Building Society and Godiva Mortgages Limited. As at 31 December 2011, this covered 90% of the mortgage and other loan assets held. Assets acquired as a result of the merger continue to be assessed using the standardised approach, however, the Society intends to assess these mortgages under the IRB approach in due course.

In line with industry best practice the Society is continuously reviewing 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 of the IRB rating system.

3. Risk management policies and objectives

3.1 Approach to risk management

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

3.2 Risk management structure

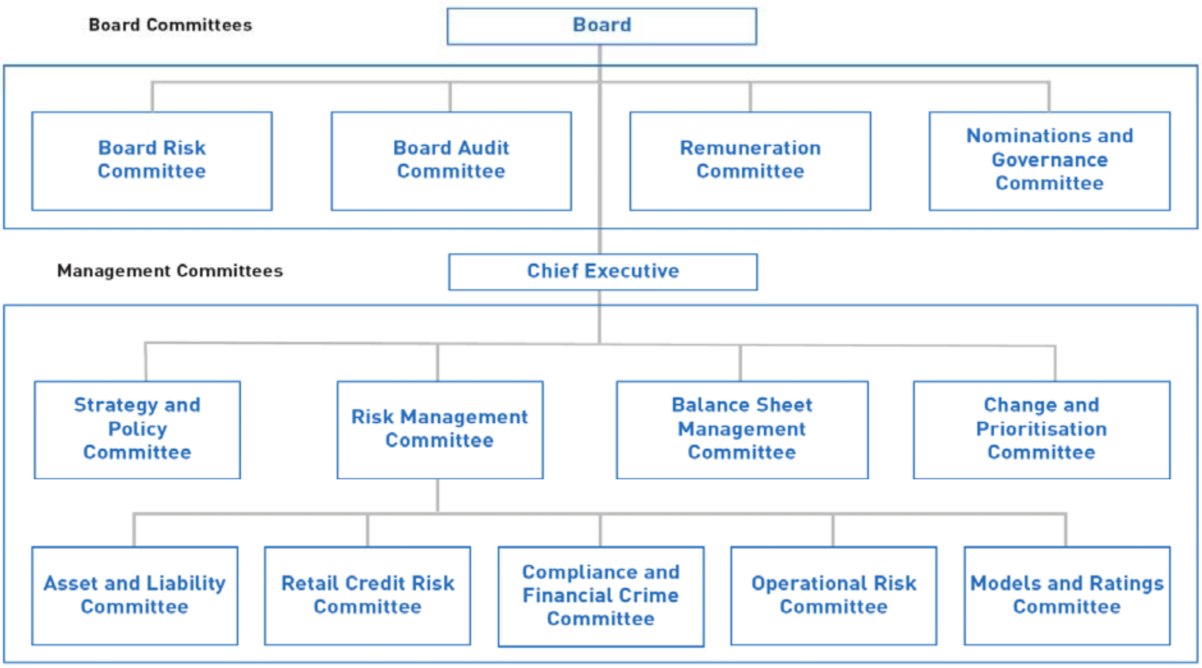
The Society's risk management structure is based on a three lines of defence model:

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

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

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

During 2011 changes were introduced to the Society's management committees to enhance oversight of the Society's performance and risk management. The structure and responsibility of management and Board Committees as at 31 December 2011 are set out below:



3.3 Governance and oversight of risk

Board

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

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

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

Board Risk Committee

The Board Risk Committee is chaired by a non-executive director and membership is made up of three other non-executive directors, the Chief Executive, Finance Director and the Chief Risk Officer. In addition, the Secretary and General Counsel attends Board Risk Committee Meetings. The Committee meets on a monthly basis and has the responsibility for overseeing risk strategy, risk policies and risk appetite and making recommendations to the Board. In particular, the Committee undertakes the following:

- oversees and advises the Board in relation to current and potential future risk exposures of the Society, 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 risks that it faces including culture, policy, processes, structure and systems; and
- reviews major initiatives, such as acquisitions or change projects, and seeks assurance that appropriate due diligence has been carried out and that any associated movement in risks to which the Society may be exposed remains within risk appetite.

Board Audit Committee

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

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

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

Remuneration Committee

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

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

Nominations and Governance Committee

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

Strategy and Policy Committee

Chaired by the Chief Executive and comprised of the executive directors and senior management. This is the senior executive decision making body representing the key business areas within the Society and oversees the strategic development and performance of the Society.

Risk Management Committee (RMC)

Chaired by the Chief Risk Officer and comprised of the executive directors and senior management. This Committee ensures that risk is being identified and managed efficiently across the Society and that the Society's Risk Management Framework remains effective. It keeps under review the Board's risk appetite statement, Internal Capital and Liquidity Adequacy Assessments, and recommends changes to the Board, through the Board Risk Committee. The minutes of the Committee are presented to the Board Risk Committee

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

- ### Asset and Liability Committee (ALCO)

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

  The Committee's terms of reference include:

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

- ### Retail Credit Risk Committee

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

  The Committee's terms of reference include:

  - the setting and authorising of changes to lending policy, credit systems and credit processes;
  - to ensure that the lending policy, credit systems and credit processes are designed to meet the volume, mix and quality of lending, as set by the corporate plan and agreed with the Board; and
  - to ensure that the Society complies with regulatory requirements, including the Mortgage Conduct of Business regulation, the FSA guiding principles of treating customers fairly and responsible lending.

- ### Compliance and Financial Crime Committee

  Chaired by the Secretary and General Counsel and comprised of senior management. The Committee oversees regulatory conduct risk, compliance and financial crime policy and risk.

  The Committee's terms of reference include:

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

- **Operational Risk Committee**

  Chaired by the Head of Marketing and comprised of senior management. This Committee monitors operational risk, business continuity, safety and security in the Society. Further, it recommends to the Board, through the Risk Management Committee, the operational risk appetite statement.

- **Models and Ratings Committee**

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

  The committee's terms of reference include:

  - to ensure compliance with the Basel II Accord and approve the resulting capital requirements;
  - to approve the rating system and any subsequent amendments;
  - to ensure that appropriate action is taken to address issues raised from performance monitoring;
  - to regularly review and approve the policy statement defining the overall approach to materiality in relation to the rating system; and
  - to perform ongoing and formal annual reviews of the accuracy and adequacy of the rating system.

Balance Sheet Management Committee

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

Change and Prioritisation Committee

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

4. Capital resources

4.1 Compliance with capital requirements

Throughout 2011 the Society has complied in full with all of its externally imposed capital requirements. The table below breaks down the components of capital available to the Society as at 31 December 2011.

4.2 Capital available

	Notes	As at 31 December 2011 £m
Tier 1		
General reserve		747.9
Pension fund surplus adjustment		(3.9)
Intangible assets		(9.5)
Deductions from tier 1 capital	1	(9.2)
Core tier 1 capital		725.3
Permanent interest bearing shares	2	160.0
Total tier 1 capital		885.3
Tier 2		
Collective provisions for impairment	3	0.4
Subordinated debt	2	67.0
Deductions from tier 2 capital	1	(9.2)
Total tier 2 capital		58.2
Total capital		943.5

1. 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.
2. Principal amount outstanding only.
3. 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.

Tier 1 capital

Tier 1 capital comprises the general reserve, permanent interest bearing shares and adjustments for the defined benefit pension fund surplus. Intangible assets do not qualify as capital for regulatory purposes and are deducted from capital. The Society's Available-for-sale reserve is excluded from tier 1 capital.

The Society has £160 million of subscribed capital which comprises permanent interest bearing shares (PIBS). Interest is paid in arrears on £40 million of PIBS at the rate of 12 1/8% p.a. in half-yearly instalments, and paid in arrears on £120 million of PIBS at the rate of 6.092% p.a. in half-yearly instalments. The shares are repayable only in the event of a winding up of the Society or otherwise with the consent of the FSA. 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 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 and the collective impairment provisions, for impairment relating to loans and advances to customers, calculated on a standardised basis. The Society has £67 million of subordinated debt which is made up of the following:

Subordinated note	Maturity date	Option to call date	Step up date	Type	Amount
Fixed rate subordinated notes 2016	4 December 2016	No option	n/a	Fixed 12.25%	£7 million
Fixed rate subordinated notes 2017	3 June 2017	3 June 2012	n/a	Fixed 8.37%	£10 million
Fixed rate subordinated notes 2021	8 November 2021	8 November 2016	n/a	Fixed 6.12%	£10 million
Fixed rate subordinated notes 2022	25 June 2022	23 June 2017	23 June 2017	Fixed 6.469%	£15 million
Fixed rate subordinated notes 2026	29 August 2026	29 August 2021	n/a	Fixed 6.33%	£10 million
Fixed rate subordinated notes 2032	23 August 2032	23 August 2027	n/a	Fixed 7.54%	£15 million

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 FSA.

Impact of Basel III

The European Commission published its proposal for implementing the provisions of Basel III in July 2011. This proposal (in the form of a draft regulation and directive) is currently under negotiation within the EU. Basel III introduces stricter definitions of what constitutes capital. Current instruments which do not meet the stricter definitions, principally the Society's Permanent Interest Bearing Shares, will be gradually derecognised for capital purposes over a ten year period expected to start in 2013. Basel III had no effect in 2011, and the Society has considered the impact of the introduction of these rules on future levels of capitalisation, including under stress testing. The directors consider that the Society will continue to remain well capitalised and there is no foreseeable requirement to issue additional capital instruments. Nevertheless, the Society is monitoring market developments and may consider issuing Basel III compliant capital instruments should the market present favourable opportunities to do so.

5. Capital adequacy

5.1 Capital management

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

5.2 Internal Capital Adequacy Assessment Process

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

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

5.3 Challenge and adoption of the ICAAP

The ICAAP document is prepared by the Society's finance team, working in conjunction with the credit risk, treasury, operational risk and compliance functions.

The ICAAP is considered within the overall strategic planning process, which maintains a strong focus on the ability of the Society's corporate plan to generate sufficient capital to meet the requirements of balance sheet growth, making an accounting profit in each year and other factors.

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

5.4 Minimum capital requirement – Pillar 1

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

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

The following table shows the Society's overall minimum capital requirement as at 31 December 2011:

	As at 31 December 2011 £m
IRB approach	
Credit risk – Retail exposures	153.7
Standardised approach	
Credit risk – Retail exposures	62.1
Credit risk – Liquidity book	15.9
Credit risk – Other	6.7
Operational risk	16.2
Total minimum capital requirement	254.6

6. Risks and their management

6.1 Overview

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

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

- credit risk;
- market risk;
- liquidity risk;
- operational risk;
- concentration risk; and
- pension obligation risk.

6.2 Credit risk

Credit risk overview

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

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

Credit risk exposures

The gross credit risk exposure and the average for the period 1 January 2011 to 31 December 2011 is as follows:

	Notes	Average 1 January 2011 - 31 December 2011 £m	As at 31 December 2011 £m
Residential mortgages	1	18,324.6	19,163.4
Unsecured and other lending	1, 2	82.3	76.6
Total		18,406.9	19,240.0
Treasury:			
Central banks and sovereigns		3,220.7	3,623.9
Multilateral development banks (supranational bonds)		148.6	188.7
Financial institutions		1,004.9	795.3
Mortgage-backed securities		297.4	233.7
Local authorities		15.4	0.5
Total		4,687.0	4,842.1
Total		23,093.9	24,082.1

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.
2. Other lending includes loans fully secured on land.

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

The geographical distribution of credit exposures at 31 December 2011 is as follows:

	Notes	United Kingdom £m	Rest of Europe £m	Rest of the World £m	Total £m
Residential mortgages	1	19,163.4	-	-	19,163.4
Unsecured and other lending	1,2	76.6	-	-	76.6
Total		19,240.0	-	-	19,240.0
Treasury:					
Central banks and sovereigns		3,570.9	53.0	-	3,623.9
Multilateral development banks (supranational bonds)		-	188.7	-	188.7
Financial institutions		371.1	414.1	10.1	795.3
Mortgage-backed securities		233.7	-	-	233.7
Local authorities		0.5	-	-	0.5
Total		4,176.2	655.8	10.1	4,842.1
Total		23,416.2	655.8	10.1	24,082.1

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.
2. Other lending includes loans fully secured on land.

The residual maturity of the exposures at 31 December 2011 is as follows:

	Notes	Up to 12 months £m	1-5 years £m	5-10 years £m	More than 10 years £m	Total £m
Residential mortgages	1	1,536.0	5,328.5	5,381.0	6,917.9	19,163.4
Unsecured and other lending	1,2	5.0	14.9	17.2	39.5	76.6
Total		1,541.0	5,343.4	5,398.2	6,957.4	19,240.0
Treasury:						
Central banks and sovereigns		1,789.4	403.6	953.8	477.1	3,623.9
Multilateral development banks (supranational bonds)		-	138.4	50.3	-	188.7
Financial institutions		766.4	8.4	17.0	3.5	795.3
Mortgage-backed securities		-	31.2	20.6	181.9	233.7
Local authorities		0.5	-	-	-	0.5
Total		2,556.3	581.6	1,041.7	662.5	4,842.1
Total		4,097.3	5,925.0	6,439.9	7,619.9	24,082.1

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.
2. Other lending includes loans fully secured on land.

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

Credit risk for retail exposures

Credit risk for retail exposures is the risk that lending will result in losses because the advances and interest due are not repaid, or not repaid in full, and because the recovery on the related security will be insufficient to cover the outstanding loan. This is the largest risk for the Society and relates directly to the primary purpose of the Society, which is to advance loans for the purpose of buying residential property against which the loan is secured.

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 as a result of the merger with Stroud & Swindon.

This retail credit risk is managed at a strategic level through a risk appetite set and monitored at Board level including risk limits for new lending, established as part of the corporate planning process and taking into account IRB modelling. These risk limits include consideration of income multiples and prudent loan to value ratios. In addition, at an operational level the Society's underwriting process seeks to ensure that customers only assume a debt that they can afford to repay, thereby safeguarding both themselves and the Society. Should a borrower experience financial difficulty, the Society has established procedures to ensure that it responds fairly, appropriately and sympathetically. Typically, this involves working with the borrower to clear arrears or making other arrangements commensurate with the borrower's circumstances. This can include overpayments to clear arrears or providing a temporary concessionary arrangement to that borrower (defined as 'forbearance'). Each case is reviewed on its own merits by a specialist department, and we always attempt to work with the borrower in difficulty to resolve matters to our mutual satisfaction taking into account an individual borrower's financial situation.

The Retail Credit Risk Committee closely monitors the use of forbearance measures and strict policies exist for circumstances in which the Society will, for example, capitalise arrears. Other measures such as temporary transfers to interest only payments are regularly reviewed and the Society has seen a reduction in this particular measure over the last 12 months.

Should the situation deteriorate significantly, it can involve the Society taking possession of the underlying security. Where possession does take place, the properties repossessed represent the collateral held against these cases.

The Society's exposure to retail credit risk is managed by a specialist department that reports to the Chief Risk Officer. This department is managed as part of the Society's risk management structure. Policies, oversight and review of the risk are provided by the Credit Risk and Lending Committee, the Risk Management Committee and Board, through the Board Risk Committee.

The exposure values relating to the Society's retail exposures, by risk grade (where 1 is the lowest risk grade), at 31 December 2011 are as follows:

	Notes	Outstanding loans £m	Undrawn loans £m
Risk grades:			
1		13,386.6	528.5
2		3,280.1	59.8
3		826.1	6.6
4		210.9	2.4
5		113.7	-
Past due		299.9	-
Total IRB		18,117.3	597.3
Standardised		1,897.9	91.9
Total retail exposures	1	20,015.2	689.2

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

Credit risk for the treasury liquidity book

Credit risk within the treasury function (wholesale credit risk) arises from the portfolio of liquid assets held, and represents the risk that counterparties will fail to repay amounts when due. The Society has a low appetite for this form of risk. As such, exposures are restricted to good quality counterparties with a low risk of failure, and limits and exposures are set accordingly. 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. 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. Exposure is reviewed on a daily basis to ensure that it remains within the approved limits. Ongoing developments for Treasury counterparties are closely monitored by a specialist credit team, and are reported to, and reviewed by, a dedicated Treasury Credit Committee. This Committee meets weekly and is chaired by the Chief Risk Officer. The Committee is empowered to take immediate action to reduce limits where this is warranted by developments. The Committee reports through ALCO to the RMC and Board Risk Committee. The allocation of capital to the credit risk within the liquidity book is calculated using the standardised approach defined by FSA regulations.

The exposure values relating to the Society's liquidity book at 31 December 2011 are as follows:

	Exposure value by Moody's rating					
	Aaa–Aa3 £m	A1–A3 £m	Baa1–Baa3 £m	Other £m	Unrated £m	Total £m
Central banks and sovereigns	3,623.9	-	-	-	-	3,623.9
Multilateral development banks (supranational bonds)	188.7	-	-	-	-	188.7
Financial institutions	366.6	348.2	35.0	17.7	27.8	795.3
Mortgage-backed securities	228.7	5.0	-	-	-	233.7
Local authorities	-	-	-	-	0.5	0.5
Total	4,407.9	353.2	35.0	17.7	28.3	4,842.1

Exposures rated as 'Other', comprise Irish financial institutions and other UK building societies. 'Unrated' institutions relate to smaller building societies and local authorities.

Impairment provisions

Assets held at amortised cost

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

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

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). The carrying amount of the asset is reduced through the use of an impairment provision and the amount of the loss is recognised in the income statement.

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 decrease the amount of the movement in the provision for loan impairment in the income statement.

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

These provisions have been deducted from the appropriate asset values shown in the 2011 Annual Report and Accounts. Provisions below are as at 31 December 2011, the latest externally audited information.

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

The performance of past due loans as at 31 December 2011 is as follows:

	Notes	£m	%
Not impaired			
Neither past due nor impaired		18,337.2	95.31
Past due up to three months but not impaired		643.3	3.34
Impaired:			
Past due three to six months		129.5	0.67
Past due over six months or in litigation		119.4	0.62
In possession		10.6	0.06
Total exposures	1,2	19,240.0	100.00

1. The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due.
2. All loans are UK-based.

Available-for-sale-assets

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

The Society assesses at each balance sheet date whether there is objective evidence that Available-for-sale assets are impaired. If such evidence exists, the cumulative loss measured as the difference between the initial cost and the fair value, is recognised in the income statement.

As at 31 December 2011 no amounts in the treasury portfolio were either past due or impaired, and as such no provision had been made.

Credit risk mitigation

The Society uses a range of techniques to reduce its exposure to credit risk.

For the residential mortgage portfolio credit risk is mitigated by assessing the credit quality of borrowers before loans are approved to ensure that the servicing of the loan falls within the customer's capacity to repay. This assessment process utilises automated credit scoring systems supplemented where appropriate by a risk based assessment from experienced underwriters. The residential property upon which the mortgage is granted represents the Society's collateral against the loan, and the use of prudent loan to value limits ensures this collateral provides significant risk mitigation.

For wholesale lending which is undertaken as part of the Society's treasury operations, multiple external ratings methodologies are used to inform lending decisions. Counterparty limits are set by the Board and are reviewed by the Society's Treasury Credit Committee on a regular basis.

For the treasury liquidity book credit risk is similarly mitigated through the approval and monitoring of credit exposures. The ALCO monitors treasury exposures and sets limits on exposures to individual counterparties and across countries and industrial sectors. These limits are reviewed by the Society's Board Risk Committee and approved by the Board. Treasury book exposures are monitored daily.

Securitisation

None of the assets originated by the Society was securitised during 2011. Certain loans and advances to customers were transferred from the Society to Coventry Building Society Covered Bonds LLP in order to secure £2,200.0 million and €650.0 million of covered bonds issued by the Society.

The Society's exposure to purchased securitisation positions amounted to £233.7 million at 31 December 2011 and comprises residential mortgage-backed securities. As at 31 December 2011, £228.7 million had a Moody's credit grading of Aaa-Aa3, and £5.0 million had a credit grading of A1-A3.

During May 2012, the Society successfully launched its first securitisation program, Leofric No.1 Plc. The strategy for this issuance was to benefit from attractive funding rates available to the Society. The issuance received £800.0 million of funding, which was securitised on a mortgage pool of £1,111.1 million. There is no significant transfer of credit risk relating to these mortgages and the Society continues to hold capital for the mortgages in a manner consistent with those retained by the Society.

Counterparty credit risk

The Society uses derivative instruments to hedge its exposure to interest rate and foreign exchange risk. Counterparty credit risk is the risk of default of a counterparty to such a derivative instrument. The risk is mitigated by offsetting the amounts due to the same counterparties ('Netting benefits') and by cash deposited by counterparties with whom the Society has a net asset position ('Collateral held').

The exposure values of derivative instruments at 31 December 2011 are given in the following table:

	31 December 2011 Exposure value £m
Interest rate contracts	259.7
Foreign exchange contracts	-
Gross positive fair value of contracts	259.7
Netting benefits	(186.1)
Net credit exposure	73.6
Collateral held	(3.1)
Net derivative credit exposure	70.5

As at 31 December 2011, over 99.3% of the net derivative credit exposure held by the Society with counterparties had Moody's credit grading of A2 or above. Included within the 'Net derivative credit exposure' are amounts that relate to derivatives in respect of the Coventry Building Society Covered Bonds LLP which are subject to collateralisation when individual bank ratings fall below a certain threshold. This threshold has not yet been reached.

Credit rating downgrades

If the Society experienced a multiple notch downgrade in its credit rating it may be required to place additional collateral with its subsidiary undertakings Coventry Building Society Covered Bonds LLP and Leofric 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.

6.3 Market risk

Market risk is the risk that the value of income arising from the Society's assets and liabilities may change adversely as a result of changes in interest rates, foreign exchange rates or house prices. The Society's policy is to manage these risks prudently, which is ensured through the setting of limits by the Board. The Society ensures compliance with these limits through a combination of matching assets and liabilities with off-setting interest rate or currency characteristics, and by the use of derivative financial instruments such as interest rate swaps and caps, foreign exchange swaps and foreign exchange forward purchase contracts. Control of market risk exposure is managed by ALCO, which makes regular reports to the Risk Management Committee and the Board Risk Committee.

The Society is further strengthening its second line of defence for oversight and independent assessment of the various market risks by the establishment of a Balance Sheet Risk Management team reporting to the Chief Risk Officer.

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

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. In particular, the issue of fixed and capped rate mortgages and fixed rate savings products exposes an organisation that principally operates within a variable rate environment (such as the Society) to the risk that interest rate fluctuations could cause either a reduction in interest income or an increase in interest expense relative to other interest flows.

The Society's policy is to manage its exposure to this risk within prudent limits governed by the Risk Management, Liquidity and Wholesale Funding Policy. This policy is subject to annual review by the Board. The detailed implementation of the policy, and compliance with the limits set within it, is monitored by the monthly meeting of the ALCO which receives a formal report from the asset and liability risk management team.

The specific management of this risk involves a combination of matching assets and liabilities with offsetting interest rate characteristics and the use of derivative financial instruments such as interest rate swaps and caps.

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

The following table shows the impact on net worth through the reporting period:

	+100bps 2011 £m	-100bps 2011 £m
Impact on equity reserves	(13.7)	14.0
Impact on profit and loss	11.1	(6.4)

The impact on equity reserves considers movements in the underlying value of assets and liabilities carried at fair value, based on the shift in market interest rates, whereas the impact on profit or loss considers the impact on the Group results in respect of shift in the return on the Group's assets and liabilities.

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

Other interest rate risk exposures, such as basis risk (the risk of loss arising from changes in the relationship between interest rates which have similar but not identical characteristics – such as LIBOR and Bank of England Base Rate) and prepayment risk (the risk of loss arising from early repayment of fixed rate mortgages and loans) are also monitored.

Foreign currency risk

Foreign currency risk arises as a result of the Group's activities in raising funds and making investments in foreign currencies. This is undertaken to ensure wholesale funds are obtained cost-effectively across a wide pool of potential providers, but exposes the Group 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.

The risk is managed through the use of currency swaps and foreign currency forward contracts and also, where appropriate, by the matching of foreign currency liabilities with assets denominated in the same currency. After taking into account the effects of cross currency swaps, the Group has no material net exposure to foreign exchange risk fluctuations or changes in foreign currency interest rates. ALCO sets limits on the level of exposure by currency which are monitored daily.

House price risk

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

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

Under these loans, the borrower receives an advance but makes no payments of interest or principal until the loan is redeemed. The interest is added to the loan and recovered by the Society when the loan is redeemed. The 'no negative equity' guarantee therefore exposes the Society to the risk that the value of the property at the time of redemption is lower than the loan plus accumulated interest. The Society manages this risk by granting loans only at relatively low loan to value ratios, subject to the age of the borrower, and through the use of statistical modelling to stress potential exposures within acceptable prudent limits. Only 2% of the Society's outstanding mortgage balances have been advanced on this type of product. The Society does not currently offer these products to new applicants.

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

6.4 Liquidity risk

Liquidity risk is the risk that the Society will be unable to meet its financial obligations as they fall due or can do so only at excessive cost. The risk is managed principally by holding funds in cash accounts and other easily realisable liquid assets. The amount and composition of liquid assets held is subject to guidance from the FSA and to the Society's regular stress testing programme that ensures it remains adequate. The stress testing programme, and other policies addressing liquidity risk, are set out in the Society's annual Individual Liquidity Adequacy Assessment (ILAA). The ILAA considers a range of time horizons from one day to several years and is compliant with the BIPRU 12 regime that was introduced by the FSA in 2010. This has resulted in a greater proportion of the liquidity book being represented by UK Government securities or invested with the Bank of England via a current account. Whilst these assets realise a relatively low yield, this reflects the very low credit risk represented by a AAA 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 team working closely with the Treasury and Balance Sheet Management functions and is monitored by ALCO and, through this Committee, by the RMC and the Board Risk Committee.

Liquidity risk is also managed through sale and repurchase arrangements (repos). Treasury assets are encumbered through repo and stock lending programmes, which ensure that these assets remain liquid and readily realisable.

6.5 Operational risk

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

Key operational risks are considered more broadly in the context of potential linkages to reputational risk, regulatory and compliance risk, change risk, legal risks, information technology and systems risk and business risk. The Society regularly stress tests such risks better to understand and manage the impacts of their occurrence and quantification to support regulatory capital allocation. This educates the Society's broader stress testing framework, including reverse stress testing.

The Society uses the standardised approach for the calculation of the operational risk capital requirement.

6.5.1 Regulatory and compliance risk

The Society is committed to meeting its legal and regulatory responsibilities and has a team dedicated to developing business standards and policy, overseeing regulatory change and monitoring compliance. In particular the Society is focused on delivering positive customer outcomes in the development and distribution of its products and services. These activities are overseen by the Compliance and Financial Crime Committee.

6.5.2 Financial Crime

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

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

6.5.3 Security and safety

The Society has a duty of care to its staff, members and visitors whilst present on Society premises. The Society has in place comprehensive health and safety polices and a compliance regime which includes internal and external inspection, the maintenance and testing of equipment as well as appropriate training programmes which are all reviewed regularly. This work is overseen by the Security and Safety Committee which reports to the Operational Risk Committee, RMC and Board each month.

6.5.4 Business continuity

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

6.6 Concentration risk

Concentration risk is the risk that accrues from a high degree of concentration in one particular business area. The Society operates within the UK mortgages and retail savings markets and as such accepts a degree of sectoral concentration risk.

The Society's natural concentration in the UK mortgage market can be exacerbated by over exposure to one geographical location or counterparty, or reliance on particular product types within the mortgage portfolio. This risk is managed by having business strategies that aim to maintain a balance of lending across the UK and regularly monitoring the Society's exposures by region.

The Society manages this risk by monitoring the geographic distribution of lending, the distribution of gross lending by channel of acquisition and by setting new lending risk limits on specific segments of the mortgage market.

6.7 Pension obligation risk

Pension obligation risk for the Society arises from the defined benefit pension scheme. This risk is generated by the potential liability of the Society for unexpected future contributions arising from variations in asset values and revised actuarial assessments of the liabilities.

The defined benefit pension scheme was closed to new members in 2001. On 31 December 2011, the Coventry Building Society Superannuation Fund merged with Stroud & Swindon Building Society Retirement Benefit Plan. As a result of Society contributions, a surplus of £3.9 million was presented for the merged defined benefit pension scheme in the 2011 Annual Report and Accounts.

As at the 31 December 2010, the two defined benefit schemes were shown separately within the 2010 Annual Report and Accounts.

The Society takes a prudent view of pension obligation risk and acts to ensure that any reported deficit is limited. Special contributions were made by the Society in 2002, 2004, 2006 and 2011. The assumptions used to evaluate the position of the pension fund are discussed with the scheme actuary and are prudent. These assumptions are independently audited by the Society's external auditors.

7. IRB rating system

7.1 The internal rating model and process

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

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

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

Probability of default model

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

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

The individual components of the PD model comprise an application model and a behavioural model.

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

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

Loss given default model

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

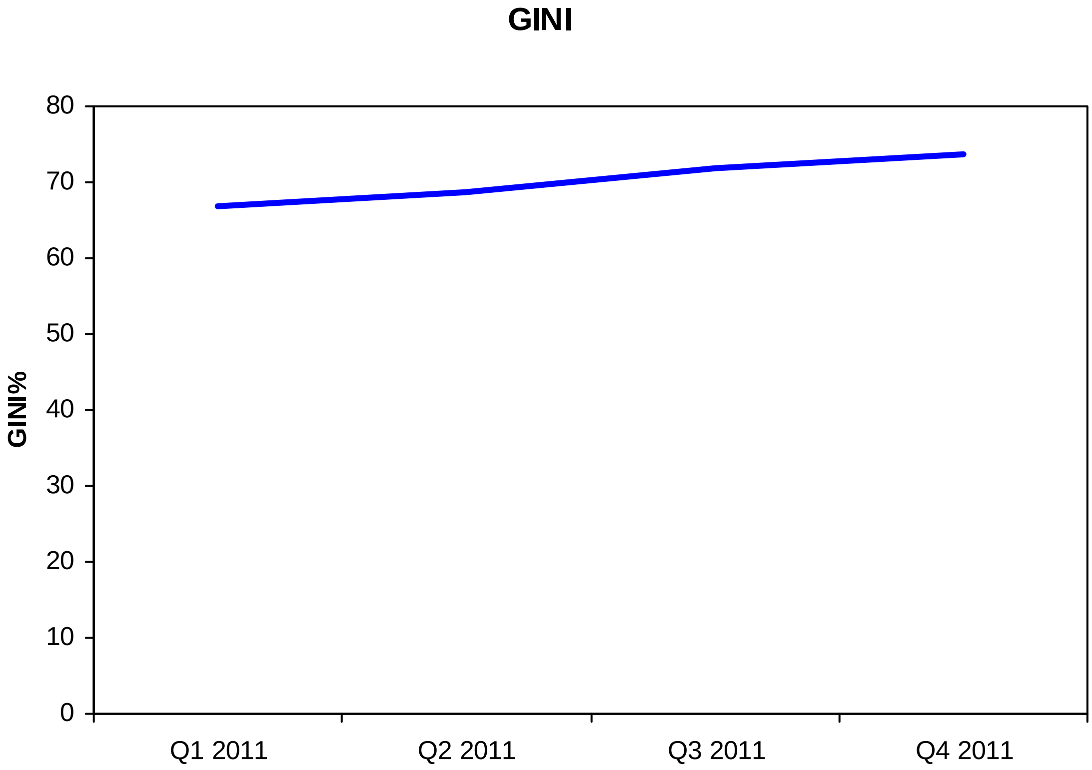
There are a number of sub-models, built using internal data from the last downturn in the early 1990s, which contribute to the overall LGD model. These include models to assess the likelihood of repossession once an account defaults, the forced sale discount that is likely to be experienced in selling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

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

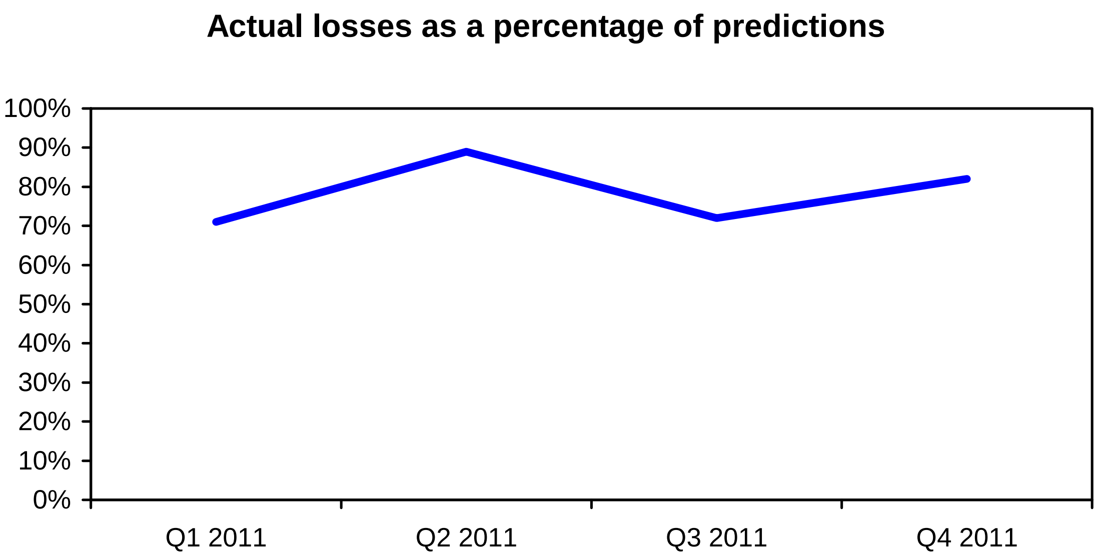
Experience over time

Over time, both the power of the 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 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.



Data integrity

The models have been implemented on the Society's internal systems with no reliance on external systems. This gives the Society complete control over how the models are maintained, how data flows into 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.

7.2 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 function. The risk models function undertakes all monitoring required to properly assess the performance of the models, using various statistical techniques, and presents reports to the Models and Ratings Committee, a sub-committee of the Risk Management Committee.

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

External verification

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

The independent external expert:

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

Use of models

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

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