Pillar 3 Disclosures
2014

Contents

1. OVERVIEW 3

1.1 Background 3
1.2 Basis and frequency of disclosures 3
1.3 Verification 4
1.4 Remuneration and governance arrangements 4
1.5 Scope of disclosures 4
1.6 Change in disclosure requirements 4

2. RISK MANAGEMENT POLICIES AND OBJECTIVES 5

2.1 Overview 5
2.2 Principal risks 5
2.3 Controlling and managing risk – overview 6
2.4 Society purpose and objectives 6
2.5 Risk strategy 6
2.6 Governance and control 7
2.7 Risk management 9

3. CAPITAL RESOURCES 11

3.1 Total available capital and compliance with capital requirements 11
3.2 Tier 1 capital 15
3.3 Tier 2 capital 15
3.4 Leverage ratio 15

4. CAPITAL ADEQUACY 17

4.1 Capital management 17
4.2 Minimum capital requirement – Pillar 1 18
4.3 Minimum capital requirement – credit risk 19
4.4 Movement in credit risk – Risk Weighted Assets (RWAs) 19
4.5 Regulatory developments 20

5. CREDIT RISK 21

5.1 Overview 21
5.1.1 Credit risk overview and exposures 21
5.1.2 Credit risk exposures 21
5.2 Retail credit risk 23
5.2.1 Management of retail credit risk 23
5.2.2 IRB rating system 26
5.2.3 Controls and governance 28
5.2.4 IRB model performance over time 29
5.2.5 Credit risk mitigation 31
5.2.6 Impairment provisions – Assets held at amortised cost 31
5.3 Treasury credit risk 35
5.3.1 Management of treasury credit risk 35
5.3.2 Credit risk mitigation 37
5.3.3 Impairment provisions – Treasury assets, held at fair value (Available-for-sale assets) 37
5.3.4 Securitisation 38
5.3.5 Counterparty credit risk – Derivatives 39

APPENDIX 1: EBA OWN FUNDS DISCLOSURE TEMPLATE 40

APPENDIX 2: CAPITAL INSTRUMENTS KEY FEATURES 43

APPENDIX 3: ASSET ENCUMBRANCE DISCLOSURE TEMPLATE 44

GLOSSARY 46

Please note, 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.

Tables

Table 1	Capital available	12
Table 2	Regulatory capital flow statement	13
Table 3	CRD IV – transitional and end-point analysis	14
Table 4	Leverage ratio	16
Table 5	Minimum capital requirement – Pillar 1	18
Table 6	Minimum capital requirement for credit risk	19
Table 7	Risk Weighted Assets (RWA) flow statement	19
Table 8	Credit risk exposure	21
Table 9	Geographical distribution of credit risk 2014 (Table 9a) and 2013 (Table 9b)	21
Table 10	Residual maturity of credit risk 2014 (Table 10a) and 2013 (Table 10b)	22
Table 11	Credit risk profile	24
Table 12	Geographical distribution of residential mortgages	24
Table 13	Residential mortgages loan to value (number of accounts)	25
Table 14	Residential mortgages new business profile	25
Table 15	Forbearance	26
Table 16	Allocation of exposures to IRB risk band	28
Table 17	Probability of Default (PD) model	29
Table 18	Actual losses as percentage of predictions	30
Table 19	Actual Exposure at Default (EAD) against predicted EAD	30
Table 20	Actual Probability of Default (PD) and Loss Given Default (LGD) against predicted	31
Table 21	Movements in impairment provisions	33
Table 22	Analysis of Society arrears compared with Council of Mortgage Lenders	33
Table 23	Past due and impaired loans by loan to value 2014 (Table 23a) and 2013 (Table 23b)	34
Table 24	Not impaired and impaired loans by segment 2014 (Table 24a) and 2013 (Table 24b)	34
Table 25	Movement in impaired loans	35
Table 26	Treasury assets exposure values by rating 2014 (Table 26a) and 2013 (Table 26b)	36
Table 27	ECAI exposure values and ratings	37
Table 28	Balance of funding secured on loans and advances 2014 (Table 28a) and 2013 (Table 28b)	38
Table 29	Derivative counterparty credit exposure	39

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.

Basel II was replaced by Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) (together referred to as CRD IV). CRD IV implements Basel III and came into force on 1 January 2014. It is enforced in the UK, together with local implementing rules and guidance, by the Prudential Regulation Authority (PRA). The objective of CRD IV 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.

CRD IV also sets out disclosure requirements relevant to banks and building societies under CRR Part Eight. These are known as Pillar 3 disclosures because they complement the minimum capital requirements in Pillar 1 and the supervisory review process in Pillar 2. The Pillar 3 disclosures are aimed at promoting market discipline by providing information on risk exposures and the management of those risks.

From 1 January 2008 the Financial Services Authority (a predecessor of the PRA) 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 permission was updated to become a CRR IRB permission from 1 January 2014. This permission 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 2014, 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 2014, this covered nearly 97% 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 CRD IV. 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 under CRD IV.

CRD IV requires a concise risk statement approved by the management body succinctly describing the institution's overall risk profile associated with the business strategy. The Society has a risk philosophy to be 'a below median risk mutual'. This is evidenced in its Common Equity Tier 1 capital ratio of 25.4%, the highest of any top 10 building society, the conservative 55.6% balance-weighted, indexed loan to value of its mortgage book and low level of arrears (number of accounts greater than three months in arrears as a percentage of loans and advances to customers of 0.68% compared with 1.33% for Council of Mortgage Lenders data). Additional information on the Society's management of risk and its risk profile are included in the remaining sections of this document, and the Risk Management Report within the 2014 Annual Report & Accounts (pages 16 to 54).

1.2 Basis and frequency of disclosures

This document sets out the 2014 Pillar 3 disclosures for the Society. These disclosures have been prepared solely to give information on the basis of calculating Basel III requirements and on the management of risks faced by the Society in accordance with the rules laid out in CRR Part Eight. The disclosures may differ from similar information in the 2014 Annual Report & Accounts prepared in accordance with International Financial Reporting Standards (IFRS); therefore the information in these disclosures may not be directly comparable with that information. All figures are as at 31 December 2014, the Society's year end, unless otherwise stated.

The introduction of CRD IV means that the Society's 2014 capital position is presented on a different basis to that reported in 2013. Where appropriate, 2013 capital information has been disclosed on a proforma basis to aid comparability.

Pillar 3 disclosures are published on an annual basis concurrently with the Annual Report & Accounts in accordance with regulatory guidelines. The European Banking Authority (EBA) has issued Guidelines on disclosure frequency and the Society is currently considering these in the context of summary Pillar 3 disclosures to be made at the same time as the 2015 interim financial statements.

1.3 Verification

These disclosures have been reviewed by the Society's Board Audit Committee on behalf of the Board, and by Ernst & Young (the Society's auditors), for compliance with Part Eight of the CRR. These disclosures have not been and are not required to be subject to independent external audit, and do not constitute any part of the Society's financial statements.

1.4 Remuneration and governance arrangements

In order to comply with the disclosure requirements of the CRR Part Eight Article 450 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 Directors' Remuneration Report within the 2014 Annual Report & Accounts on pages 69 to 82.

Furthermore disclosure requirements relating to governance arrangements under CRR Part Eight Article 435, and in particular the declaration approved by the management body of the adequacy of risk management arrangements, are included in the Directors' Report on Corporate Governance on pages 57 to 64 and Annual Business Statement on pages 136 and 137 within the 2014 Annual Report & Accounts.

The 2014 Annual Report & Accounts are published on the Society's website www.thecoventry.co.uk/accounts2014.

1.5 Scope of disclosures

The Society is an EEA parent institution that is regulated by the PRA and Financial Conduct Authority (FCA). The Basel III framework therefore applies to the Society and its subsidiary undertakings. Information on these subsidiaries is set out in note 16 to the 2014 Annual Report & Accounts. There are no differences between the basis of consolidation of the Group for accounting and prudential purposes.

There is a requirement to calculate and maintain regulatory capital ratios on both a Group and an Individual Consolidated (or solo) basis. The subsidiaries included in the Individual Consolidated basis are:

- Godiva Mortgages Limited
- ITL Mortgages Limited
- Five Valleys Property Company Limited

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 the entities included in the Individual Consolidated basis.

The Group consolidation additionally includes special purpose entities (SPEs) used by the Society for the issuance of wholesale funds. These SPEs have minimal levels of both retained capital and risk weighted assets and there are therefore no significant differences between the Individual Consolidated basis and the Group. For this reason, the disclosures in this document are on a Group basis only.

No Pillar 3 information has been omitted as either being proprietary or confidential.

1.6 Change in disclosure requirements

CRD IV introduces some new disclosure requirements for 2014 and these are substantially dealt with in Appendices 1 to 3. In future years the Pillar 3 report will also include further disclosures in compliance with the timeline in CRD IV regulations.

2. Risk management policies and objectives

2.1 Overview

The Society is a mutual organisation run for the long-term benefit of its members. In keeping with this, the Board adopts a prudent approach to managing risk.

The risks of the organisation are managed on a Group basis to include the Society and its subsidiaries. The term 'Society' is therefore used below to include the activities of the Society and its subsidiaries.

2.2 Principal risks

The risk classes inherent within the business are set out below and within each of these classes the Society's principal risks are also set out. The Society defines a principal risk as 'an inherent risk exposure that could materially compromise the Society's ability to grow and provide attractive products to saving and borrowing members'.

Risk class	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. Within this class the Society considers risks arising from retail credit risk and treasury credit risk to be individual principal risk categories.
Market risk	Market risk is a collective principal risk category and is defined as 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 currencies, although exposure to foreign currencies is immaterial.
Liquidity and funding risk	Liquidity and funding risk is a principal risk category. 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.
Conduct risk	Conduct risk is the risk that the Society's behaviours fail to deliver good customer outcomes.
Operational risk	Operational risk is the risk of loss arising from inadequate internal processes, systems or people, or from external events. The Society assesses the risks at a more granular level against which the following are considered to be the principal operational risk categories: legal and regulatory, IT systems, information security, financial crime and people.
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. The Society considers strategic risk, the risk to delivering the Strategic Plan, to be the principal business risk.

In addition to these principal risks, the Society is also exposed to model risk which is the risk that an adverse outcome occurs as a direct result of weakness or failure in the design or use of a model. Given that models are frequently used in the assessment and monitoring of principal risks, model risk is therefore a feature of each of the categories above. The Society uses a variety of techniques to mitigate model risk including sensitivity analysis to key assumptions and applying shock stresses. A formal committee is dedicated to the oversight of the Internal Ratings Based (IRB) models and considers validation reports from third party experts. The Society also identifies, monitors and manages the top and emerging risks that could affect delivery of the Strategic Plan as an integral element of its risk management strategy.

Disclosures relating to market, liquidity and funding, conduct, operational and business risks are included in the 2014 Annual Report & Accounts Risk Management Report and are therefore not duplicated in this document. This document does, however, include additional credit risk information to that in the 2014 Annual Report & Accounts given this risk is the principal driver of the Society's Pillar 1 capital requirement. Therefore in order to provide the reader with a comprehensive overview, the 2014 Annual Report & Accounts credit risk disclosures are also included in this document, together with the additional disclosures.

2.3 Controlling and managing risk – overview

Whilst the Society has not fundamentally changed its risk management approach, during the year the approach has continued to evolve. In particular during 2014 the Society has sought to better document and evidence its approach to risk management through the formalisation of an Enterprise Risk Management Framework (ERMF) and this work is ongoing. The primary purpose of the ERMF is to set out the Society's approach to managing risk and provision of oversight by defining and documenting the Society's purpose and objectives; risk strategy; governance and control; and risk management together with the principles upon which the framework is based. The ERMF should ensure a more consistent approach to risk management across all risk categories.

How the Society controls and manages risks is set out in the sections that follow.

2.4 Society purpose and objectives

The Society determines and regularly revisits its purpose and objectives through the annual strategic planning process and through defining its vision for the future. The risk management process complements and supports the Society's Strategic Plan and vision.

The Society exists solely for the benefit of its current and future members, meeting their needs for savings and residential property mortgages. In delivering its strategic objectives the Society is committed to Putting Members First in everything it does and fully embraces the mutual ethos on which the Society was founded. These objectives therefore drive the risk appetite adopted by the Society 'to be a below median risk mutual' and set a strong risk culture in which it operates.

The Society operates a very simple business model – simple products, simple ways of operating and simple and transparent communication. It operates solely within the UK retail financial services market and only takes on risks that it understands and can manage.

2.5 Risk strategy

Set by the Board, the risk strategy translates the Society's purpose and objectives into an approach to risk management that incorporates risk culture, Board risk appetite and the adoption of the 'three lines of defence' model. The risk strategy defines the set of risk principles on which the risk framework is constructed.

Risk culture

Risk culture is defined as the normal attitudes and behaviour exhibited by staff at all levels with regard to risk awareness, risk taking and risk management.

The Society's risk culture is built on the following three elements:

- Tone from the top – the Board and executive management encourage staff to act with integrity, especially in the fair treatment of customers, and to escalate observed non-compliance. Staff are encouraged to report risk incidents and 'near misses'.
- Accountability – employees understand the core values of the Society and therefore the approach to risk. This is supported by the Society's performance management process.
- Incentives – the Society's performance management arrangements promote the Society's desired risk management behaviours and attitudes. In particular, the Society does not operate any sales incentives for staff.

Board risk appetite

The Board sets high level risk appetite statements to provide a framework for business decision making and to identify and articulate the risks that the Board is willing to take in delivering the Strategic Plan.

The Board has a risk philosophy to be a 'below median risk mutual' which also provides a check and balance against the underlying appetite statements and limits for each of the Society's risk categories.

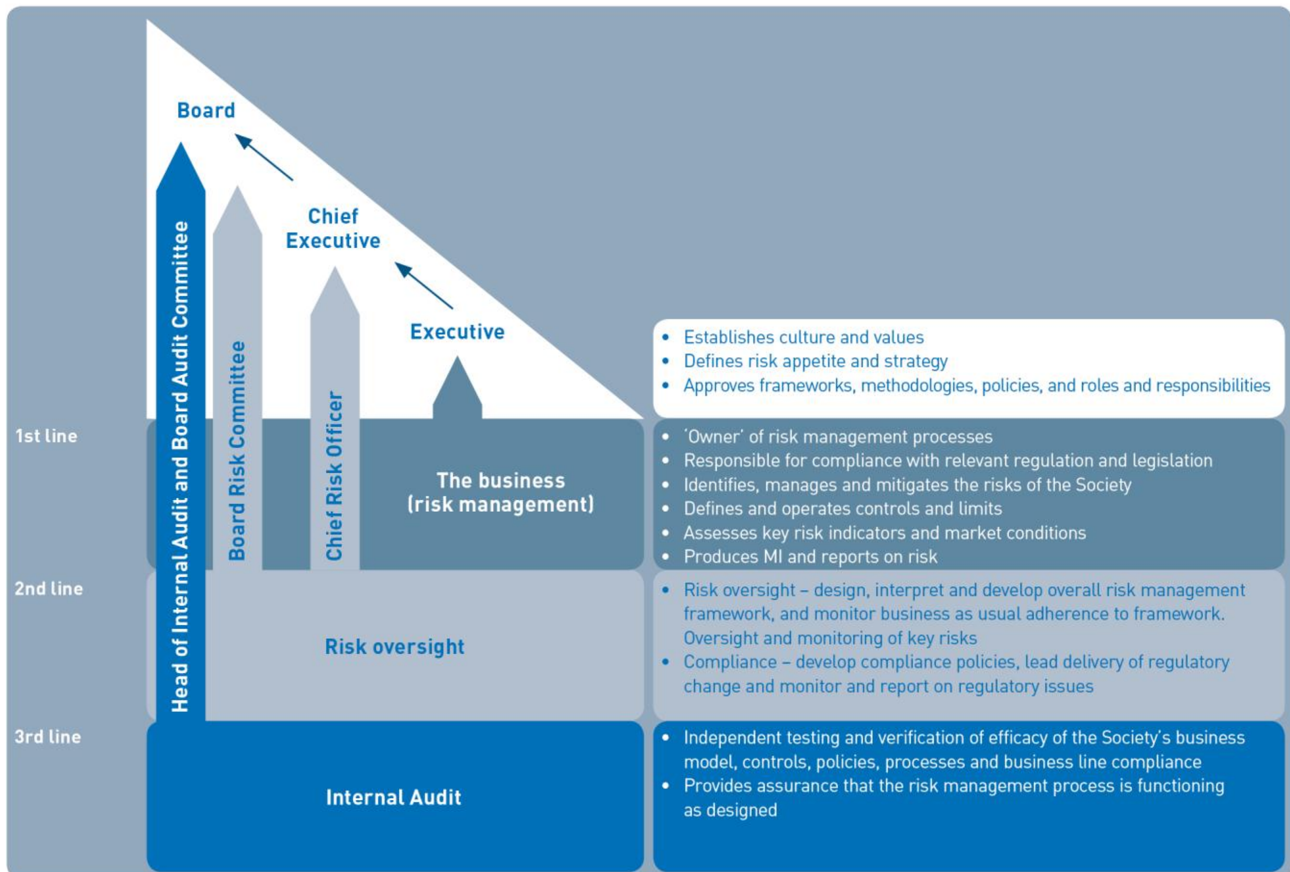
Additionally, the Board has set a boundary condition to be able to withstand a severe but plausible stress and still report an accounting profit and meet minimum capital requirements. The Society will tend to operate with a lower level of risk than its stated appetite or boundary condition, if it is possible to do so and still meet its Strategic Plan targets.

The Society's performance against Board limits is reviewed monthly as part of a consolidated risk report by both the Risk Management Committee (RMC) and Board Risk Committee (BRC).

Three lines of defence

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.

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



- 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 risks impact their area of the business and to put 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 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 the 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 on the results of the work performed.

2.6 Governance and control

Risk governance structure

Governance is maintained through delegation of authority from the Board, down through the management hierarchy, supported by a committee based structure designed to ensure that risk appetites, policies, procedures, controls and reporting are fully in line with regulation, law, corporate governance and industry good practice.

The risk governance structure in operation during the year is set out overleaf. This structure is being considered as part of the ERMF development and is expected to remain broadly consistent with the addition of a dedicated risk oversight committee which the Chief Risk Officer will chair to facilitate a comprehensive second line review of risk across all categories.

Further information on the BRC is included in the 2014 Annual Report & Accounts Directors' Report on Corporate Governance on page 61 and on the BAC in the 2014 Annual Report & Accounts Board Audit Committee Report on pages 65 to 68.

Risk governance structure

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), Strategic Plan, Risk Appetite, Recovery and Resolution Plan and stress testing.

Chief Executive

Board Risk Committee (BRC)

Chair: Non-executive director

- Overseeing and advising the Board on current and potential risk exposures to the Society, including reviewing 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.
- Seeks 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.

Asset and Liability Committee (ALCO)

Chair: Finance Director

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

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.

Models and Ratings Committee (MRC)

Chair: Non-executive director

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

2.7 Risk management

The risk management approach encompasses the requirements for identifying, assessing, managing, monitoring and reporting on risk. Techniques involved include the use of risk and control self-assessment, the use of key risk indicators, risk management information, the monitoring of risks by each of the three lines of defence, risk modelling and stress testing and planning.

The risk management processes are designed to deliver the Society's risk management objectives which at a strategic level are to:

- Identify risks against the Strategic Plan and Society objectives.
- Assess risk exposures by impact and likelihood.
- Respond to risks by evaluating their position against risk appetite, formulating associated management responses and monitoring the agreed management action plans and progress.

Stress testing and planning

The Society recognises that stress testing is a key tool to understanding and managing risk. In support of this, the Society has developed and maintains a detailed stress testing framework that covers stress testing, scenario planning and contingency planning. As well as an understanding of the Society's resilience to internal and external shocks, 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 Internal Capital Adequacy Assessment Process (ICAAP) 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 the Society's 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 in support of the overall capital calculation. 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 of England Base Rate scenarios.

ILAA

The Individual Liquidity Adequacy Assessment (ILAA) 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 prescriptive, using very detailed rules and guidance issued within prudential regulations and reported 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's stress tests and regulatory returns are completed weekly, alongside a monthly operational stress and six-monthly alternative stress tests.

Reverse stress testing

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 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 risk strategy or underlying controls.

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

Recovery and Resolution Plans

The regulatory authorities are keen to avoid committing more taxpayers' funds towards any failed banks and building societies and are requiring them to formulate plans to avoid such eventualities. The recovery plan outlines what can be done to stop the Society from failing whilst the resolution section provides the data required to establish a resolution plan for the Society. The process of preparation for such extreme events enables the Board to plan actions it would take to recover from adverse conditions which would otherwise lead to failure. The recovery plan represents a 'menu of options' for the Society to deal with firm-specific or market-wide stresses and which can be incorporated into a credible and executable plan.

3. Capital resources

3.1 Total available capital and compliance with capital requirements

As at 31 December 2014 and throughout the financial year, the Society complied with the capital requirements that were in force as set out by European and national legislation.

As explained in Section 1 Overview, there is a requirement to calculate and maintain regulatory capital ratios on both a Group basis and on an Individual Consolidated (or solo) basis. However, as there are no significant differences between the Group and Individual Consolidated basis the capital information in this section is set out on a Group basis only.

The Society continues to use an Internal Ratings Based (IRB) approach to retail credit risk and standardised approach for other exposures and risks to calculate capital requirements. The PRA has confirmed that the original Basel II IRB permission for retail credit risk transferred to a CRR IRB permission from 1 January 2014.

Basel III was implemented through the Capital Requirements Regulations and Directive (together 'CRD IV'). CRD IV came into force on 1 January 2014 and is supervised in the UK, together with local implementing rules and guidance, by the Prudential Regulation Authority. The CRD IV framework is supplemented by a number of technical standards published by the European Banking Authority. The objective of CRD IV 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.

Table 1 shows the composition of capital resources for the Society as at 31 December 2014 on a CRD IV basis. Appendix 1 sets out this information in the template format published by the EBA in 'Implementing Technical Standard (ITS) 2013/01'.

The Society's CET 1 capital and CET 1 ratio are disclosed on an end-point basis as no transitional provisions apply to these items. Additional Tier 1 (AT 1) and Tier 2 capital (and therefore total capital ratios) include instruments that are grandfathered and are therefore disclosed on a transitional basis (Table 3 shows the position on both a transitional and end-point CRD IV basis).

Table 1 also shows the composition of the capital resources for the Society as at 31 December 2013 on a Basel II basis as this was the capital regime that applied at that time. The impact of CRD IV is complex, but in summary reduces the Society's capital resources primarily through the inclusion of the negative Available-for-sale reserve, and restricting the eligibility of Permanent Interest Bearing Shares and subordinated debt on a phased basis under transitional rules which extend to 31 December 2021. CRD IV also increases risk weighted assets by capturing risks associated with the valuation or ultimate realisation of assets which were deemed not to be sufficiently recognised under Basel II. The quantification of these impacts can be seen in Tables 1 and 2.

Table 1 shows that, even with the negative impacts from the transition to CRD IV, the Society has increased its CET 1 capital and CET 1 capital ratio through organic profitability. The total Tier 1 and total capital positions have also improved having been additionally strengthened by the issuance of Perpetual Capital Securities, a form of Additional Tier 1 (AT 1).

Table 1: Capital available

	Notes	CRD IV As at 31 December 2014 £m	Basel II As at 31 December 2013 £m
Common Equity Tier 1 (CET 1)			
General reserve		**1,061.9**	914.6
Available-for-sale reserve	1	**(0.7)**	-
Cash flow hedge reserve	2	**32.8**	-
Common Equity Tier 1 prior to regulatory adjustments		**1,094.0**	914.6
Common Equity Tier 1 regulatory adjustments			
Prudent additional valuation adjustment	3	**(1.7)**	-
Intangible assets	4	**(15.9)**	(12.2)
Cash flow hedge reserve	2	**(32.8)**	-
Excess of expected loss over impairment	5	**(21.1)**	(11.1)
Pension fund surplus adjustment	6	**(1.3)**	(5.1)
Foreseeable distributions	7	**(10.0)**	-
Common Equity Tier 1		**1,011.2**	886.2
Additional Tier 1 capital (AT 1)			
Permanent Interest Bearing Shares (PIBS)	8	**128.0**	160.0
Additional Tier 1 – Perpetual Capital Securities (PCS)		**396.9**	-
Total Additional Tier 1		**524.9**	160.0
Total Tier 1		**1,536.1**	1,046.2
Tier 2			
Collective provisions for impairment		**6.1**	2.0
Subordinated debt	8	**42.2**	54.1
Total Tier 2 prior to regulatory adjustments		**48.3**	56.1
Tier 2 regulatory adjustments			
Excess of expected loss over impairment	5	**-**	(11.1)
Total Tier 2 capital		**48.3**	45.0
Total capital		**1,584.4**	1,091.2
Risk weighted assets			
IRB approach			
Credit risk - retail exposures		**3,020.4**	2,787.5
Standardised approach			
Credit risk - retail exposures		**361.6**	387.4
Credit risk - liquidity book		**112.8**	185.7
Credit risk - other		**39.4**	42.0
Credit valuation adjustment risk	9	**46.5**	-
Operational risk		**396.5**	250.8
Total risk weighted assets		**3,977.2**	3,653.4
Capital ratios (as a percentage of risk weighted assets)			
Common Equity Tier 1		**25.4%**	24.3%
Total Tier 1		**38.6%**	28.6%
Total capital		**39.9%**	29.9%

Notes

1. Under CRD IV the Available-for-sale reserve is included in regulatory capital.
2. Under CRD IV and Basel II the cash flow hedge reserve does not form part of regulatory capital.
3. Under CRD IV a prudent valuation adjustment is applied in respect of assets and liabilities held at fair value.
4. Under CRD IV and Basel II intangible assets do not form part of regulatory capital.
5. Under CRD IV, the net expected loss over accounting provision is deducted in full from CET 1 capital gross of tax. Under Basel II the deduction was split 50% net of tax from Core Tier 1 and 50% net of tax from Tier 2.
6. Under CRD IV and Basel II the pension fund surplus does not count towards regulatory capital. Under CRD IV the surplus is net of deferred tax.
7. Foreseeable distributions in respect of AT 1 securities (Perpetual Capital Securities) are deducted from CET 1 capital under CRD IV, net of tax.
8. Under CRD IV transitional 'grandfathering' provisions Permanent Interest Bearing Shares and Subordinated debt are subject to amortisation for regulatory capital purposes. At 31 December 2014 the deduction is 20%.
9. Under CRD IV a capital charge relating to credit valuation adjustment risk is required.

Table 2 shows the movement in capital during 2014 including the impact of the adoption of CRD IV.

Table 2: Regulatory capital flow statement

	£m
Common Equity Tier 1 capital at 1 January 2014	886.2
Profit for the year	158.5
Other changes to General reserves	(11.2)
Foreseeable distributions	(10.0)
Prudent valuation adjustments[1]	(1.7)
Change in intangible assets	(3.7)
Available-for-sale reserve[1]	(0.7)
Change in expected loss over impairment[1]	(10.0)
Change in pension fund surplus adjustment[1]	3.8
Common Equity Tier 1 capital at 31 December 2014	**1,011.2**
Additional Tier 1 capital at 1 January 2014	160.0
Issuance of Additional Tier 1 capital securities	396.9
Amortisation of Permanent Interest Bearing Shares[1]	(32.0)
Additional Tier 1 capital at 31 December 2014	**524.9**
Total Tier 1 capital at 31 December 2014	**1,536.1**
Tier 2 capital at 1 January 2014	45.0
Amortisation of Subordinated debt[1]	(11.9)
Expected loss over impairment – now deducted from Common Equity Tier 1[1]	11.1
Change in collective provisions for impairment	4.1
Tier 2 capital at 31 December 2014	**48.3**
Total regulatory capital at 31 December 2014	**1,584.4**

1. Capital flow for these line items is due in whole or in part to the adoption of CRD IV.

Table 2 further demonstrates that the Society's strong trading performance and AT 1 capital issuance has more than off-set the negative impacts of the transition to CRD IV.

Table 3 shows the CRD IV capital position on both a transitional and end-point basis (i.e. assuming all CRD IV requirements were in force in full with no transitional provisions permitted). Table 3 also contains 31 December 2013 CRD IV information on a proforma basis had the transitional rules been applied at that date.

Table 3: CRD IV – transitional and end-point analysis

	Notes	Transitional CRD IV		End-point CRD IV	
		As at 31 December 2014 £m	As at 31 December 2013 £m	**As at 31 December 2014 £m**	As at 31 December 2013 £m
Common Equity Tier 1 (CET 1)					
General reserve		**1,061.9**	914.6	**1,061.9**	914.6
Available-for-sale reserve		**(0.7)**	(12.1)	**(0.7)**	(12.1)
Cash flow hedge reserve		**32.8**	(7.5)	**32.8**	(7.5)
Common Equity Tier 1 prior to regulatory adjustments		**1,094.0**	895.0	**1,094.0**	895.0
Common Equity Tier 1 regulatory adjustments					
Prudent additional valuation adjustment	1	**(1.7)**	(1.7)	**(1.7)**	(1.7)
Intangible assets	2	**(15.9)**	(12.2)	**(15.9)**	(12.2)
Deferred tax asset	3	**-**	(1.4)	**-**	(1.4)
Cash flow hedge reserve	2	**(32.8)**	7.5	**(32.8)**	7.5
Excess of expected loss over impairment	4	**(21.1)**	(27.9)	**(21.1)**	(27.9)
Pension fund surplus adjustment	2	**(1.3)**	(4.1)	**(1.3)**	(4.1)
Foreseeable distributions	5	**(10.0)**	-	**(10.0)**	-
Common Equity Tier 1		**1,011.2**	855.2	**1,011.2**	855.2
Additional Tier 1 capital (AT 1)					
Permanent Interest Bearing Shares (PIBS)	6	**128.0**	128.0	**-**	-
Additional Tier 1 - Perpetual Capital Securities (PCS)		**396.9**	-	**396.9**	-
Total Additional Tier 1		**524.9**	128.0	**396.9**	-
Total Tier 1		**1,536.1**	983.2	**1,408.1**	855.2
Tier 2					
Collective provisions for impairment		**6.1**	2.0	**6.1**	2.0
Subordinated debt	6	**42.2**	44.4	**-**	-
Total Tier 2		**48.3**	46.4	**6.1**	2.0
Total capital		**1,584.4**	1,029.6	**1,414.2**	857.2
Risk weighted assets					
IRB approach					
Credit risk - retail exposures		**3,020.4**	2,787.5	**3,020.4**	2,787.5
Standardised approach					
Credit risk - retail exposures		**361.6**	387.4	**361.6**	387.4
Credit risk - liquidity book		**112.8**	185.7	**112.8**	185.7
Credit risk - other		**39.4**	56.8	**39.4**	56.8
Credit valuation adjustment risk		**46.5**	82.0	**46.5**	82.0
Operational risk		**396.5**	250.8	**396.5**	250.8
Total risk weighted assets		**3,977.2**	3,750.2	**3,977.2**	3,750.2
Capital ratios (as a percentage of risk weighted assets)	7				
Common Equity Tier 1		**25.4%**	22.8%	**25.4%**	22.8%
Total Tier 1		**38.6%**	26.2%	**35.4%**	22.8%
Total capital		**39.9%**	27.5%	**35.6%**	22.9%

Notes

1. A prudent valuation adjustment is applied in respect of assets and liabilities held at fair value.
2. Items do not form part of regulatory capital, net of associated deferred tax.
3. An adjustment is required for deferred tax assets that rely on future profitability.
4. The expected loss over accounting provisions is deducted gross of tax.
5. Foreseeable distributions in respect of AT 1 securities (Perpetual Capital Securities) are deducted, net of tax.
6. Under transitional 'grandfathering' provisions, Permanent Interest Bearing Shares (PIBS) and Subordinated debt are subject to amortisation. At 31 December 2014 the deduction is 20%.
7. CRD IV sets a minimum for Tier 1 capital of 6% of risk weighted assets (RWAs) of which Common Equity Tier 1 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% RWAs.

The increase in CET 1 capital is primarily driven by retained earnings of £158.5 million. Total Tier 1 capital and total regulatory capital have additionally been increased by the issue of £400.0 million of AT 1 capital. RWAs increased by £227.0 million, primarily driven by an increase in IRB risk weighted assets, reflecting continuing growth in the mortgage book, and an increase in the capital allocation for operational risk, calculated under the standardised approach. Capital allocation for operational risk is calculated using a prescribed formula which is based on the Society's net income over a three year period. Therefore in line with the growth of the Society, operational RWAs have also increased.

The movements above resulted in the Group's CET 1 ratio increasing from 22.8% to 25.4% under the CRD IV approach.

3.2 Tier 1 capital

Tier 1 capital comprises

- General reserve
- Available-for-sale reserve
- AT 1 capital – Permanent Interest Bearing Shares (PIBS)
- AT 1 capital – Perpetual Capital Securities (PCS)
- Adjustments as set out by the regulatory requirements governing capital resources

The General reserve represents the Society's accumulated accounting profits.

The Society issued £400.0 million (£396.6 million net of issuance costs) of AT 1 capital in the form of marketable Perpetual Capital Securities in June 2014. These capital securities bear a discretionary distribution coupon of 6.375%, and have no fixed repayment date, although the Society retains the right to repay them in November 2019, with PRA approval. The capital securities are convertible into Core Capital Deferred Shares (the equivalent of common shares for a building society, with a capped return) if the CET 1 capital ratio of the Society should fall below 7%. Due to the low risk nature of the Society's lending, the Society already had a high CET 1 ratio with significant excess capital to meet risk based requirements. The Society issued AT 1 capital to strengthen the leverage ratio – see 3.4 below - to a level that exceeds current proposed minimum regulatory requirements.

Appendix 2 show the key features of the Society's Tier 1 capital instruments and further information can be found in notes 26 and 27 to the 2014 Annual Report & Accounts.

The adjustments required by regulatory requirements under CRD IV are set out in Table 1.

3.3 Tier 2 capital

Tier 2 capital comprises

- Subordinated debt
- Collective provisions for impairment for Standardised exposures

Subordinated debt instruments are unsecured and rank behind the claims of all depositors, creditors and shareholders in the Society other than holders of PIBS and Perpetual Capital Securities. Appendix 2 also shows the key features of the Society's subordinated debt instruments and more information can be found in note 25 to the 2014 Annual Report & Accounts.

3.4 Leverage ratio

CRD IV introduces a non-risk based leverage ratio that is supplementary to the risk based capital requirements and was originally proposed as a 'backstop' measure. The calculation determines a ratio based on the relationship between Tier 1 capital and exposures to on and off balance sheet items. The leverage ratio does not distinguish between unsecured and secured loans or recognise the ratio of loan to value of secured lending. The Financial Policy Committee (FPC) has reviewed the CRD IV requirements and has indicated that the proposed minimum level of this ratio in the UK will be 3%. Following the issue of AT 1 capital in June 2014 the Society comfortably meets this minimum requirement with a ratio of 3.9% (on an end-point basis) at 31 December 2014.

The FPC set out the UK leverage ratio requirements following a review of the leverage ratio during 2014. This framework is more complex than the regime envisaged by the Basel Committee and is intended to 'mirror' aspects of the risk weighted capital requirement. The components of the proposed leverage ratio requirement are a minimum ratio of 3%, of which 25% may be met using high quality AT 1 capital, and two additional buffers that are to be met using CET 1 capital: a supplementary leverage buffer, which will apply to the largest UK banks and building societies and be implemented from 2019 (from 2016 for firms deemed globally significant), and a countercyclical leverage buffer that will apply to all firms. The levels of these buffers will be set to 35% of the corresponding risk weighted systemic risk buffer and countercyclical buffer (CCyB). The CCyB is set by the FPC and is currently zero (maximum 0.9% leverage impact). Given the size of the Society, it is anticipated it will qualify for a supplementary buffer but the level is uncertain and could have a maximum additional leverage requirement of 1.05%. The FPC has indicated it will provide up to 24 months' notice for any increase in the CCyB and therefore the minimum requirement currently proposed for the Society is 3% but could increase to a minimum of 4.95% from 1 January 2019. The Board is confident that the Society will meet the requirements that are imposed on it with an appropriate level of headroom.

The following table details the leverage ratio on an end-point basis. The calculation has been performed in accordance with the definition of CRD IV as amended by the European Commission delegated regulation. The calculation reflects constraints on the inclusion of AT 1 capital as proposed by the FPC's review of the leverage ratio published in October 2014. Whilst all of the Society's recently issued AT 1 capital meets the Basel III requirements and therefore serves to protect members' interests, only £242.5 million is eligible for this particular measure. Prior year figures have been restated to reflect the most current guidance.

Table 4: Leverage ratio

	Notes	**End-point CRD IV As at 31 December 2014 £m**	End-point CRD IV As at 31 December 2013 £m
Total Tier 1 capital		**1,408.1**	855.2
Adjustment for AT 1 restriction		**(154.4)**	-
Total Tier 1 capital for leverage ratio		**1,253.7**	855.2
Leverage ratio exposures			
Total balance sheet assets		**31,278.3**	28,253.3
Mortgage pipeline	1	**684.3**	477.4
Other committed facilities (undrawn lending)	1	**33.8**	38.9
Repurchase agreements	2	**392.2**	398.3
Netted derivative adjustments	3	**(27.1)**	(32.4)
Items included in the capital calculation	4	**(33.9)**	(45.3)
Total leverage ratio exposures		**32,327.6**	29,090.2
Leverage ratio		**3.9%**	2.9%

Notes

1. Mortgage pipeline and other commitments are subject to a 50% risk weighting as per the delegated regulation amending CRD IV.
2. Repurchase agreements represents the extent to which collateral provided on repurchase agreements exceeds the amount borrowed.
3. The netted derivative adjustment figure converts the accounting value of derivatives to an exposure measure.
4. Adjustments to asset balances that have already been included in the capital calculation are removed from the total balance sheet assets figure.

The leverage ratio has increased from 2.9% to 3.9% on an end-point basis. This primarily reflects an increase in Total Tier 1 capital, driven by organic profitability and the AT 1 issuance, partially offset by growth in total leverage ratio exposures.

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 Strategic Plan. In this process the Society reviews its risk management framework, together with the financial projections developed for the Strategic 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
- 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 'UK variant scenario' 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 the Bank of England Base Rate when interest rates rise significantly from their current level.
- Increased retail funding costs arising from stresses driven by the end of all Funding for Lending Scheme (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 ICAAP adopted by the Board in February 2014 was subject to SREP during 2014 and the ICG was updated accordingly.

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 strategic planning process. 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 Common Equity 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 that the Society's level of regulatory capital surplus will tend to be driven by non risk based measures such as the CRD IV leverage ratio.

The Pillar 2 framework described above is currently being updated as part of the implementation of CRD IV and details are provided in section 4.5 regulatory developments.

4.2 Minimum capital requirement – Pillar 1

As explained in Section 1 Overview, there is a requirement to calculate and maintain regulatory capital ratios on both a Group basis and on an Individual Consolidated (or solo) basis. However, as there are no significant differences between the Group and Individual Consolidated basis the capital information in this section is set out on a Group basis only.

The Society's minimum capital requirement under Pillar 1 is the sum of the credit risk capital requirement and the operational risk capital requirement. Market risk is not included in the Pillar 1 requirement because the Society does not have a trading book and foreign exchange risk is negligible.

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 (TSA) approach. The results of the calculation are well in excess of actual experienced losses, suggesting the approach is prudent.

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

Table 5: Minimum capital requirement – Pillar 1

	CRD IV As at 31 December 2014 £m	Basel II As at 31 December 2013 £m
IRB approach		
Credit risk – Retail exposures	**241.6**	223.0
Standardised approach		
Credit risk – Retail exposures	**28.9**	31.0
Credit risk – Liquidity book	**9.0**	14.9
Credit risk – Other	**3.2**	3.4
Credit valuation adjustment risk	**3.7**	-
Operational risk	**31.7**	20.0
Capital resources requirement under Pillar 1	**318.1**	292.3
Total capital resources on a transitional basis (per Table 1)	**1,584.4**	1,091.2
Capital resources surplus over requirement	**1,266.3**	798.9

CRD IV sets a minimum for Tier 1 capital of 6% of risk weighted assets of which Common Equity Tier 1 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% RWAs.

4.3 Minimum capital requirement – credit risk

The following table shows the composition of the minimum capital required for credit risk at 31 December 2014.

Table 6: Minimum capital requirement for credit risk

	CRD IV As at 31 December 2014 £m	Basel II As at 31 December 2013 £m
Internal Ratings Based (IRB) exposure classes		
Retail mortgages (prime secured against residential property)	**241.6**	223.0
Standardised exposure classes		
Institutions with short term credit assessments	**3.3**	4.7
Other Institutions[1]	**3.8**	4.7
Securitisation positions	**1.9**	5.5
Corporates (commercial lending)	**0.5**	0.6
Retail mortgages (secured against residential property)	**23.5**	24.7
Other retail (unsecured loans)	**2.7**	3.1
Non-credit obligation assets (fixed assets and other)	**3.2**	3.4
Past due	**2.2**	2.6
Total minimum capital requirement standardised	**41.1**	49.3
Total minimum capital requirement IRB and standardised	**282.7**	272.3

1. Other institutions includes minimum capital requirement of £0.3 million for covered bonds and £0.1 million for equity at both year ends.

The overall capital requirement for credit risk has increased by 3.8% over the year. Capital requirements calculated under the IRB approach have increased by £18.6 million. This has been offset by a £8.2 million reduction in standardised requirements. For further information see Table 7 below.

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

The following table shows the movement in credit risk RWAs over 2014. Movements reflect changes in book size and book quality.

Table 7: Risk Weighted Assets (RWA) flow statement

	IRB mortgages £m	**Standardised mortgages and loans £m**	**Treasury £m**	**Other £m**	**Total £m**
RWAs at 1 January 2014 (Basel II)	2,787.5	387.4	185.7	42.0	**3,402.6**
Book size increase/(decrease)	332.3	(7.9)	(3.0)	(2.6)	**318.8**
Book quality improvement	(99.4)	(17.9)	(69.9)	-	**(187.2)**
RWAs at 31 December 2014 (CRD IV)	**3,020.4**	**361.6**	**112.8**	**39.4**	**3,534.2**

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

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

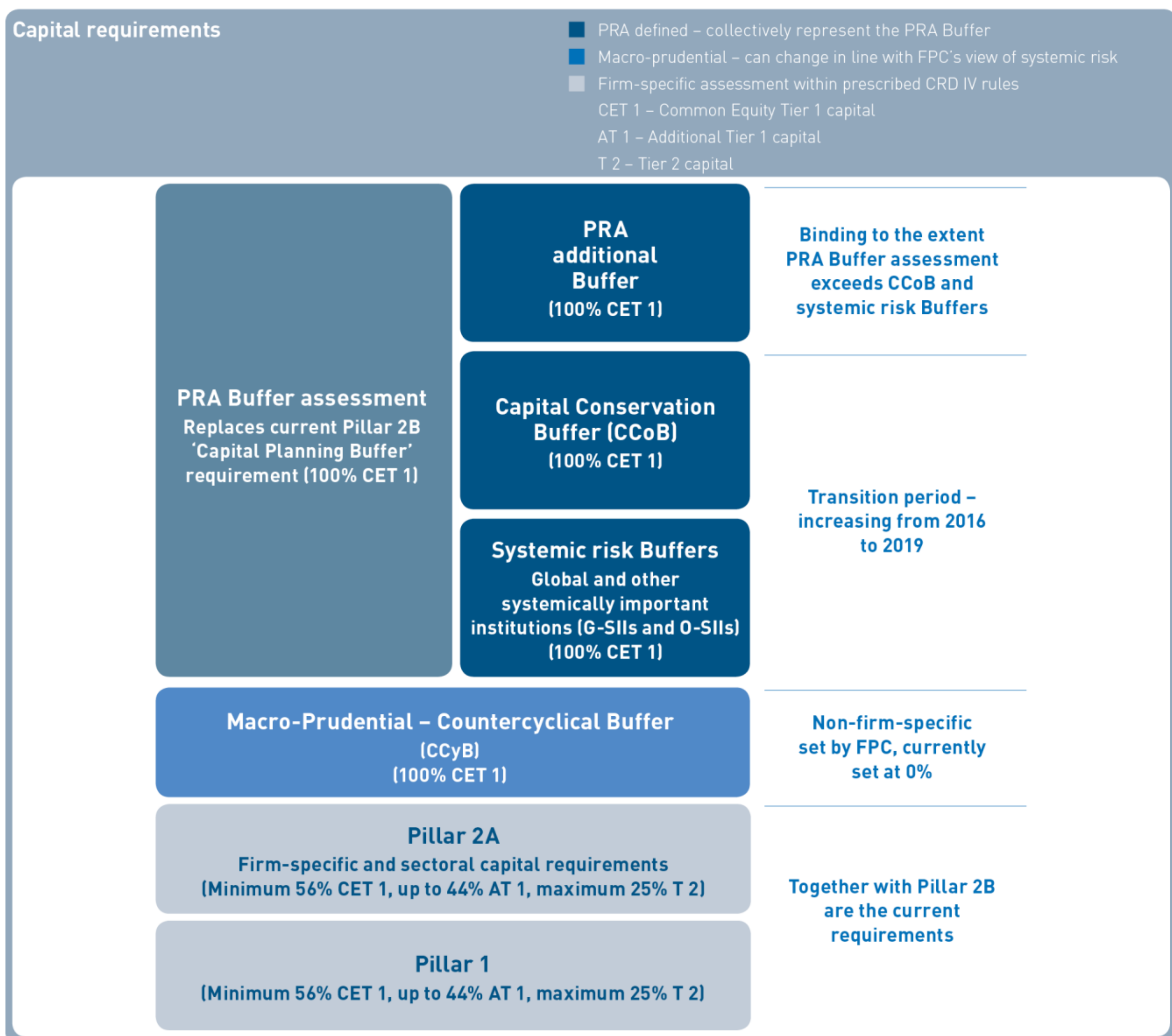
Even though there has been a small absolute increase in the on balance sheet treasury exposures there has been a decrease in related RWAs. This primarily reflects more of the treasury assets being held in zero risk weighted assets (central banks and sovereigns) with a corresponding reduction in higher rated Residential Mortgage Backed Securities.

4.5 Regulatory developments

As noted in 4.1, the Pillar 2 framework is currently being updated as part of CRD IV implementation.

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 supplementary common equity capital buffers, which will meet some or all of the requirements previously captured under Pillar 2B. These comprise 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; and macro-prudential countercyclical buffers (CCyB) and sectoral capital requirements (SCR). The Financial Policy Committee published a Policy Statement in January 2014 explaining the circumstances in which the SCR and CCyB may be applied, to counter emerging threats to financial stability. The SCR can be applied by amending the Society's 'risk weights' which affect RWAs and minimum capital requirements or via capital buffers (within Pillar 2A) which apply over and above minimum capital requirements.

Capital utilised in meeting the firm specific Pillar 1 and Pillar 2A capital requirements, which may include a firm-specific buffer, may not be used in meeting the additional CRD IV supplementary buffers. The diagram below shows the constituent elements of the CRD IV capital requirements that could impact the Society combined with the quality of capital that can be used to meet the minimum requirements.



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)
- 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. Exposures are net of impairment provisions.

Table 8: Credit risk exposure

	Notes	**Average 1 January 2014 - 31 December 2014 £m**	**As at 31 December 2014 £m**	Average 1 January 2013 - 31 December 2013 £m	As at 31 December 2013 £m
Residential mortgages	1	**25,481.4**	**26,908.5**	23,003.0	24,054.2
Unsecured and other lending	1	**57.0**	**51.1**	65.0	62.9
Total		**25,538.4**	**26,959.6**	23,068.0	24,117.1
Treasury:					
Central banks and sovereigns	1,2	**3,259.6**	**3,330.3**	3,252.8	3,188.9
Multilateral development banks (supranational bonds)	2	**83.1**	**70.5**	156.4	95.7
Financial institutions	1,2	**430.0**	**439.9**	579.0	420.0
Residential Mortgage Backed Securities (RMBS)	2	**146.1**	**109.5**	193.5	182.8
Total		**3,918.8**	**3,950.2**	4,181.7	3,887.4
Total		**29,457.2**	**30,909.8**	27,249.7	28,004.5

Table 9a: Geographical distribution of credit risk 2014

As at 31 December 2014	Notes	**United Kingdom £m**	**Rest of Europe £m**	**Rest of the World £m**	**Total £m**
Residential mortgages	1	**26,908.5**	**-**	**-**	**26,908.5**
Unsecured and other lending	1	**51.1**	**-**	**-**	**51.1**
Total		**26,959.6**	**-**	**-**	**26,959.6**
Treasury:					
Central banks and sovereigns	1,2	**3,330.3**	**-**	**-**	**3,330.3**
Multilateral development banks (supranational bonds)	2	**-**	**70.5**	**-**	**70.5**
Financial institutions	1,2	**424.1**	**15.5**	**0.3**	**439.9**
Residential Mortgage Backed Securities (RMBS)	2	**109.5**	**-**	**-**	**109.5**
Total		**3,863.9**	**86.0**	**0.3**	**3,950.2**
Total		**30,823.5**	**86.0**	**0.3**	**30,909.8**

Notes
1. Held at amortised cost using the effective interest method and after deduction of impairment provisions where appropriate.
2. Held at fair value.

Table 9b: 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	62.9	-	-	62.9
Total		24,117.1	-	-	24,117.1
Treasury:					
Central banks and sovereigns	1,2	3,188.9	-	-	3,188.9
Multilateral development banks (supranational bonds)	2	-	95.7	-	95.7
Financial institutions	1,2	310.6	14.3	95.1	420.0
Residential Mortgage Backed Securities (RMBS)	2	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

The maturity of exposures is shown on a contractual basis:

Table 10a: Residual maturity of credit risk 2014

As at 31 December 2014	Notes	**Up to 12 months £m**	**1-5 years £m**	**5-10 years £m**	**More than 10 years £m**	**Total £m**
Residential mortgages	1	**2,116.9**	**7,188.2**	**7,232.4**	**10,371.0**	**26,908.5**
Unsecured and other lending	1	**3.9**	**8.5**	**12.4**	**26.3**	**51.1**
Total		**2,120.8**	**7,196.7**	**7,244.8**	**10,397.3**	**26,959.6**
Treasury:						
Central banks and sovereigns	1,2	**1,958.1**	**368.6**	**808.1**	**195.5**	**3,330.3**
Multilateral development banks (supranational bonds)	2	**35.5**	**35.0**	**-**	**-**	**70.5**
Financial institutions	1,2	**428.5**	**1.7**	**5.8**	**3.9**	**439.9**
Residential Mortgage Backed Securities (RMBS)	2	**20.2**	**-**	**-**	**89.3**	**109.5**
Total		**2,442.3**	**405.3**	**813.9**	**288.7**	**3,950.2**
Total		**4,563.1**	**7,602.0**	**8,058.7**	**10,686.0**	**30,909.8**

Table 10b: 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	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	1,2	1,889.4	250.3	873.5	175.7	3,188.9
Multilateral development banks (supranational bonds)	2	25.4	70.3	-	-	95.7
Financial institutions	1,2	379.0	32.0	5.5	3.5	420.0
Residential Mortgage Backed Securities (RMBS)	2	32.2	-	-	150.6	182.8
Total		2,326.0	352.6	879.0	329.8	3,887.4
Total		4,265.7	6,962.4	7,421.6	9,354.8	28,004.5

Notes
1. Held at amortised cost using the effective interest method and after deduction of impairment provisions where appropriate.
2. Held at fair value.

5.2 Retail credit risk

5.2.1 Management of retail credit risk

The Society operates a simple business model, focusing on its principal objectives, one of which is 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 a borrower to repay their mortgage, and will materialise if that inability to repay results in repossession of the borrower's property, and subsequent loss if the value of the property upon sale is insufficient to pay the mortgage balance in full.

Exposure to this risk is monitored and managed by a specialist department that reports to the Chief Risk Officer, and is 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.

Since the Mortgage Market Review came into force in April 2014, for all owner-occupier mortgages the Society has also operated an affordability model. This seeks to determine on new applications, if the borrower's income, after considering key spending requirements, is sufficient to meet both the current mortgage payment and future payments in the event of interest rates rising, by the inclusion of a stressed rate in the assessment of affordability.

Buy to let mortgages are assessed principally against the ability of rental income to meet likely mortgage payments in a higher interest rate environment. The buy to let lending undertaken is low risk, low loan to value business, and the amount of equity within the property means that even in the event of default, typically credit losses are low. Along with assessing rental income and stipulating conservative minimums 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.

There is also a comprehensive quality assurance programme to monitor the quality of lending decisions (owner-occupier and buy to let) and adherence to lending policy.

The Society's mortgage lending is only secured against properties in the UK. The Society's natural concentration in the UK market could then be exacerbated by overexposure 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 macroeconomic 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 department 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. Where shortcomings are identified, action plans are put in place to rectify the issue. These are monitored and closure is subject to oversight.

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.

Loans and advances to customers, gross of impairment provisions, are shown below:

Table 11: Credit risk profile

Loans and advances to customers	2014 £m	2014 %	2013 £m	2013 %
Residential mortgages: owner-occupier	**16,835.2**	**62.4**	15,161.1	62.8
Residential mortgages: buy to let	**9,657.4**	**35.8**	8,419.8	34.9
Total traditional residential mortgages	**26,492.6**	**98.2**	23,580.9	97.7
Residential near-prime mortgages	**105.2**	**0.4**	116.0	0.5
Residential self-certification mortgages	**331.6**	**1.2**	382.6	1.6
Commercial mortgages[1]	**6.3**	**-**	8.3	-
Total non-traditional mortgages	**443.1**	**1.6**	506.9	2.1
Unsecured personal loans[1]	**50.0**	**0.2**	56.7	0.2
Total gross balance	**26,985.7**	**100.0**	24,144.5	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.

Residential mortgages: owner-occupier includes £314.5 million (1.2% of total gross balances) (2013: £330.0 million and 1.4%) 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.

Geographic concentration

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

Table 12: Geographical distribution of residential mortgages

Region	2014 %	2013 %
East of England	**12.6**	12.4
London	**14.8**	14.2
Midlands	**15.1**	16.0
North East	**9.0**	9.1
North West	**8.6**	8.6
Scotland & Northern Ireland	**4.6**	4.6
South Central	**12.9**	12.6
South East	**10.8**	10.6
South West & Wales	**11.6**	11.9
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 2014 is analysed below, together with an analysis of gross new lending in the year. The following tables are by value unless stated otherwise:

Table 13: Residential mortgages loan to value (number of accounts)

Book analysis	2014 %	2013 %
Indexed loan to value:		
< 50%	**48.1**	45.0
50% to 65%	**25.9**	26.6
65% to 75%	**13.0**	13.7
75% to 85%	**8.8**	9.1
85% to 95%	**3.7**	4.1
> 95%	**0.5**	1.5
Total	**100.0**	100.0
Average indexed loan to value of stock (simple average)	**48.6**	50.0
Average indexed loan to value of stock (balance weighted)	**55.6**	57.7

Table 14: Residential mortgages new business profile

New business profile (Gross lending)[1]	2014 %	2013 %
Owner-occupier purchase	**38.8**	36.7
Owner-occupier remortgages	**23.8**	24.0
Buy to let	**37.4**	39.3
Total	**100.0**	100.0
Average loan to value (simple average)	**64.6**	63.6
Average loan to value (balance weighted)	**66.6**	66.5

1. New business and average loan to value of new business excludes further advances (2014: £152.4 million, 2013: £141.7 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 2014 the Society capitalised arrears on 25 accounts (2013: 13) in total, of which 22 are currently performing and up to date (2013: 10). Comparison with industry data show that arrears capitalised by the Society measured as a percentage of the loan book by value are less than 5% of the industry average.

The Society no longer lends on an interest-only basis for owner-occupier mortgages. The option to transfer members on to temporary interest-only payments has been curtailed accordingly and is only used in very rare situations. During 2014 only four mortgages were put on to a temporary interest-only basis (2013: four) of which three are currently performing and up to date (2013: three).

Table 15: Forbearance

	2014 No of accounts	2014 Carrying value £m	2013 No of accounts	2013 Carrying value £m
Forbearance: Accounts past due				
Arrangements	**2,355**	**266.4**	2,789	323.4
Concessions	**109**	**11.9**	208	22.2
Term extensions[1]	**15**	**1.6**	41	4.6
Capitalisation of arrears[1]	**3**	**0.3**	3	0.4
Temporary transfer to interest-only[1,2]	**1**	**0.1**	1	0.1
Forbearance indicators: Accounts not past due				
Payment holidays granted by Collections department[1]	**1,152**	**138.6**	1,605	197.5
Term extensions[1]	**52**	**6.7**	61	7.0
Capitalisation of arrears[1]	**22**	**3.2**	10	1.1
Temporary transfer to interest-only[1,2]	**3**	**0.4**	3	0.3

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 a £6.8 million provision (2013: £9.9 million) in total for all cases in these forbearance categories.

The number of accounts in the various forbearance categories has fallen compared with the previous year end, reflecting the improving economic environment and improved credit risk profile of the Society's borrowers.

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 2014 there were 2,714 members with such potential impairment indicators, to the value of £280.0 million (1.0% of the mortgage book). A collective provision of £0.2 million is being held, which reflects the low probabilities of default (since 31 December 2013, only 19 cases in these categories had gone into arrears by six or more months) and high collateral values (the average simple loan to value is 45.9% and only 35 cases are above 95% loan to value) of these mortgages.

The Society has also put in place systems to collect information on all requests by borrowers for changes to the terms and conditions of their mortgage, and is tracking the performance of these changes over time to determine if there are further incidences of potential impairment that are not immediately evident at the time of the request. Examples of the types of changes include changes to payment date or method, drawdown requests (where allowed for by the product), and requests for permission to temporarily let the (owner-occupier) borrower's property.

5.2.2 IRB rating system

The Society continues to use the retail IRB approach, permission for use from January 2008 having been granted by the regulators, to determine the required level of capital to support the majority of its credit risk for retail exposures. All lending is covered by the IRB approach with the exception of the following, where capital is calculated using the standardised approach:

- Unsecured personal loans
- Lifetime mortgages (equity release)
- Housing association loans
- Credit impaired loans
- Mortgages acquired from Bank of Ireland in 2012

Across the Society, nearly 97% of balances outstanding as at December 2014 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
- 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 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 under IFRS (£26.1 million at 31 December 2014, £27.4 million 31 December 2013) differs from the amount determined from the expected loss models (£46.4 million at 31 December 2014, £53.1 million 31 December 2013) that are used for regulatory purposes.

The LGD model used for expected losses is calibrated to downturn conditions (i.e. 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 probability of 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 actual one year default rate is 0.36% whilst the portfolio average long run PD is 0.71% (December 2013 to December 2014 period).

Allocation of exposures to risk grades by the IRB rating system
The following table shows the Society's retail exposures under IRB.

Table 16: Allocation of exposures to IRB risk band

PD bands up to:	Exposure at default estimate 2014 £m	Average loss given default 2014 %	Average risk weight 2014 %	RWAs 2014 £m	Exposure at default estimate 2013 £m	Average loss given default 2013 %	Average risk weight 2013 %	RWAs 2013 £m
0.10	**19,142.0**	**14.8**	**5.2**	**987.6**	16,146.5	12.1	4.2	671.4
0.20	**5,459.2**	**19.1**	**9.5**	**520.9**	4,921.5	17.2	8.6	420.8
0.30	**1,632.7**	**20.1**	**15.7**	**256.1**	1,561.3	19.1	14.8	231.6
0.50	**1,081.4**	**21.7**	**21.4**	**231.7**	1,078.2	20.5	20.2	217.4
1.00	**584.5**	**26.4**	**42.0**	**245.6**	616.8	26.3	43.5	268.1
3.00	**257.5**	**31.1**	**74.1**	**190.8**	298.9	32.1	76.4	228.3
9.99	**123.2**	**20.3**	**75.0**	**92.3**	132.7	20.5	76.7	101.8
99.99	**272.8**	**22.4**	**109.8**	**299.5**	303.7	24.0	116.2	352.9
In Default	**100.0**	**22.2**	**195.9**	**195.9**	140.5	23.6	210.1	295.2
Total	**28,653.3**			**3,020.4**	25,200.1			2,787.5

The PDs disclosed in the table above are on a point in time basis. The PD model for retail exposures uses a hybrid rating system, which transforms the point in time assessment to a regulatory long run average used in the calculation of capital via the allocation of accounts to risk grades.

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, these offers will only be cancelled if adverse information is received after it has been made, for example via a late notification from a solicitor. In some cases, offers will not be taken up by the customer and will expire. It is conservatively assumed that all offers will complete, and therefore a conversion factor of 100% is assigned to these undrawn exposures.

At 31 December 2014, the value of undrawn exposures being rated under the IRB approach was £1,416.5 million (2013: £1,005.2 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.

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 and 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.

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 model department.

The independent external expert:

- Reviews the frequency, quality and appropriateness of the monitoring reports.
- Reviews the appropriateness of the risk model department's own analysis and conclusions about model performance.
- Provides comment and independent assessment on changes to models recommended by the risk model department.
- Comments on the documentation surrounding all aspects of the models.
- 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:

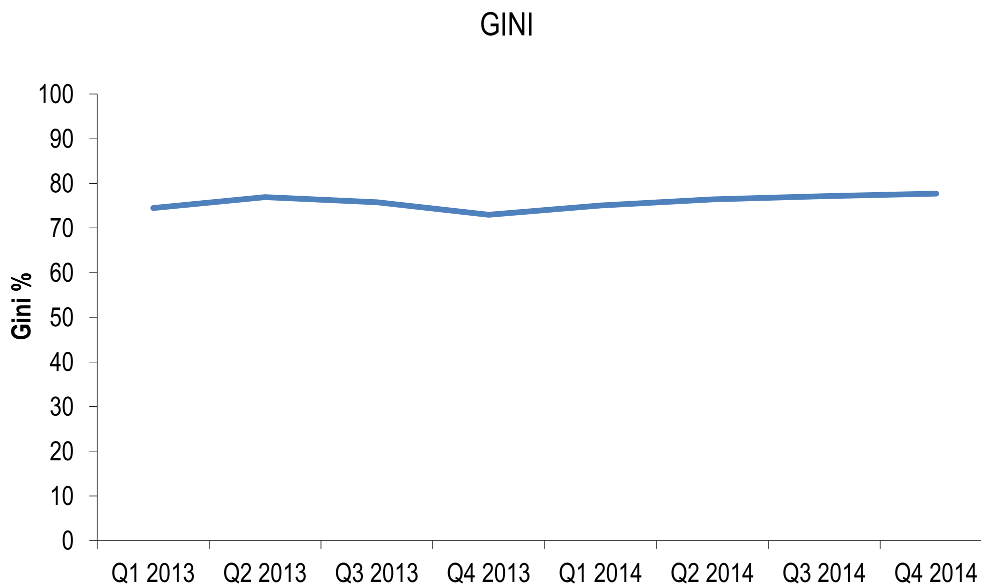
- the application PD model is integrated into the application decision making process – the same application model that provides the PD assessment of new applications is used to determine the credit risk, and hence the level of underwriter involvement (alongside lending policy considerations and valuations) 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
- the impairment and capital models are incorporated into the stress test models for use within the strategic and capital planning process, to determine projected capital and impairment requirements in various forward looking scenarios and stresses including within the Society's regulatory ICAAP.

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 following chart 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 17: Probability of Default (PD) model

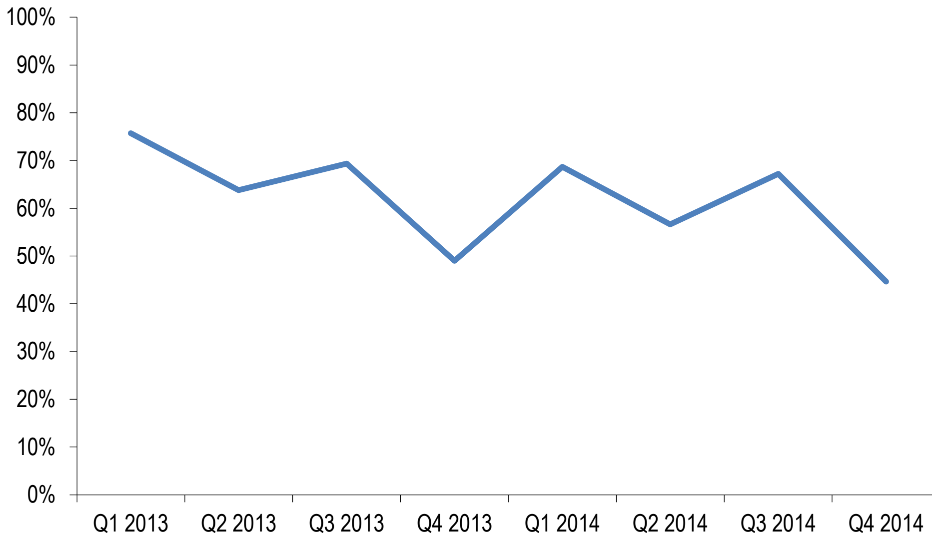


The correlation of recent experience of losses to predicted shortfalls is shown in the following graph. Predicted shortfalls in the capital calculation are made using the downturn LGD model, and are set to an assumed peak-to-trough fall in house prices that mirror a downturn in the housing market. Average actual losses are therefore consistently below predictions given this downturn has not been experienced across the two most recent years.

On average over the course of 2014, 14 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).

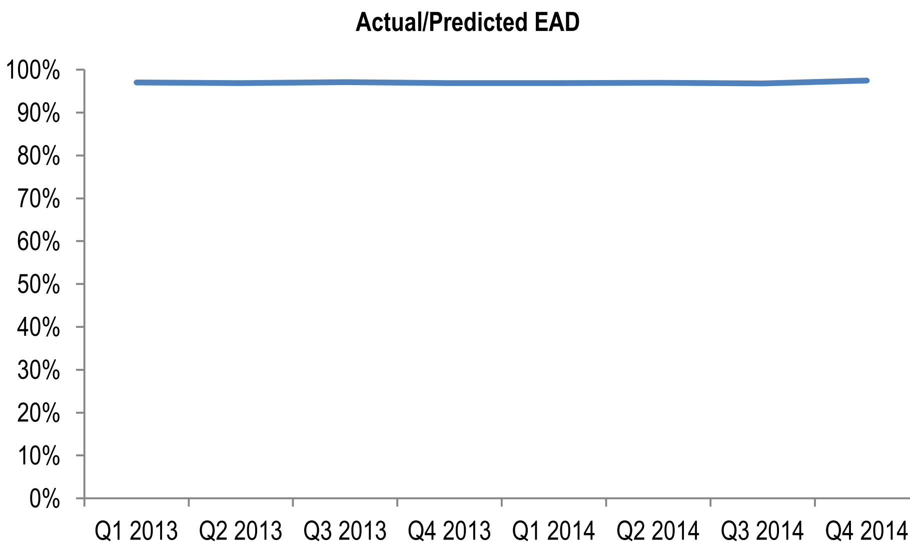
With such small numbers of sales, the loss experience can be affected by individual unusual cases that give rise to losses that could not be reasonably predicted using a statistical model. Generally however loss experience has been better than expected, with actual losses by the end of the year significantly below predictions, reflecting both the conservative nature of the Society's provision calculations and the improving economic environment, particularly in relation to property prices.

Table 18: 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 19: 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 PD prediction and is in excess of the currently 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 20: Actual Probability of Default (PD) and Loss Given Default (LGD) against predicted

IRB retail mortgages	**Actual 2014 %**	Predicted 2014 %	Actual 2013 %	Predicted 2013 %
PD	**0.18**	0.24	0.24	0.27
LGD	**5.62**	5.65	5.71	6.09

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.

Predicted and actual PD and LGD rates have fallen, reflecting the improved economic environment and the improved credit risk profile of the book.

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 model department to drill into any aspect of model performance.

Regular reconciliations and reviews of data quality and accuracy are conducted by the risk model department, which as part of its monitoring role also included identifying and investigating outliers and correcting 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 loan to value (<50%) owner occupier remortgages and similarly low loan to value 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% loan to value. 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 assumptions 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 Society 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 forgo some element of the payment due or where other impairment indicators are present.

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

Estimating future cash flows

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

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

Individual assessment of impairment

The identification of loans for individual assessment of impairment is via a set days-past-due trigger being met or if, in the opinion of management, there is evidence that individually identifiable loans are impaired even if a set days-past-due trigger has not yet been met. For example, a small number of customers have been declared bankrupt but continue to make their mortgage repayments as scheduled. These customers can be individually identified and therefore an individual assessment can be made as to the level of 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 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 the value and saleability of properties, something 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. Evidence-based results are used to identify potential forbearance indicators, measure the performance of accounts with these indicators, and determine the level of impairment provision required.

Use of overlays

Management applies overlays to assumptions to ensure that an appropriate level of conservatism in cash flow forecasts 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 backwards looking experience used in the model, an overlay may be applied to reflect forward looking judgement of cash flows. 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 short-term 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 Stroud & Swindon Building Society in 2010 of £5.2 million (2013: £6.0 million) has been included within the opening and closing provisions.

Table 21: Movements in impairment provisions

Group	Loans fully secured on residential property 2014 £m	Other loans 2014 £m	Total 2014 £m	Loans fully secured on residential property 2013 £m	Other loans 2013 £m	Total 2013 £m
At 1 January						
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
	25.3	**2.1**	**27.4**	25.8	1.8	27.6
Charge for the year						
Individual impairment	**1.7**	**3.6**	**5.3**	4.4	0.4	4.8
Collective impairment	**0.1**	**-**	**0.1**	1.6	(0.1)	1.5
	1.8	**3.6**	**5.4**	6.0	0.3	6.3
(Credit)/charge set against fair value adjustment	**(0.4)**	**(0.2)**	**(0.6)**	0.8	0.8	1.6
Amounts written off	**(5.8)**	**(0.3)**	**(6.1)**	(7.3)	(0.8)	(8.1)
At 31 December						
Individual impairment	**11.7**	**4.4**	**16.1**	16.2	1.3	17.5
Collective impairment	**9.2**	**0.8**	**10.0**	9.1	0.8	9.9
Total	**20.9**	**5.2**	**26.1**	25.3	2.1	27.4

In terms of impaired mortgages, the Society's performance is compared with figures published by the Council of Mortgage Lenders (CML). From these figures it can be seen that the performance of the Society has remained strong, with arrears reducing over the year, and its position remains favourable to the industry.

Table 22: Analysis of Society arrears compared with Council of Mortgage Lenders

	2014		2013	
	Group %	**CML[1] %**	Group %	CML[1] %
Greater than three months	**0.68**	**1.33**	0.90	1.68
Greater than six months	**0.26**	**0.70**	0.41	0.91
Greater than one year	**0.08**	**0.28**	0.12	0.37
In possession	**0.02**	**0.06**	0.03	0.08

1. Council of Mortgage Lenders' data at 31 December 2014 (31 December 2013).

Loans are categorised by arrears status in line with industry practice and are identified as being either not past due and not impaired (if up to date at the balance sheet date), as past due up to three months but not impaired, or as impaired (if more than three months in arrears or in possession). An analysis of past due and impaired loans by value is shown in Table 23.

Table 23a: Past due and impaired loans by loan to value 2014

As at 31 December 2014	**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%	**9,697.5**	**97.3**	**24.3**	**10.9**	**0.1**	**(3.7)**	**9,826.4**
50% to 65%	**8,324.8**	**92.7**	**28.3**	**16.6**	**0.2**	**(4.3)**	**8,458.3**
65% to 75%	**4,228.2**	**62.4**	**19.9**	**15.5**	**0.4**	**(2.7)**	**4,323.7**
75% to 85%	**2,871.0**	**50.7**	**14.9**	**13.3**	**0.2**	**(3.0)**	**2,947.1**
85% to 95%	**1,140.5**	**28.5**	**15.1**	**11.7**	**0.9**	**(2.8)**	**1,193.9**
> 95%	**131.6**	**15.2**	**8.4**	**8.7**	**5.9**	**(5.2)**	**164.6**
Unsecured	**45.6**	**3.5**	**0.6**	**0.3**	**-**	**(4.4)**	**45.6**
Total	**26,439.2**	**350.3**	**111.5**	**77.0**	**7.7**	**(26.1)**	**26,959.6**

Table 23b: Past due and impaired loans by loan to value 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%	7,360.5	71.6	17.2	15.2	0.2	(2.2)	7,462.5
50% to 65%	7,821.3	80.6	26.3	17.8	-	(4.0)	7,942.0
65% to 75%	4,181.5	68.9	21.1	21.0	0.2	(3.5)	4,289.2
75% to 85%	2,673.3	60.2	22.2	18.9	0.3	(3.0)	2,771.9
85% to 95%	1,101.3	49.8	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	23,528.3	366.1	124.3	114.8	11.0	(27.4)	24,117.1

The Society held properties valued at £6.4 million (2013: £9.1 million) pending their sale against balances of £5.8 million (net of provisions) (2013: £8.2 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 mortgages and loans. Balances are shown gross of impairment provisions.

Table 24a: Not impaired and impaired loans by segment 2014

As at 31 December 2014	**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**
Residential mortgages							
Owner-occupier	**16,484.3**	**223.1**	**73.6**	**51.6**	**2.6**	**(9.0)**	**16,826.2**
Buy to let	**9,562.9**	**69.9**	**13.1**	**9.4**	**2.1**	**(9.5)**	**9,647.9**
Non-traditional mortgages							
Residential near-prime	**57.9**	**22.7**	**14.1**	**9.2**	**1.3**	**(1.1)**	**104.1**
Residential self-certified	**283.1**	**30.3**	**10.1**	**6.4**	**1.7**	**(1.3)**	**330.3**
Commercial lending	**5.5**	**0.8**	**-**	**-**	**-**	**(0.8)**	**5.5**
Unsecured	**45.5**	**3.5**	**0.6**	**0.4**	**-**	**(4.4)**	**45.6**
Total	**26,439.2**	**350.3**	**111.5**	**77.0**	**7.7**	**(26.1)**	**26,959.6**

Table 24b: 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
Residential mortgages							
Owner-occupier	14,758.4	238.1	89.2	69.5	5.9	(11.9)	15,149.2
Buy to let	8,325.9	62.8	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	23,528.3	366.1	124.3	114.8	11.0	(27.4)	24,117.1

Movement in impaired loans

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

Table 25: 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 2014	**164.6**	**31.1**	**28.3**	**25.1**	**-**	**1.0**	**250.1**
Classified as impaired during the year	**118.6**	**33.7**	**22.3**	**27.8**	**0.1**	**1.5**	**204.0**
Transferred from impaired to unimpaired	**(130.1)**	**(34.8)**	**(24.9)**	**(31.5)**	**(0.1)**	**(0.7)**	**(222.1)**
Amounts written off	**(3.8)**	**(1.2)**	**(0.2)**	**(0.6)**	**-**	**(0.3)**	**(6.1)**
Charged to impaired loans	**2.2**	**0.7**	**0.5**	**0.4**	**-**	**-**	**3.8**
Repayments and other movements	**(23.7)**	**(4.9)**	**(1.4)**	**(3.0)**	**-**	**(0.5)**	**(33.5)**
Impaired at 31 December 2014	**127.8**	**24.6**	**24.6**	**18.2**	**-**	**1.0**	**196.2**

Loan balances are shown gross of provisions. The balances reflect 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 (sale proceeds from properties in possession) and repayments (from customers reducing the outstanding balances). Amounts charged to impaired loans include 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.

Ongoing developments for treasury counterparties are closely monitored, and are reported to, and reviewed by the 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 Asset and Liability Committee (ALCO) to RMC and BRC.

Derivatives are only executed with organisations that have a Board approved credit limit, and the vast majority include arrangements requiring that any movement in the value of the derivative be offset by the placing of cash collateral to reduce the resulting credit exposure on a weekly basis.

As part of its liquidity management, the Society also enters into sale and repurchase (repo) transactions where highly rated assets such as gilts are sold with an agreement to repurchase at an agreed price on a later date. The cash received may be less than the market value of the asset creating a credit exposure. Any subsequent market movements in the value of the asset will alter this exposure and is therefore subject to daily collateralisation to mitigate this position. All repo counterparties are subject to review by the Treasury Credit Committee and approval by the Board.

The Society has no exposure to emerging markets, hedge funds, non-UK Residential Mortgage Backed Securities (RMBS), non-UK covered bonds or credit default swaps and well over 99% of exposures have an investment grade rating.

The exposure values relating to the Society's liquidity book and by reference to Moody's ratings are as follows:

Table 26a: Treasury assets exposure value by rating 2014

As at 31 December 2014	**Aaa–Aa3 £m**	**A1–A3 £m**	**Baa1–Baa3 £m**	**Unrated[3] £m**	**Total £m**
Central banks and sovereigns[1]	**3,330.3**	**-**	**-**	**-**	**3,330.3**
Multilateral development banks (supranational bonds)[1]	**70.5**	**-**	**-**	**-**	**70.5**
Financial institutions	**213.7**	**110.8**	**113.7**[2]	**1.7**	**439.9**
Residential mortgage-backed securities	**105.0**	**4.5**	**-**	**-**	**109.5**
Total	**3,719.5**	**115.3**	**113.7**	**1.7**	**3,950.2**

Table 26b Treasury assets exposure value by rating 2013

As at 31 December 2013	Aaa–Aa3 £m	A1–A3 £m	Baa1–Baa3 £m	Unrated[3] £m	Total £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
Residential mortgage-backed securities	177.9	4.9	-	-	182.8
Total	3,786.1	95.6	4.1	1.6	3,887.4

1. Risk weighting for central banks and sovereigns and multilateral development banks (supranational banks) is 0%.
2. Credit Support Annexes in relation to derivative liabilities.
3. Unrated institutions comprise smaller building societies.

The allocation of capital to credit risk within the liquidity book is calculated using the standardised approach. For central banks, sovereigns, multilateral banks and UK Financial Institutions with a residual maturity of less than three months, risk weights prescribed in CRD IV are used. At 31 December 2014, the exposure for UK Financial Institutions with a residual maturity of less than three months were £205.9 million with a capital requirement of £3.3 million (2013: £3.0 million). For covered bonds, RMBS and other Financial Institutions the Society uses credit ratings published by Moody's and this is unchanged from the previous year. Moody's is recognised as an eligible External Credit Assessment Institution (ECAI) for this purpose. The table below shows the exposure values and rating associated with each credit quality step.

Table 27: ECAI exposure values and ratings

	Moody's rating	Risk weight %	Exposure value 2014 £m	RWA 2014 £m	Exposure value 2013 £m	RWA 2013 £m
Retail Mortgage Backed Securities (RMBS)						
Credit quality step 1	**Aaa-Aa3**	**20**	**105.0**	**1.7**	175.4	2.8
Credit quality step 2	**A1-A3**	**50**	**4.5**	**0.2**	4.9	0.2
Unrated		**1250**	**-**	**-**	2.5	2.5
Total RMBS			**109.5**	**1.9**	182.8	5.5
Covered bonds						
Credit quality step 1	**Aaa-Aa3**	**10**	**40.1**	**0.3**	39.7	0.3
Total covered bond			**40.1**	**0.3**	39.7	0.3
Financial institutions						
Credit quality step 1	**Aaa-Aa3**	**20**	**94.2**	**1.5**	170.1	2.8[1]
Credit quality step 2	**A1-A3**	**50**	**32.6**	**1.3**	53.8	2.1
Credit quality step 3	**Baa1**	**50**	**14.7**	**0.6**	9.4	0.4
Total financial institutions			**141.5**	**3.4**	233.3	5.3
Total			**291.1**	**5.6**	455.8	11.1

1. Includes £1.7 million of capital included in 'Institutions with short term credit assessments' in Table 6.

5.3.2 Credit risk mitigation

Treasury exposures 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 swaps undertaken 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 exposures.

The Coventry Building Society Covered Bonds LLP undertakes each swap it executes under a separate ISDA agreement. Each agreement includes a CSA which either provides for full collateralisation of the swap or for full collateralisation when the counterparty bank credit rating falls below a certain threshold. Substantially all of the net derivative credit exposure in Table 29 below relates to this latter arrangement. The counterparty has a credit rating of Aa3.

The Society has entered into Global Master Repurchase Agreements for all of its repurchase transactions. These are legal agreements that cover the terms of transactions between the two parties, including standard provisions that are generic to the market. One such provision covers the requirement for both parties to enter into an exchange of collateral. For the Society this is calculated on a daily basis to mitigate against net exposure arising from changes in market value. As a consequence of this daily exchange of collateral and the credit quality of the repurchase counterparties the Pillar 1 capital requirement at 31 December 2014 is less than £0.2 million and is included in 'Other institutions' in Table 6.

5.3.3 Impairment provisions – Treasury assets, held at fair value (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 adjustments) as well as the extent to which coupon payments have been made on a timely basis. As at 31 December 2014 no amounts in the treasury portfolio were either past due or impaired, and as such no provision has 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 Table 27 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 406 of the Capital Requirements Regulations.

As at 31 December 2014, no purchased securitisation positions were past due or impaired. The Society uses the standardised approach 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 can be used to source additional funding. Table 28 illustrates the balances of external funding secured on the Group's loans and advances:

Table 28a: Balance of funding secured on loans and advances 2014

		Notes in issue[1]			
As at 31 December 2014	**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	**527.1**	**314.3**	**-**	**52.5**	**366.8**
Securitisation programme – Mercia No.1 plc	**1,539.1**	**-**	**308.1**	**1,128.3**	**1,436.4**
Total	**2,066.2**	**314.3**	**308.1**	**1,180.8**	**1,803.2**

Table 28b: Balance of funding secured on loans and advances 2013

		Notes in issue[1]			
As at 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

1. Notes in issue exclude Class Z notes, representing the first loss piece in the structure. All Class Z notes are held by the Group undrawn.

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 31 December 2014, the nominal value of listed debt securities in issue had fallen to £367.1 million of which £52.5 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. This remains the position as at 31 December 2014.

Coventry Building Society and Godiva Mortgages Limited are the originators and servicers. Other roles fulfilled by these firms are described in the prospectuses and for the Society include cash manager, interest rate swap guarantor (for Mercia) and interest rate swap provider (for Leofric). 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 Leofric and Mercia 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 or losses 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 CRD IV 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.

The Group's obligations in respect of the Leofric and Mercia securitisation vehicles are limited to cash flows from the underlying assets and the Society and its subsidiaries are under no obligation to support any losses that may be incurred by the securitisation programmes or holders of the issued notes. The parties holding the notes in issue are therefore only entitled to obtain payment to the extent of the resources in the Leofric and Mercia securitisation vehicles respectively.

Mercia and Leofric do, however, represent a liquidity risk to the Group due to legal covenants within the swap documentation which need to be fulfilled in the event of a downgrade by the Society. The cash flows required in the event of a downgrade are considered in the Society's internal assessment of its liquidity requirements and would be dependent on market conditions at the date of downgrade.

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 discussed 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 29: Derivative counterparty credit exposure

	Exposure value As at 31 December 2014 £m	Exposure value As at 31 December 2013 £m
Gross positive fair value of contracts	**208.3**	191.2
Netting benefits	**(125.8)**	(102.8)
Net credit exposure	**82.5**	88.4
Collateral held	**(39.5)**	(46.4)
Net derivative credit exposure	**43.0**	42.0

As at 31 December 2014, all counterparties with whom the Society has a net derivative credit exposure had a Moody's credit rating of A2 or above. The derivative exposure can only be settled net following a default or other predetermined event, and therefore there is no right of set-off in the balance sheet.

The net exposure value of derivatives at 31 December 2014, which includes uplifts for Potential Future Credit Exposure (PFCE) under the mark to market method for assessing counterparty credit risk, totalled £133.8 million (2013: £111.0 million).

Wrong way risk occurs when exposure to 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.

Appendix 1: EBA Own Funds Disclosure Template

		Transitional CRD IV		End-point CRD IV	
		2014 £m	2013 £m	**2014 £m**	2013 £m
Common Equity Tier 1 (CET1) Capital: instruments and reserves					
1	Capital instruments and the related share premium accounts				
2	Retained earnings	**1,061.9**	914.6	**1,061.9**	914.6
3	Accumulated other comprehensive income (and other reserves)	**32.1**	(19.6)	**32.1**	(19.6)
4	Amount of qualifying items referred to in Article 484 (3) and the related share premium accounts subject to phase out from CET1				
5	Minority interests (amount allowed in consolidated CET1)				
5a	Independently reviewed interim profits net of any foreseeable charge or dividend	**(10.0)**	-	**(10.0)**	-
6	Common Equity Tier 1 (CET1) capital before regulatory adjustments	**1,084.0**	895.0	**1,084.0**	895.0
Common Equity Tier 1 (CET1) capital: regulatory adjustments					
7	Additional value adjustments (negative amount)	**(1.7)**	(1.7)	**(1.7)**	(1.7)
8	Intangible assets (net of related deferred tax liability (negative amount)	**(15.9)**	(12.2)	**(15.9)**	(12.2)
10	Deferred tax assets that rely on future profitability excluding those arising from temporary differences (net of related tax liability where the conditions in Article 38 (3) are met) (negative amount)		(1.4)		(1.4)
11	Fair value reserves related to gains or losses on cash flow hedges	**(32.8)**	7.5	**(32.8)**	7.5
12	Negative amounts resulting from the calculation of expected loss amounts	**(21.1)**	(27.9)	**(21.1)**	(27.9)
13	Any increase in equity that results from securitised assets (negative amount)				
14	Gains or losses on liabilities valued at fair value resulting from changes in own credit standing				
15	Defined-benefit pension fund assets (negative amount)	**(1.3)**	(4.1)	**(1.3)**	(4.1)
16	Direct and indirect holdings by an institution of own CET1 instruments (negative amount)				
17	Direct, indirect and synthetic holdings of the CET 1 instruments of financial sector entities where those entities have reciprocal cross holdings with the institution designed to inflate artificially the own funds of the institution (negative amount)				
18	Direct, indirect and synthetic holdings by the institution of the CET1 instruments of financial sector entities where the institution does not have a significant investment in those entities (amount above 10% threshold and net of eligible short positions) (negative amount)				
19	Direct, indirect and synthetic holdings by the institution of the CET1 instruments of financial sector entities where the institution has a significant investment in those entities (amount above 10% threshold and net of eligible short positions) (negative amount)				
20a	Exposure amount of the following items which qualify for a RW of 1250%, where the institution opts for the deduction alternative				
20b	of which: qualifying holdings outside the financial sector (negative amount)				
20c	of which: securitisation positions (negative amount)				
20d	of which: free deliveries (negative amount)				
21	Deferred tax assets arising from temporary differences (amount above 10% threshold, net of related tax liability where the conditions in Article 38 (3) are met) (negative amount)				
22	Amount exceeding the 15% threshold (negative amount)				
23	of which: direct and indirect holdings by the institution of the CET1 instruments of financial sector entities where the institution has a significant investment in those entities				
25	of which: deferred tax assets arising from temporary differences				
25a	Losses for the current financial year (negative amount)				
25b	Foreseeable tax charges relating to CET1 items (negative amount)				
27	Qualifying AT1 deductions that exceed the AT1 capital of the institution (negative amount)				
28	Total regulatory adjustments to Common Equity Tier 1 (CET1)	**(72.8)**	(39.8)	**(72.8)**	(39.8)
29	Common Equity Tier 1 (CET1) capital	**1,011.2**	855.2	**1,011.2**	855.2

		Transitional CRD IV		End-point CRD IV	
		2014 £m	2013 £m	**2014 £m**	2013 £m
Additional Tier 1 (AT1) capital: instruments					
30	Capital instruments and the related share premium accounts	**396.9**	-	**396.9**	-
31	of which: classified as equity under applicable accounting standards	**396.9**	-	**396.9**	-
32	of which: classified as liabilities under applicable accounting standards				
33	Amount of qualifying items referred to in Article 484 (4) and the related share premium accounts subject to phase out from AT1	**128.0**	128.0	**-**	-
34	Qualifying Tier 1 capital included in consolidated AT1 capital (including minority interests not included in row 5) issued by subsidiaries and held by third parties				
35	of which: instruments issued by subsidiaries subject to phase out				
36	Additional Tier 1 (AT1) capital before regulatory adjustments	**524.9**	128.0	**396.9**	-
Additional Tier 1 (AT1) capital: regulatory adjustments					
37	Direct and indirect holdings by an institution of own AT1 instruments (negative amount)				
38	Direct, indirect and synthetic holdings of the AT1 instruments of financial sector entities where those entities have reciprocal cross holdings with the institution designed to inflate artificially the own funds of the institution (negative amount)				
39	Direct, indirect and synthetic holdings of the AT1 instruments of financial sector entities where the institution does not have a significant investment in those entities (amount above 10% threshold and net of eligible short positions) (negative amount)				
40	Direct, indirect and synthetic holdings by the institution of the AT1 instruments of financial sector entities where the institution has a significant investment in those entities (net of eligible short positions) (negative amount)				
42	Qualifying T2 deductions that exceed the T2 capital of the institution (negative amount)				
43	Total regulatory adjustments to Additional Tier 1 (AT1) capital	**-**	-	**-**	-
44	Additional Tier 1 (AT1) capital	**524.9**	128.0	**396.9**	-
45	Tier 1 capital (T1 = CET1 + AT1)	**1,536.1**	983.2	**1,408.1**	855.2
Tier 2 (T2) capital: instruments and provisions					
46	Capital instruments and the related share premium accounts				
47	Amount of qualifying items referred to in Article 484 (5) and the related share premium accounts subject to phase out from T2	**42.2**	44.4	**-**	-
48	Qualifying own funds instruments included in consolidated T2 capital (including minority interests and AT1 instruments not included in rows 5 or 34) issued by subsidiaries and held by third parties				
49	of which: instruments issued by subsidiaries subject to phase out				
50	Credit risk adjustments	**6.1**	2.0	**6.1**	2.0
51	Tier 2 (T2) capital before regulatory adjustments	**48.3**	46.4	**6.1**	2.0
Tier 2 (T2) capital: regulatory adjustments					
52	Direct and indirect holdings by an institution of own T2 instruments and subordinated loans (negative amount)				
53	Holdings of the T2 instruments and subordinated loans of financial sector entities where those entities have reciprocal cross holdings with the institution designed to inflate artificially the own funds of the institution (negative amount)				
54	Direct and indirect holdings of the T2 instruments and subordinated loans of financial sector entities where the institution does not have a significant investment in those entities (amount above 10% threshold and net of investment in those entities (amount above 10% threshold and net of eligible short positions) (negative amount)				
55	Direct and indirect holdings by the institution of the T2 instruments and subordinated loans of financial sector entities where the institution has a significant investment in those entities (net of eligible short positions) (negative amount)				
57	Total regulatory adjustments to Tier 2 (T2) capital	**-**	-	**-**	-
58	Tier 2 (T2) capital	**48.3**	46.4	**6.1**	2.0
59	Total capital (TC = T1 + T2)	**1,584.4**	1,029.6	**1,414.2**	857.2
60	Total risk weighted assets	**3,977.2**	3,750.2	**3,977.2**	3,750.2

		Transitional CRD IV		End-point CRD IV	
		2014 **£m**	2013 £m	**2014** **£m**	2013 £m
Capital ratios and buffers					
61	Common Equity Tier 1 (as a percentage of total risk exposure amount)	**25.4%**	22.8%	**25.4%**	22.8%
62	Tier 1 (as a percentage of total risk exposure amount)	**38.6%**	26.2%	**35.4%**	22.8%
63	Total capital (as a percentage of total risk exposure amount)	**39.9%**	27.5%	**35.6%**	22.9%
64	Institution specific buffer requirement (CET1 requirement in accordance with article 92 (1) (a) plus capital conservation and countercyclical buffer requirements, plus systemic risk buffer, plus systemically important institution buffer expressed as a percentage of risk exposure amount)				
65	of which: capital conservation buffer requirement				
66	of which: countercyclical buffer requirement				
67	of which: systemic risk buffer requirement				
67a	of which: Global Systemically Important Institution (G-SII) or Other Systemically Important Institution (O-SII) buffer				
68	Common Equity Tier 1 available to meet buffers (as a percentage of risk exposure amount)	**20.9%**	18.3%	**20.9%**	18.3%
Amounts below the thresholds for deduction (before risk weighting)					
72	Direct and indirect holdings of the capital of financial sector entities where the institution does not have a significant investment in those entities (amount below 10% threshold and net of eligible short positions)	**1.7**	1.6	**1.7**	1.6
73	Direct and indirect holdings by the institution of the CET1 instruments of financial sector entities where the institution has a significant investment in those entities (amount below 10% threshold and net of eligible short positions)	**-**	3.5	**-**	3.5
75	Deferred tax assets arising from temporary differences (amount below 10% threshold, net of related tax liability where the conditions in Article 38 (3) are met)				
Applicable caps on the inclusion of provisions in Tier 2					
76	Credit risk adjustments included in T2 in respect of exposures subject to standardised approach (prior to the application of the cap)	**8.4**	2.0	**8.4**	2.0
77	Cap on inclusion of credit risk adjustments in T2 under standardised approach	**6.1**	-	**6.1**	-
78	Credit risk adjustments included in T2 in respect of exposures subject to internal ratings-based approach (prior to the application of the cap)				
79	Cap for inclusion of credit risk adjustments in T2 under internal ratings- based approach				
Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2014 and 1 Jan 2022)					
80	Current cap on CET1 instruments subject to phase out arrangements				
81	Amount excluded from CET1 due to cap (excess over cap after redemptions and maturities)				
82	Current cap on AT1 instruments subject to phase out arrangements	**128.0**	128.0	-	-
83	Amount excluded from AT1 due to cap (excess over cap after redemptions and maturities)	**32.0**	32.0	-	-
84	Current cap on T2 instruments subject to phase out arrangements	**42.2**	44.4	-	-
85	Amount excluded from T2 due to cap (excess over cap after redemptions and maturities)	**10.5**	11.1	-	-

Appendix 2: Capital Instruments Key Features

1	Issuer	Coventry	Coventry	Coventry	Coventry	Coventry (Stroud & Swindon)	Coventry (Stroud & Swindon)	Coventry (Stroud & Swindon)	Coventry (Stroud & Swindon)
2	ISIN	XS1079786239	GB0002290764	GB00B177CL57	XS0150313871	N/a	N/a	N/a	N/a
3	Gov. law (sub)	English	English	English	English	English	English	English	English
	Regulatory treatment								
4	Trans. CRR rules	AT1	AT1	AT1	T2	T2	T2	T2	T2
5	Post-transitional CRR rules	AT1	Ineligible	Ineligible	Ineligible	T2	Ineligible	Ineligible	Ineligible
6	Eligible at Group (G), Individual Consolidated (IC) or Society (S)	G; IC; S	G; IC; S	G; IC; S	G; IC; S	G; IC; S	G; IC; S	G; IC; S	G; IC; S
7	Instrument type (types to be specified by each jurisdiction)	Perpetual Capital Security	PIBS	PIBS	Sub Debt	Sub Debt	Sub Debt	Sub Debt	Sub Debt
8	Regulatory capital value (£m)	396,920,211	40,000,000	120,000,000	15,000,000	2,697,318	15,000,000	10,000,000	10,000,000
9	Nominal amount of instrument	400,000,000	40,000,000	120,000,000	15,000,000	7,000,000	15,000,000	10,000,000	10,000,000
9a	Issue px	100	100.749	100	100	100	100	100	100.0041
9b	Redemption px	100	100	100	100	100	100	100	100
10	Accounting classification	Shareholders' equity	Liability - amortised cost	Liability - amortised cost	Liability - amortised cost	Liability - amortised cost	Liability - amortised cost	Liability - amortised cost	Liability - amortised cost
11	Date of issue	19-Jun-14	28-May-92	14-Jun-06	25-Jun-02	27-Nov-91	23-Aug-01	29-Aug-03	08-Nov-06
12	Perpetual or dated	Perpetual	Perpetual	Perpetual	Dated	Dated	Dated	Dated	Dated
13	Original maturity	No maturity	No maturity	No maturity	25-Jun-22	05-Dec-16	23-Aug-32	29-Aug-26	08-Nov-21
14	Issuer call	Yes	No	Yes	Yes	No	Yes	Yes	Yes
15	Optional call date, contingent call dates and redemption amount	01/11/2019; par regulatory/tax call	N/a	29/06/2016; par tax call	25-Jun-17	Par tax call	23-Aug-27	29-Aug-21	08-Nov-16
16	Subsequent call dates, if applicable	5 yearly	N/a	Quarterly	N/a	N/a	N/a	N/a	N/a
	Coupons / dividends								
17	Fixed or floating dividend/coupon	Fixed to fixed	Fixed	Fixed to floating	Fixed to fixed	Fixed	Fixed to fixed	Fixed to fixed	Fixed to fixed
18	Coupon rate and any related index	6.375%	12.125%	6.092%	6.469%	12.250%	7.540%	6.327%	6.120%
19	Existence of a dividend stopper	No	No	No	No	No	No	No	No
20a/b	Fully discretionary, partially or mandatory (in terms of timing)	Fully discretionary	Partially discretionary	Partially discretionary	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory
21	Existence of step up or other incentive to redeem	No	No	Yes	Yes	No	Yes	Yes	Yes
22	Noncumulative or cumulative	Non-cumulative	Non-cumulative	Non-cumulative	N/a	N/a	N/a	N/a	N/a
23	Convertible or non-convertible	Convertible	Non-convertible	Non-convertible	Non-convertible	Non-convertible	Non-convertible	Non-convertible	Non-convertible
24	If convertible, conversion trigger(s)	Contactual - CET1 <7%	N/a	N/a	N/a	N/a	N/a	N/a	N/a
25	If convertible, fully or partially	Fully	N/a	N/a	N/a	N/a	N/a	N/a	N/a
26	If convertible, conversion rate	One for every £67 held	N/a	N/a	N/a	N/a	N/a	N/a	N/a
27	If convertible, mandatory or optional conversion	Mandatory	N/a	N/a	N/a	N/a	N/a	N/a	N/a
28	Specify output instrument	CCDS	N/a	N/a	N/a	N/a	N/a	N/a	N/a
29	Specify issuer of output instrument	Coventry	N/a	N/a	N/a	N/a	N/a	N/a	N/a
30	Write-down features	Contractual: none; statutory: via bail-in	Contractual: none; statutory: via bail-in	Contractual: none; statutory: via bail-in	Contractual: none; statutory: via bail-in	Contractual: none; statutory: via bail-in	Contractual: none; statutory: via bail-in	Contractual: none; statutory: via bail-in	Contractual: none; statutory: via bail-in
31-34	If w/d, trigger(s), full/partial, PWD/TWD	N/a	N/a	N/a	N/a	N/a	N/a	N/a	N/a
35	Instrument type immediately senior	Tier 2	Tier 2	Tier 2	Senior unsecured	Senior unsecured	Senior unsecured	Senior unsecured	Senior unsecured
36	Non-compliant transitioned features	No	Yes	Yes	Yes	No	Yes	Yes	Yes
37	If yes, specify non-compliant features	N/a	No contractual wtite-down or conversion	No contractual wtite-down or conversion	Step-up reset rate	N/a	Step-up reset rate	Step-up reset rate	Step-up reset rate

Appendix 3: Asset Encumbrance Disclosure Template

Templates A and C are as prescribed in EBA Guideline EBA/GL/2014/03 on disclosure of encumbered and unencumbered assets. The values disclosed are median values of quarterly data on a rolling basis over the previous twelve months.

The carrying amount of encumbered assets in Template A row 010 column 010 is in respect of on balance sheet assets only and therefore excludes off balance sheet Funding for Lending Scheme (FLS) treasury bills. The amount shown in Template C row 010 column 030 includes both encumbered on and off balance sheet assets and therefore includes off balance sheet FLS treasury bills.

Template A - Assets

		Carrying amount of encumbered assets £m	Fair value of Encumbered assets £m	Carrying amount of unencumbered assets £m	Fair value of unencumbered assets £m
		010	040	060	090
010	**Assets of the reporting institution**	**5,822.7**		**23,703.6**	
030	Equity instruments	**-**	**-**	**-**	**-**
040	Debt securities	**386.3**	**386.3**	**1,271.8**	**1,271.8**
120	Other assets	**5,436.4**		**22,431.8**	

Template B - Collateral received

The EBA Guideline allows competent authorities to waive the requirement to disclose Template B – Collateral received, and in Supervisory Statement SS11/14 (CRD IV11; compliance with the European Banking Authority's Guidelines on the disclosure of encumbered and unencumbered assets) the PRA waived the Template B requirements subject to a firm meeting certain criteria. The Society meets the criteria and therefore Template B is not disclosed.

Template C – Encumbered assets/collateral received and associated liabilities

		Matching liabilities, contingent liabilities or securities lent £m	Assets, collateral received and own debt securities issued other than covered bonds and ABSs encumbered £m
		010	030
010	**Carrying amount of selected financial liabilities**	**4,415.6**	**6,522.7**

Template D – Information on importance of encumbrance

The most material sources of encumbrance for the Society are secured funding via the Society's covered bond and securitisation programmes which are supported by pledging mortgage assets. Further detail on these activities is set out in note 15 to the 2014 Annual Report & Accounts. The Society also pledges debt securities as collateral in sale and repurchase transactions – see note 14 to the 2014 Annual Report & Accounts.

An additional source of encumbrance is the collateralisation of derivatives liabilities. The Society also treats some cash and balances with the Bank of England, some loans and advances to credit institutions and some debt securities as encumbered even though there are no associated liabilities. An example of this would be liquid assets held within the Group's covered bond and securitisation programmes as these are not available for use in the Group's day-to-day operations.

In common with many other financial institutions, the Society began to make increasing use of secured funding from the start of the financial crisis with the establishment of its covered bond programme in 2008 and securitisation programmes (Leofric No. 1 plc in 2011 and Mercia No. 1 plc in 2012). During 2014 the overall encumbrance position has remained relatively stable with no major new initiatives and with any volatility driven by short term gilt repo activity, continuing pay down of Leofric and the pre-funding of upcoming contractual covered bond redemptions in line with regulatory requirements.

The encumbered assets are predominantly all on the Society's own balance sheet other than around £80 million of mortgage assets from its subsidiary Godiva Mortgages Limited and the liquid assets held within the Group's covered bond and securitisation programmes already referred to.

The over collateralisation of £2.1 billion in Template C predominantly represents over-collateralisation in respect of the externally issued covered bond and securitisation programmes, of treasury bills drawn down under the FLS scheme and encumbered assets with no corresponding liabilities (see 2nd paragraph above).

A general description of terms and conditions of the collateralisation agreements entered into for securing liabilities are available in the 2014 Annual Report & Accounts as follows; for sale and repurchase transactions of debt securities in note 14 and 32; for the covered bond and securitisation programmes in note 15; and for derivatives in note 32.

The £22.4 billion unencumbered other assets (Template A column 060 row 120) comprise £20.3 billion of loans and advances to customers, £1.9 billion of cash and balances with the Bank of England and loans and advances to credit institutions, and £0.2 million of other assets (including derivative assets, intangible assets and property plant and equipment) that would not be available for encumbrance in the normal course of business.

Of the unencumbered £20.3 billion of loans and advances to customers, £5.1 billion are readily available as collateral to secure funding (representing assets that although technically encumbered are held in respect of retained self-issued notes in the Society's covered bond and securitisation programmes and approved Bank of England mortgage portfolios). A further £8.0 billion of loans and advances would be eligible for use to support future external or self-issuances under the Society's covered bond and securitisation programmes.

Glossary

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

Additional Tier 1 (AT 1) capital	Capital that meets certain criteria set out in CRD IV. In particular, the criteria require that upon the occurrence of a trigger event, the AT 1 capital instrument converts to Common Equity Tier 1 capital or the principal is written down on a permanent or temporary basis; or grandfathered instruments such as Permanent Interest Bearing Shares (PIBS).
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 value of non-derivative financial assets that are categorised as Available-for-sale.
Average loan to value	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 loan to value'.
Basel II	The Basel Committee on Banking Supervision's statement of best practice that defined the methods by which firms should calculate their regulatory capital requirements to retain sufficient capital to protect the financial system against unexpected losses, prior to 1 January 2014.
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 were implemented in the European Union via CRD IV, which came into force on 1 January 2014.
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.
Buy to let 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 and to protect against excessive leverage. The level is set by regulators and the 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, Available-for-sale reserve, eligible Additional Tier 1 capital, subordinated debt and collectively assessed impairment allowances, less all required regulatory adjustments.
Collateral	Security pledged by the borrower to the lender in case of default.
Common Equity Tier 1 capital (CET 1)	Common Equity Tier 1 capital comprises general reserves and the negative balance on the Available-for-sale reserve, less regulatory deductions. Common Equity Tier 1 must absorb losses on a going concern basis.
Common Equity Tier 1 ratio	Common Equity Tier 1 capital as a percentage of risk weighted assets.
Core Tier 1 capital	Core Tier 1 capital comprises general reserves, less intangible assets, pension surplus and other regulatory deductions. This class of capital is replaced by Common Equity Tier 1 capital under CRD IV.
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.
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.
Derivative	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.
EEA parent institution	A parent financial institution situated in a Member State of the European Economic Area which is not a subsidiary of another financial institution also situated in the EEA.
Encumbered assets	Assets used to secure third party liabilities or otherwise pledged. This excludes loans and advances to customers that, although technically encumbered, are held in respect of undrawn self-issued notes under the Group's covered bond and securitisation programmes.
End-point	Full implementation of CRD IV with no transitional provisions.
Enterprise Risk Management Framework (ERMF)	A framework that seeks to provide the context and guidance for cohesive risk management activity across the Society and its subsidiaries.
European Banking Authority	An independent European Union authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector.
Expected loss	A 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 parameter used in IRB approaches to estimate the amount outstanding at the time of default.
External Credit Assessment Institution (ECAI)	An ECAI (e.g. Moody's, Standard and Poor's and Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.
Fair value	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.
Financial Conduct Authority (FCA)	A statutory body responsible for the conduct of business regulation and supervision of UK financial institutions in the UK.
Financial Policy Committee (FPC)	A committee based at the Bank of England, charged with identifying, monitoring and taking action to reduce or remove systemic risks with a view to protect and enhance the resilience of the UK financial system. It is also responsible for supporting the economic policy of the UK Government.
Fitch Ratings	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, which can be temporary or permanent, is made on the contractual terms of a loan in response to the borrower's financial difficulties.

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 and distributions to holders of Perpetual Capital Securities (net of tax).
Gilts	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.
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 loan to value	Loan to value calculated on the basis of the latest property valuation being adjusted by the relevant house price index movement since that date.
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/collective assessment of impairment	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 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 to support all relevant current and future risks. This assessment includes determination of a number of capital buffers to be held in case of potential future economic stress, and provides confirmation that the Society has appropriate processes in place to ensure compliance with regulatory requirements.
Internal ratings-based approach (IRB)	An advanced approach to measuring capital requirements in respect of credit risk under Pillar 1. 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	A calculation brought in as part of CRD IV which measures the relationship between eligible Tier 1 capital and exposures to on and off balance sheet items.
Loan to value	The amount of mortgage loan as a percentage of the value of the property.
Loss Given Default (LGD)	A 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.
Member	A person who holds a share in the Society or has 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	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.

Mortgage Market Review	New mortgage conduct of business rules implemented by the FCA, which required all mortgage lenders to enhance responsible lending controls for mortgages and implement robust mortgage advice services by 26 April 2014, to ensure that all mortgages are affordable and to minimise the risk of detrimental outcomes for customers.
Near-prime	Loans to borrowers with marginally weakened credit histories such that their credit risk is greater than 'prime' customers, but is not considered heavily adverse.
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.
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.
Permanent Interest Bearing Shares (PIBS)	Unsecured, perpetual deferred shares of the Society offering a fixed coupon. PIBS rank equally with each other and Perpetual Capital Securities. They rank behind all other creditors of the Society including subordinated liabilities and the claims of Shareholding Members (other than Perpetual Capital Securities) as to principal and interest. PIBS are also known as subscribed capital. These are a form of Tier 1 capital under Basel II, however under Basel III are included as Tier 1 under transitional rules only.
Perpetual Capital Securities (PCS)	Securities that pay a non-cumulative coupon at the discretion of the Society. They rank equally with each other and Permanent Interest Bearing Shares (also AT 1 capital) but behind all other creditors of the Society including subordinated liabilities and the claims of Shareholding Members (other than Permanent Interest Bearing Shares) as to principal and interest.
Pillar 1	The part of the Basel Framework which sets out the regulatory minimum capital requirements for credit, market and operational risk.
Pillar 2	The part of the Basel 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 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 regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. The PRA is a subsidiary of the Bank of England.
Residential Mortgage Backed Securities (RMBS)	Asset backed securities that represent interests in a group of residential mortgages which give the investor the right to cash received from future mortgage payments of both principal and interest.
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 (RWAs)	The value of assets, after adjustment to reflect the degree of risk they represent in accordance with the relevant capital rules.
Sale and repurchase agreement (repo)	An agreement to sell a financial security together with a commitment by the seller to repurchase the asset at a specified price on a given date. In substance this forms a secured loan, with the difference between the purchase price and repurchase price being the interest rate.
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 residential mortgages as the loan pool for securitisation purposes.

Sovereign exposure	Exposures to governments and on account of cash balances and deposits with central banks.
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. In this approach the risk weighting used in the capital calculation is determined by specified percentages.
Stress testing	Testing undertaken to provide an understanding of the Society's resilience to internal and external shocks.
Subordinated liabilities	A form of Tier 2 capital that is unsecured. Subordinated notes rank equally with each other and behind all other creditors of the Society and the claims of Shareholding Members (other than holders of Permanent Interest Bearing Shares and Perpetual Capital Securities) as to principal and interest.
Subscribed capital	See Permanent Interest Bearing Shares.
Tier 1 capital	A component of regulatory capital comprising Common Equity Tier 1 and Additional Tier 1 capital.
Tier 2 capital	A component of regulatory capital comprising qualifying subordinated debt and eligible collective impairment allowances.
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.
Unencumbered assets	Assets readily available as collateral to secure funding. This includes loans and advances to customers that, although technically encumbered, are held in respect of undrawn self-issued notes under the Group's covered bond and securitisation programmes and are therefore readily available as collateral to secure funding.
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.