PILLAR 3 DISCLOSURES

2015

YBS GROUP

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1 Overview

1.1 Background

This document is prepared under the European Union's Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) (together commonly referred to as CRD IV) in place on 31 December 2015.

CRD IV came into force on 1 January 2014 and updates the three "pillars" of the Basel Framework which first came into force from 1 January 2008. Pillar 1 of the standards sets out the minimum capital requirements firms are required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1, assess the suitability of Pillar 1 capital requirements and demonstrate their ability to manage their capital position through a period of stress. Pillar 3 aims to improve market discipline by requiring firms to publish key details of their risks, capital and risk management.

Yorkshire Building Society Group ("the Group") has adopted the Pillar 1 standardised approach to credit risk and operational risk, and is also subject to Pillars 2 and 3. The rules are enforced in the UK by the Prudential Regulation Authority (PRA).

1.2 Basis and Frequency of Disclosures

This disclosure document has been prepared by the Group in accordance with the requirements of Pillar 3 set out in Articles 431-451 of the CRR. Unless otherwise stated, all figures are as at 31 December 2015, the Group's financial year-end.

1.3 Scope

Yorkshire Building Society (YBS) is an EEA parent institution that is regulated in the UK by the PRA and Financial Conduct Authority (FCA). CRD IV therefore applies to YBS and its subsidiary undertakings.

Consolidation of the Group position for regulatory capital purposes (the "Capital Group") is similar to the statutory consolidated Group position produced for the Annual Report and Accounts but differs in the following respects:

- One Group company, Yorkshire Key Services Limited, which provides computer services, is outside of the scope of CRD IV and is therefore not consolidated for capital purposes due to the non-financial nature of its activities, but is fully consolidated in the Annual Report and Accounts. The Group's investment in Yorkshire Key Services is neither deducted nor consolidated on grounds of materiality but is risk weighted.
- Some definitions of assets and capital differ between the regulatory capital adequacy rules under CRD IV and the statutory accounting requirements under International Financial Reporting Standards (IFRS); Table 2 gives a detailed reconciliation of statutory accounting capital values to regulatory capital values.

There are no restrictions or impediments to the movement of capital between legal entities within the Capital Group, and there is no material capital surplus or deficit relating to Group legal entities that do not form part of the Capital Group.

Under CRD IV, YBS as a legal entity must also maintain a 'solo' capital requirement. In this area, YBS has made use of provisions laid down in CRD IV to provide capital resources and requirements to the PRA under a solo-consolidated basis. Solo-Consolidation enables both the intra group exposures and investments of YBS in its subsidiaries within the Solo-Consolidated Group to be eliminated when calculating capital resource requirements and the reserves of such solo subsidiaries to be aggregated with the parent when calculating capital resources.

The Group entities included under solo consolidation in 2015 were:

Yorkshire Building Society

Accord Mortgages Limited

Norwich & Peterborough (LBS) Limited

Further details of the Group's principal subsidiary undertakings are included in Note 10 to the Annual Report and Accounts.

1.4 Location and Verification

These disclosures have been reviewed by the Group's Audit Committee on behalf of the Group's Board and are published on the Group's corporate website (www.ybs.co.uk) at the same time as the Group's Annual Report and Accounts. The disclosures are not subject to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Group's Annual Report and Accounts.

1.5 Regulatory Developments

Following the introduction of CRD IV in 2014, there have been a number of regulatory changes as CRD IV becomes fully implemented. The following changes have had an impact on the Group in 2015:

- Inclusion of Available for Sale (AFS) reserves within capital resources
- Applying 100% risk weight to Self-Build Mortgages

1.6 Recent Developments

In Q4 2015, the Group started using central counterparties to settle eligible derivative contracts. Exposures to a central counterparty (clearing house) attract a 2% risk weight and no Credit Valuation Adjustment.

2 Risk Management

2.1 Risk Management

The activities of financial institutions inevitably involve a degree of risk taking, so the Group's ability to properly identify, measure, monitor and report risk is critical to its soundness and its ability to provide value and fair outcomes to its membership and customers. The Group's risk management framework and governance structures are intended to provide appropriate and comprehensive monitoring, control and ongoing management of the major risks to which the Group is exposed. These are fully set out in the Strategic Report and Risk Management Report in the Annual Report and Accounts.

3 Capital Adequacy

3.1 Capital Management

The Group's management of its capital is based on a number of key principles:

- The Group will at all times ensure it holds sufficient capital, of the right quality and stability, to ensure financial sustainability and the security of members' deposits, to support its strategic objectives, to retain the confidence of key external stakeholders and to fulfil its regulatory requirements.
- The Group will seek to utilise its capital resources in an appropriate manner and achieve a suitable level of return on that capital. This includes seeking to align its regulatory capital needs with its risk capital needs by means of pursuing an application for the Internal Ratings Based (IRB) approach to the calculation of its capital requirements.
- The Group will, as far as possible, seek to ensure an appropriate and efficient mix of capital is available commensurate with its risk profile and strategic ambitions, in line with its status as a deposit taker and a mutual organisation.

The Group seeks to generate profit in order to be self-sustainable from a capital perspective based on a long term growth aspiration, although the Group would consider using external capital under certain circumstances.

The Group considers both risk based capital requirements and non-risk based leverage requirements when determining the Group's capital strategy and has adopted a range of performance metrics over and above the regulatory minimum as the Group's risk appetite.

Summarised regulatory capital positions and forecasts (including forecasts under stress scenarios) are reported monthly to the Board and quarterly to the Group Risk Committee. Specific capital management reports are presented to the Capital Management Committee and appropriate executive risk and management committees.

Regulatory capital covers the following risks across the Capital Group:

- Pillar 1 risks (i.e. credit risk and operational risk). The minimum capital requirement is calculated using regulatory-prescribed risk weightings. The Group has adopted the standardised approach to both credit and operational risk in order to calculate the Pillar 1 minimum capital requirement.
- Pillar 2A risks (i.e. all other material risks for which the Group does not require the provision of regulatory capital under Pillar 1). Each material risk that the Group has identified outside the scope of Pillar 1 (e.g. pension obligation risk, interest rate risk, concentration risk) has undergone considered and vigorous stress testing to calculate an economic value for each of the material risks across the Group where capital is an appropriate mitigant, and are documented in the Internal Capital Adequacy Assessment Process (ICAAP) document (see section 3.2 below).
- Capital Planning Buffer. The Group calculates an additional capital requirement (in addition to the Pillar 1 and Pillar 2A amounts above) representing the amount by which the Group's capital surplus would reduce through a "severe but plausible" stress scenario over the Group's planning horizon. This additional requirement is known as the Capital Planning Buffer and does not form part of the overall regulatory minimum capital requirement. From 2016 this will be replaced by a 'Capital Conservation Buffer (CCB)' introduced as part of CRD IV and supplemented by a 'PRA Buffer' where the CCB is not sufficient to cover the capital erosion identified over a severe but plausible scenario.
- Counter Cyclical Buffer. The Group currently is not required to hold this additional capital buffer.

3.2 Internal Capital Adequacy Assessment Process

The Group undertakes at least annually an ICAAP, which is an internal assessment of its capital requirement. In performing the ICAAP, the Group considers the key risks to which it is exposed, and the levels of capital and other financial resources that should be held to safeguard the interests of its members and depositors, particularly during times of stress.

This process includes:

- Identification by senior managers of the relevant risk categories for the Group.
- Establishment, under the sponsorship of individual Chief Officers, of separate work streams to consider each risk category in detail.
- Analysis of the risks within each work stream, involving relevant personnel from across the business, and documented in individual risk assessment documents.

- Consideration of whether capital is an appropriate mitigant to the risk. Where this is deemed to be the case, capital requirements are calculated based on the results of stress testing for each risk category. Where capital is not deemed appropriate to mitigate a particular risk, alternative management actions are identified and described within the risk assessment. For certain risks where capital is not an appropriate mitigant, the holding of liquidity can be used to mitigate the risk. In these cases, the risk is considered in more depth as part of the Individual Liquidity Adequacy Assessment (ILAA) process.
- Calculation of an appropriate Capital Planning Buffer to absorb a "severe but plausible" economic stress event over the Group's planning horizon, should such a scenario materialise, thereby ensuring minimum capital requirements are maintained.
- Approval of individual risk assessment documents by the relevant sponsor and committee.
- Documentation of the overall process and assessment, which is presented to the Risk Overlap Committee before being presented to the Group Risk Committee and the Board (with whom ultimate responsibility lies) for challenge and approval.

Further information on the material risks identified as part of the ICAAP can be found in sections 4, 5 and 6 of this document.

3.3 Total Available Capital

At 31 December 2015 and throughout the year, the Group complied with the capital requirements that were in force as set out by European and national legislation. The following table shows the breakdown of the total available capital for the Capital Group and Solo-Consolidated Group as at 31 December 2015.

Table 1 - Capital Resources	Group	Group	Solo	Solo
£m	**2015**	**2014**	**2015**	**2014**
Common Equity Tier 1 (CET1)				
General reserve	2,117.6	1,989.5	2,105.8	1,991.1
AFS reserve	4.9	-	4.9	-
Pension scheme adjustment	(45.7)	(51.5)	(45.7)	(51.5)
Deductions from CET1				
Intangible fixed assets	(36.8)	(35.7)	(36.8)	(35.7)
Securitisation holdings deducted from capital resources	(27.8)	(27.4)	(27.8)	(27.4)
Deferred tax assets that rely on future profitability	(4.7)	(7.2)	(4.7)	(7.2)
Total CET1	**2,007.5**	**1,867.7**	**1,995.7**	**1,869.3**
Additional Tier 1 Capital				
Permanent Interest Bearing Shares (PIBS)	4.7	5.5	4.7	5.5
Total Tier 1 capital	**2,012.2**	**1,873.2**	**2,000.4**	**1,874.8**
Tier 2 Capital				
Subordinated liabilities	286.1	299.5	286.1	299.5
Adjustment to subordinated liabilities	(3.2)	(11.2)	(3.2)	(11.2)
Collective provisions for impairment	33.3	23.4	33.3	23.4
Total Tier 2 capital	**316.2**	**311.7**	**316.2**	**311.7**
Total capital available	**2,328.4**	**2,184.9**	**2,316.6**	**2,186.5**

3.4 Tier 1 Capital

3.4.1 Common Equity Tier 1 Capital

Common Equity Tier 1 Capital comprises the general reserve, AFS reserve and adjustments for items reflected in the general reserve which are treated separately for capital adequacy purposes. The following items are deducted under CRD IV:

- Defined benefit scheme pension assets are deducted from Tier 1 capital resources, net of any associated deferred tax liabilities. At 31 December 2015, the net impact of the adjustment was a reduction in Tier 1 capital of £45.7m.
- An adjustment is also made in respect of intangible assets. For accounting purposes, items including software development costs, other intangibles resulting from business combinations and goodwill are capitalised as intangible fixed assets where they meet certain criteria. Intangibles are deducted from capital under the regulatory rules and at 31 December 2015, the deduction amounted to £36.8m.
- Securitisation positions (including resecuritisations) that are unrated or have low external ratings can be risk weighted at 1250% or deducted from CET1 capital under CRD IV. The policy used in the Group is to deduct this as in the above table.
- Under CRD IV, deferred tax assets that rely on future profitability are deducted from CET1 capital.

3.4.2 Additional Tier 1 Capital

Additional Tier 1 Capital comprises PIBS. PIBS are unsecured deferred shares and rank behind the claims of all subordinated noteholders, depositors, creditors and investing members of the Group. Further details about PIBS are provided in Note 30 to the Group's Annual Report and Accounts and full terms and conditions of the Group's Permanent Interest Bearing Shares can be found on the Group's website:

http://www.ybs.co.uk/your-society/treasury/wholesale_funding/introduction.html

Under CRD IV subscribed capital is being phased out over a ten year period. Currently 70% of the subscribed capital balance sheet carrying value qualifies as Tier 1 capital.

3.5 Tier 2 Capital

Tier 2 Capital comprises the Group's qualifying subordinated liabilities, the collective impairment provision, and adjustments for items treated separately for capital adequacy purposes.

- Subordinated notes are unsecured and rank behind the claims of all depositors, creditors and investing members (other than holders of PIBS) of the Group. For regulatory capital purposes, the value of any subordinated liabilities is amortised in the last 5 years to maturity. More details of the subordinated liabilities are included in Note 29 to the Annual Report and Accounts and full terms and conditions for the Group's subordinated liabilities can be found on the Group's website:

  http://www.ybs.co.uk/your-society/treasury/wholesale_funding/subordinated-debt-info.html

- To the extent that collective provisions for impairment have been recognised in the income and expenditure account, they may be added back to Tier 2 capital.

3.6 Reconciliation of Regulatory Capital to Balance Sheet Capital

The table below shows how the balance sheet capital values in the Annual Report and Accounts reconcile to the regulatory capital equivalent for the Group at December 2015.

Table 2 - Reconciliation of Accounting Capital to Regulatory Capital £m	Accounting Balance Sheet Capital Value	Adjustments to Balance Sheet Capital Value	Regulatory Capital Value	Ref
CET1				
Total equity attributable to members	2,104.9			1
Less reserves not included in regulatory capital:				
Hedging reserve		23.0		2
Non-consolidated subsidiary		(5.4)		6
Total adjustments to Common Equity Tier 1 resources		17.6		
CET1	**2,104.9**	**17.6**	**2,122.5**	
Regulatory deductions from CET1				
Intangible fixed assets		(36.8)		3
Securitisation holdings deducted from capital resources		(27.8)		3
Defined benefit pension fund assets		(61.7)		3
Deferred tax liability associated with defined pension fund assets		16.0		3
Deferred tax assets that rely on future profitability		(4.7)		
Total regulatory deductions from Common Equity Tier 1 capital		(115.0)		
Total CET1	**2,104.9**	**(97.4)**	**2,007.5**	
Additional Tier 1 capital				
Subscribed capital (Permanent Interest Bearing Shares)	6.8			1
Adjustment to phase out subscribed capital		(2.1)		
Total Additional Tier 1 capital	**6.8**	**(2.1)**	**4.7**	5
Total Tier 1 capital after deductions	**2,111.7**	**(99.5)**	**2,012.2**	
Tier 2 capital				
Collective provisions for impairment	0.0	33.3	33.3	4
Subordinated liabilities	286.1	(3.2)	282.9	1
Tier 2 capital after deductions	**286.1**	**30.1**	**316.2**	
Total capital resources after deductions	**2,397.8**	**(69.4)**	**2,328.4**	

[1] Statement of Financial Position, Annual Report and Accounts
[2] Statement of Changes in Members' Interest, Annual Report and Accounts
[3] Pillar 3 Disclosures, Table 1
[4] Note 9 (Impairment) Annual Report and Accounts
[5] As per 3.4.2 above only 70% of subscribed capital balance sheet carrying value qualifies as Tier 1 capital
[6] See section 1.3 for further details

3.7 Capital Flow Statement

The table below shows the flow of Group regulatory capital and associated deductions in 2015.

Table 3 - Regulatory Capital Flow Statement £m	2015	Ref
<u>Total CET1 Capital</u>		
1 January 2015	1,867.7	
Total comprehensive income in 2015	144.6	1
Profits allocated to available for sale reserve	(1.4)	2
Losses allocated to hedging reserve	(13.8)	2
Decrease in pension scheme adjustment	5.8	
Increase in intangible fixed assets	(1.1)	
Increase in securitisation holdings deducted from capital resources	(0.4)	
Decrease in deferred tax adjustment	2.5	
Regulatory change – inclusion of AFS reserve	4.9	4
Increase in non-consolidated subsidiary	(1.3)	
Total CET1 Capital at 31 December 2015	**2,007.5**	
<u>Additional Tier 1 capital</u>		
1 January 2015	5.5	
Movement in market valuation of PIBS	(0.8)	
Additional Tier 1 capital at 31 December 2015	**4.7**	
Total Tier 1 capital at 31 December 2015	**2,012.2**	
<u>Tier 2 capital</u>		
1 January 2015	311.7	
Capital maturity	(10.0)	3
Movement in fair value adjustments to subordinated liabilities	(3.4)	
Increase in amortisation of subordinated liabilities	8.0	
Increase in collective provisions for impairment	9.9	
Tier 2 capital before deductions at 31 December 2015	**316.2**	
Total capital available at 31 December 2015	**2,328.4**	

[1] Statement of Comprehensive Income, Annual Report and Accounts
[2] Statement of Changes in Member's Interest, Annual Report and Accounts
[3] £10m is the carrying value of the maturity
[4] In line with regulatory changes, AFS reserves are now included in regulatory capital

3.8 Minimum Capital Requirement (Pillar 1)

The following tables show the risk weighted assets (RWA) for each of the Group's exposure classes and the resultant Pillar 1 minimum capital requirements (being 8% of RWAs).

Table 4 - Risk Weighted Assets £m	Group 2015	Group 2014	Solo 2015	Solo 2014
Loans secured by mortgages on immovable property				
Loans to individuals	11,428.7	10,951.4	11,428.7	10,951.4
Commercial lending (including SME)	360.4	357.8	360.4	357.8
Past due	603.0	755.0	603.0	755.0
Immovable property risk weighted assets	**12,392.1**	**12,064.2**	**12,392.1**	**12,064.2**
Wholesale exposure classes				
Securitisation positions	20.2	137.6	20.2	137.6
Financial institutions	398.8	349.1	398.8	349.1
Short term claims on financial institutions and corporates	86.6	77.0	86.5	76.9
Wholesale risk weighted assets	**505.6**	**563.7**	**505.5**	**563.6**
Retail				
Current accounts	-	1.4	-	1.4
Personal loans	0.3	0.1	0.3	0.1
Retail risk weighted assets	**0.3**	**1.5**	**0.3**	**1.5**
Operational risk weighted assets	736.7	649.2	841.2	764.0
Other credit risk weighted assets	248.3	277.1	254.0	284.7
Total risk weighted assets	**13,883.0**	**13,555.7**	**13,993.1**	**13,678.0**

Table 5 - Pillar 1 Requirements	**Group**	**Group**	**Solo**	**Solo**
£m	**2015**	**2014**	**2015**	**2014**
Loans secured by mortgages on immovable property				
Loans to individuals	914.3	876.1	914.3	876.1
Commercial lending (including SME)	28.8	28.6	28.8	28.6
Past due	48.2	60.4	48.2	60.4
Immovable property requirement	**991.3**	**965.1**	**991.3**	**965.1**
Wholesale exposure classes				
Securitisation positions	1.6	11.0	1.6	11.0
Financial institutions	31.9	27.9	31.9	27.9
Short term claims on financial institutions and corporates	6.9	6.2	6.9	6.2
Wholesale requirement	**40.4**	**45.1**	**40.4**	**45.1**
Retail				
Current accounts	-	0.1	-	0.1
Personal loans	0.0	-	0.0	-
Retail requirement	**0.0**	**0.1**	**0.0**	**0.1**
Operational risk pillar 1 requirement	58.9	51.9	67.3	61.1
Other credit risk assets	19.9	22.3	20.3	22.8
Minimum capital requirement	**1,110.5**	**1,084.5**	**1,119.3**	**1,094.2**

3.9 Capital Adequacy

The table below summarises the Group's capital adequacy position, using key figures from Tables 1, 4 and 5.

Table 6 - Capital Adequacy	**Group**	**Group**	**Solo**	**Solo**
£m / %	**2015**	**2014**	**2015**	**2014**
Capital Excess				
Total pillar 1 capital requirement	1,110.5	1,084.5	1,119.3	1,094.2
Total capital resources	2,328.4	2,184.9	2,316.6	2,186.5
Excess of own funds over minimum pillar 1 requirement	**1,217.9**	**1,100.4**	**1,197.3**	**1,092.3**
Total risk weighted assets	13,883.0	13,555.7	13,993.1	13,678.0
Common Equity Tier 1 capital resources	2,007.5	1,867.7	1,995.7	1,869.3
Tier 1 capital resources	2,012.2	1,873.2	2,000.4	1,874.8
Total capital resources	2,328.4	2,184.9	2,316.6	2,186.5
Common Equity Tier 1 capital ratio	**14.5%**	**13.8%**	**14.3%**	**13.7%**
Tier 1 capital ratio	**14.5%**	**13.8%**	**14.3%**	**13.7%**
Total capital ratio	**16.8%**	**16.1%**	**16.6%**	**16.0%**

Sections 4 and 5 provide further detail on the significant risks captured under Pillar 1, i.e. credit risk and operational risk, including the nature of the exposures and the key risk management techniques. A summary of other significant risks captured under Pillar 2 is contained in section 6.

Given the total minimum capital requirements are not materially different on a Group or solo consolidated basis, the disclosures in the remainder of this document are on a Group basis.

3.10 RWA Flow Statement

The table below shows the causes of movements in risk weighted assets in the year at the Group level. In the figures below, operational risk has been included to fully illustrate overall RWA movements. Changes in operational risk requirements reflect income growth within the regulatory prescribed income streams.

Table 7 - RWA Flow Statement £m	2014 RWAs	Portfolio Quality	Portfolio Growth	Regulatory Changes	Income Growth	2015 RWAs
Loans secured on immovable property	12,064.2	(95.3)	420.5	2.7	-	12,392.1
Wholesale credit risk	563.7	(22.9)	(35.2)	-	-	505.6
Banking credit risk	1.5	-	(1.2)	-	-	0.3
Other credit risk	277.1	-	(28.8)	-	-	248.3
Operational risk	649.2	-	-	-	87.5	736.7
Total risk weighted assets	**13,555.7**	**(118.2)**	**355.3**	**2.7**	**87.5**	**13,883.0**

3.11 Leverage Ratio

This is a non-risk based requirement that measures the relationship between capital resources and an adjusted measure of total on- and off-balance sheet assets. A minimum leverage ratio of 3% is in force for the UK's largest institutions until 2017, when it will be become mandatory for all other institutions (including the Group) from 2018.

The ratio is calculated as:

$$\frac{\text{Tier 1 Capital}}{\text{Total on- and off-balance sheet assets (adjusted for deductions)}}$$

Table 8 - Leverage Ratio £m	2015	2014
Balance Sheet Assets	**38,210.6**	**37,567.2**
Adjustments		
Mortgage pipeline	507.0	452.9
Other committed facilities	18.4	17.5
Repurchase agreements	1,926.6	1,437.3
Netted derivatives adjustment	64.9	5.2
Tier 1 deductions	(115.0)	(121.8)
Leverage Ratio Assets	**40,612.5**	**39,358.3**
Tier 1 Capital Resources	**2,012.2**	**1,873.2**
Leverage Ratio %	**5.0%**	**4.8%**

3.12 Impact of CRD IV

As noted in section 1.1, the Basel III regulations have been written into European law in the form of a Regulation and Directive commonly known as CRD IV, in force from 1 January 2014.

This section is intended to assist in understanding how the regulations will affect the Group's capital position. The table below shows the capital position under the current CRD IV rules as they stand under PRA national implementation, and on a final rules basis (applying the final CRD IV rules without transitional elements, as the rules will stand in 2022). All figures are as at the end of 2015.

Table 9 - CRD IV Capital Position £m	Transitional	Final Rules
Common Equity Tier 1 (CET1)		
General reserve	2,117.6	2,117.6
Regulatory adjustments:		
Available for sale reserve	4.9	4.9
Pension scheme adjustment	(45.7)	(45.7)
CET1 deductions:		
Intangible fixed assets	(36.8)	(36.8)
Securitisation holdings deducted from capital resources	(27.8)	(27.8)
Deferred tax assets that rely on future profitability	(4.7)	(4.7)
Total CET1 capital	**2,007.5**	**2,007.5**
Additional Tier 1 (AT1) Capital		
Permanent Interest Bearing Shares (PIBS)	4.7	0.0
Total Tier 1 capital	**2,012.2**	**2,007.5**
Tier 2 (T2) Capital		
Subordinated liabilities	282.9	282.9
Collective provisions for impairment	33.3	33.3
Total Tier 2 capital	**316.2**	**316.2**
Total capital	**2,328.4**	**2,323.7**
Current RWAs	13,883.0	13,883.0
Total RWAs under CRD IV	**13,883.0**	**13,883.0**
CET1 Ratio	**14.5%**	**14.5%**
Tier 1 Ratio	**14.5%**	**14.5%**
Total Capital Ratio	**16.8%**	**16.7%**
Leverage Ratio	**5.0%**	**4.8%**

4 Significant Risk Categories - Credit Risk

4.1 Credit Risk Overview

Credit risk is the potential risk of financial loss arising from the failure of a customer or other counterparty to settle their financial and contractual obligations as they fall due.

For the purposes of Pillar 3 disclosures, credit risk is sub-divided into loans secured by mortgages on immovable property, wholesale (treasury) and retail (banking & personal loans). Details of the Group's risk management and governance practices can be found in the Risk Management Report in the Group's Annual Report and Accounts, with further details of exposures included in Notes 38 and 39.

4.2 Credit Risk Exposures

The gross credit risk exposure (based on the definitions for regulatory capital purposes, before impairment provision and credit risk mitigation) and the average for the year is summarised as follows:

Table 10 - Credit Risk Exposure	Average during	Dec 2015	Average during	Dec 2014
£m	**2015**		**2014**	
Loans secured by mortgages on immovable property				
Loans to individuals	33,172.1	33,549.2	31,520.3	32,414.0
Commercial lending (including SME)	426.5	446.3	418.1	415.1
Total loans secured on immovable property exposure	**33,598.6**	**33,995.5**	**31,938.4**	**32,829.1**
Wholesale				
Securitisation positions	60.6	36.9	142.3	133.6
Central governments or central banks	9,663.2	12,614.8	8,957.5	9,588.7
Financial institutions	798.1	784.4	2,385.3	2,457.5
Short term claims on institutions and corporates	311.8	432.9	319.0	348.1
Total wholesale exposure	**10,833.7**	**13,869.0**	**11,804.1**	**12,527.9**
Retail				
Current accounts	2.1	1.9	2.6	2.4
Personal loans	2.9	2.3	4.7	3.7
Total retail exposure	**5.0**	**4.2**	**7.3**	**6.1**
Other assets exposure	305.8	311.6	273.2	324.4
Total credit risk exposure	**44,743.1**	**48,180.3**	**44,023.0**	**45,687.5**

The section below gives a detailed breakdown of the material risk categories. A further geographical analysis of loans secured by mortgages on immovable property is disclosed in Note 39 in the Annual Report and Accounts.

The geographical distribution of the Group's exposures is as follows.

Table 11 - Credit Risk Exposure - Geographic Distribution 2015	UK	Other European Countries	North America	Rest of the World	Total
£m	**2015**	**2015**	**2015**	**2015**	
Loans secured by mortgages on immovable property					
Loans to individuals	33,497.0	52.2	-	-	**33,549.2**
Commercial lending (including SME)	446.3	-	-	-	**446.3**
Total loans secured on immovable property	**33,943.3**	**52.2**	**-**	**-**	**33,995.5**
Wholesale					
Securitisation positions	-	17.8	-	19.1	**36.9**
Central governments or central banks	12,614.8	-	-	-	**12,614.8**
Financial institutions	395.0	141.4	34.4	213.6	**784.4**
Short-term claims on institutions and corporates	304.4	0.1	128.4	-	**432.9**
Total wholesale credit exposure	**13,314.2**	**159.3**	**162.8**	**232.7**	**13,869.0**
Total credit risk exposure (excl. retail and other assets)	**47,257.5**	**211.5**	**162.8**	**232.7**	**47,864.5**

Table 11 - Credit Risk Exposure - Geographic Distribution 2014	UK	Other European Countries	North America	Rest of the World	Total
£m	**2014**	**2014**	**2014**	**2014**	
Loans secured by mortgages on immovable property					
Loans to individuals	32,352.6	61.4	-	-	**32,414.0**
Commercial lending (including SME)	415.1	-	-	-	**415.1**
Total loans secured on immovable property	**32,767.7**	**61.4**	**-**	**-**	**32,829.1**
Wholesale					
Securitisation positions	61.2	44.2	10.7	17.5	**133.6**
Central governments or central banks	9,588.7	-	-	-	**9,588.7**
Financial institutions	1,141.2	487.5	170.1	658.7	**2,457.5**
Short-term claims on institutions and corporates	255.1	1.5	91.5	-	**348.1**
Total wholesale credit exposure	**11,046.2**	**533.2**	**272.3**	**676.2**	**12,527.9**
Total credit risk exposure (excl. retail and other assets)	**43,813.9**	**594.6**	**272.3**	**676.2**	**45,357.0**

The residual maturity of the exposures is as follows.

Table 12 - Credit Risk Exposure - Residual Maturity 2015	Up to 12 months	1 to 5 years	5 to 10 years	> than 10 years	Total
£m	2015	2015	2015	2015	
Loans secured by mortgages on immovable property					
Loans to individuals	3,985.5	2,276.7	3,972.6	23,314.4	33,549.2
Commercial lending (including SME)	11.9	28.3	53.1	353.0	446.3
Total loans secured on immovable property	**3,997.4**	**2,305.0**	**4,025.7**	**23,667.4**	**33,995.5**
Wholesale					
Securitisation positions	-	27.9	-	9.0	36.9
Central governments or central banks	3,422.8	77.8	151.3	8,962.9	12,614.8
Financial institutions	-	61.4	492.6	230.4	784.4
Short-term claims on institutions and corporates	432.9	-	-	-	432.9
Total wholesale exposure	**3,855.7**	**167.1**	**643.9**	**9,202.3**	**13,869.0**
Total credit risk exposure (excl. retail and other assets)	**7,853.1**	**2,472.1**	**4,669.6**	**32,869.7**	**47,864.5**

Table 12 - Credit Risk Exposure - Residual Maturity 2014	Up to 12 months	1 to 5 years	5 to 10 years	> than 10 years	Total
£m	2014	2014	2014	2014	
Loans secured by mortgages on immovable property					
Loans to individuals	3,492.8	2,175.2	3,942.1	22,803.9	32,414.0
Commercial lending (including SME)	13.8	38.5	52.0	310.8	415.1
Total loans secured on immovable property	**3,506.6**	**2,213.7**	**3,994.1**	**23,114.7**	**32,829.1**
Wholesale					
Securitisation positions	20.1	27.4	-	86.1	133.6
Central governments or central banks	3,652.0	-	373.3	5,563.4	9,588.7
Financial institutions	1,402.5	76.2	333.2	645.6	2,457.5
Short-term claims on institutions and corporates	348.1	-	-	-	348.1
Total wholesale exposure	**5,422.7**	**103.6**	**706.5**	**6,295.1**	**12,527.9**
Total credit risk exposure (excl. retail and other assets)	**8,929.3**	**2,317.3**	**4,700.6**	**29,409.8**	**45,357.0**

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

For the purposes of generating risk weightings for its wholesale and asset securitisation exposures, the Group uses Standard and Poor's and Fitch and Moody's as External Credit Assessment Institutions (ECAIs), using a composite rating where a counterparty is rated by more than one agency. There has been no change in the Group's use of ECAIs during the year. The following tables show the exposure values associated with each credit quality step for wholesale exposures under the standardised approach:

Table 13 - Sovereign Exposure Credit Quality Steps						2015
Central Government, Central Banks and Multilateral Development Banks						
Credit Quality Step	**Risk Weight (<3 months / >3 months)**	**S&P rating**	**Fitch rating**	**Moody's rating**	**Exposure values £m**	**Exposure values after mitigation[1] £m**
1	0%/0%	AAA to AA-	AAA to AA-	Aaa to Aa3	12,614.8	5,574.3
Total					**12,614.8**	**5,574.3**
						2014
Credit Quality Step	**Risk Weight (<3 months / >3 months)**	**S&P rating**	**Fitch rating**	**Moody's rating**	**Exposure values £m**	**Exposure values after mitigation[1] £m**
1	0%/0%	AAA to AA-	AAA to AA-	Aaa to Aa3	9,588.7	5,412.3
Total					**9,588.7**	**5,412.3**

[1] Mitigation recognises the benefit of collateral held against these investments – see Section 4.6.2 Credit Risk Mitigation: Wholesale

Table 14 - Wholesale Exposure Credit Quality Steps						2015
Financial institutions, Covered bonds and Short-term claims						
Credit Quality Step	**Risk Weight (<3 months / >3 months)**	**S&P rating**	**Fitch rating**	**Moody's rating**	**Exposure values £m**	**Exposure values after mitigation[1] £m**
1	20%/20%	AAA to AA-	AAA to AA-	Aaa to Aa3	493.7	226.7
2	20%/50%	A+ to A-	A+ to A-	A1 to A3	647.8	455.9
3	20%/50%	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	72.4	27.6
4	50%/100%	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	3.4	3.4
5	50%/100%	B+ to B-	B+ to B-	B1 to B3	-	-
6	150%/150%	CCC+ and below	CCC+ and below	Caa1 and below	-	-
Unrated	20%/50%	Unrated	Unrated	Unrated	-	-
Total					**1,217.3**	**713.6**
						2014
Credit Quality Step	**Risk Weight (<3 months / >3 months)**	**S&P rating**	**Fitch rating**	**Moody's rating**	**Exposure values £m**	**Exposure values after mitigation[1] £m**
1	20%/20%	AAA to AA-	AAA to AA-	Aaa to Aa3	890.5	186.6
2	20%/50%	A+ to A-	A+ to A-	A1 to A3	1,906.3	437.8
3	20%/50%	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	-	-
4	50%/100%	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	3.1	3.1
5	50%/100%	B+ to B-	B+ to B-	B1 to B3	-	-
6	150%/150%	CCC+ and below	CCC+ and below	Caa1 and below	5.7	5.7
Unrated	20%/50%	Unrated	Unrated	Unrated	-	-
Total					**2,805.6**	**633.2**

Included within the 2015 exposures above, is approximately £4m of exposures (rated at A+) that relate to centrally cleared counterparties. The exposures have been risk weighted at 2% as per CRD IV rules.

4.3 Securitisation Positions

Issued Securitisations

The Group has securitised certain mortgage loans by transferring the loans to special purpose entities (SPEs) under the 'Brass' and 'Tombac' securitisation programmes. The SPEs are fully consolidated into the Group accounts. The transfer of the mortgage loans to the SPEs are not treated as sales by the Group as these structures were not intended to achieve significant transfer of credit risk away from the Group, but to benefit from attractive funding rates. The risks relating to the underlying mortgage pools therefore remains with the Group and is included in the 'secured by mortgages on immovable property' sections detailed in this document. There are no specific capital requirements for the securitisation vehicles. Note 35 in the Annual Report and Accounts provides more information on the securitisation programme.

The Group has also retained notes from its securitisation issues to be used as collateral for use in sale and repurchase agreements or central bank operations. Investments in self-issued notes and the equivalent 'deemed loan', together with the related income, expenditure and cash flows are not recognised in the Society's financial statements. This avoids the 'grossing-up' of the financial statements that would otherwise arise.

To manage interest rate risk the SPEs enter in to derivative transactions. Treatment of derivatives relating to securitisations can be found in Note 34 of the Annual Report and Accounts.

The Society and its subsidiaries are under no obligation to support any losses that may be incurred by the securitisation programme or holders of the notes issued and do not intend to provide such further support.

The total value of notes issued to third parties as at 31 December 2015 is £0.7 billion (31 December 2014: £0.8 billion). Residential mortgage loans are currently pledged as security on these issues, with credit enhancement also structured into each programme. The notes issued are rated by Moody's and Fitch.

Purchased Securitisations

The Group's exposures listed below relate to purchased securitisation positions, including resecuritisations (which is defined as a securitisation instrument where at least one of the underlying exposures is itself a securitisation).

Table 15 - Securitisation Positions by Investment type	**Exposure Values**	
£m	**2015**	**2014**
Collateralised Debt Obligation (CDO)	9.0	9.2
Collateralised Loan Obligation	-	15.6
Principal Protected Note	-	10.7
UK Prime RMBS	-	49.7
UK Buy to Let RMBS	-	11.6
Synthetic Collateralised Debt Obligation	27.9	36.8
Total	**36.9**	**133.6**

Securitisation exposures are currently limited to legacy portfolios which have been in run off for a significant period. No new investment has been undertaken since 2008, although a small amount was added to the portfolio in 2010 and 2011 following the Chelsea and N&P mergers respectively.

Monthly monitoring of the portfolios is undertaken, including review of statistics of the underlying asset pools and compliance with structural tests where applicable using the investor reports published for each of the investments, and reported to the Wholesale and Commercial Credit Committee on a regular basis.

The fair values are based on either quoted market prices, where available, or via valuations provided by external parties.

The following table shows the Group's aggregate exposure to purchased securitisations, split by their associated credit quality steps:

Table 16 - Securitised Positions Exposure Credit Quality Steps

2015

Credit Quality Step	Risk Weight	S & P rating	Fitch rating	Moody's rating	Exposure values £m
1	20%	AAA to AA-	AAA to AA-	Aaa to Aa3	-
2	50%	A+ to A-	A+ to A-	A1 to A3	-
3	100%	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	-
4	350%	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	-
5	Deducted	B+ and below	B+ and below	B1 and below	27.9
Total					**27.9**

Table 16 - Resecuritised Positions Exposure Credit Quality Steps

2015

Credit Quality Step	Risk Weight	S & P rating	Fitch rating	Moody's rating	Exposure values £m
1	40%	AAA to AA-	AAA to AA-	Aaa to Aa3	-
2	100%	A+ to A-	A+ to A-	A1 to A3	-
3	225%	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	9.0
4	650%	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	-
5	Deducted	B+ and below	B+ and below	B1 and below	-
Total					**9.0**

Table 16 - Securitised Positions Exposure Credit Quality Steps

2014

Credit Quality Step	Risk Weight	S&P rating	Fitch rating	Moody's rating	Exposure values £m
1	20%	AAA to AA-	AAA to AA-	Aaa to Aa3	56.1
2	50%	A+ to A-	A+ to A-	A1 to A3	25.2
3	100%	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	-
4	350%	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	-
5	Deducted	B+ and below	B+ and below	B1 and below	27.4
Total					**108.7**

Table 16 - Resecuritised Positions Exposure Credit Quality Steps

2014

Credit Quality Step	Risk Weight	S & P rating	Fitch rating	Moody's rating	Exposure values £m
1	40%	AAA to AA-	AAA to AA-	Aaa to Aa3	7.8
2	100%	A+ to A-	A+ to A-	A1 to A3	-
3	225%	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	-
4	650%	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	17.0
5	Deducted	B+ and below	B+ and below	B1 and below	-
Total					**24.8**

4.4 Impairment Provisions

4.4.1 Loans Secured by Mortgages on Immovable Property

Further details of the Group's accounting policy for impairment losses on loans and advances to customers is given in Note 1 of the Annual Report and Accounts.

The following table shows the past due loans and provisions for impaired exposures (equivalent to value adjustments) and charges to the Income Statement for the year ended 31 December 2015. Please note that the figures below show the customer balances used for provisioning as opposed to capital exposure values (which include potential exposures due to undrawn facilities and pipeline business that do not appear on balance sheet) and therefore do not match the totals in capital exposure tables above.

Table 17 - Loans secured on immovable property (£m) Exposures not subject to fair value	Total 2015	Total 2014
Neither past due nor individually impaired	**27,449.2**	**25,303.3**
Past Due		
Up to 3 months	553.7	656.2
3 to 6 months	101.3	126.4
6 to 12 months	48.2	59.6
Over 12 months	16.3	23.7
Possessions	10.2	19.2
Total past due	**729.7**	**885.1**
Total exposures	**28,178.9**	**26,188.4**
Provisions	**45.9**	**43.3**
Charge for the year	**12.8**	**20.2**
Fair Value Held	**-**	**-**

Table 17 - Loans secured on immovable property (£m) Exposures subject to fair value	Total 2015	Total 2014
Neither past due nor individually impaired	**4,840.9**	**5,591.8**
Past Due		
Up to 3 months	340.3	441.6
3 to 6 months	70.2	84.6
6 to 12 months	27.9	32.4
Over 12 months	9.3	11.8
Possessions	18.2	23.3
Total past due	**465.9**	**593.7**
Total exposures	**5,306.8**	**6,185.5**
Provisions	**0.1**	**3.0**
Credit for the year	**(2.8)**	**(4.3)**
Fair Value Held	**58.7**	**68.7**

Table 17 - Loans secured on immovable property (£m) All exposures	Total 2015	Total 2014
Neither past due nor individually impaired	**32,290.1**	**30,895.1**
Past Due		
Up to 3 months	894.0	1,097.8
3 to 6 months	171.5	211.0
6 to 12 months	76.1	92.0
Over 12 months	25.6	35.5
Possessions	28.4	42.5
Total past due	**1,195.6**	**1,478.8**
Total exposures	**33,485.7**	**32,373.9**
Provisions	**46.0**	**46.3**
Charge for the year	**10.0**	**15.9**
Fair Value Held	**58.7**	**68.7**

Impairment is assessed based on the arrears of each loan. Where mortgages are in arrears by 2 months or more, they are individually assessed for impairment. All mortgages that are past due but not impaired are less than two months in arrears. Where retail or commercial mortgages are less than two months in arrears they are assessed for collective impairment, unless individual impairment triggers exist on any of these loans.

The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due. The assets acquired during the mergers with the Chelsea Building Society and N&P Building Society in 2010 and 2011 respectively were subject to a number of significant adjustments to reflect their "fair value" rather than the value at which they were recorded in Chelsea or N&P's own records; i.e. as if they had been acquired, individually, by YBS in standalone transactions. This included an adjustment to reflect the amount that the Group expects to lose, at any point in the future, through borrower defaults. This approach is different to that for the existing mortgage assets where only currently impaired loans can be taken into account for impairment provisions. The effect is, provided the estimate of future losses is accurate, that any future losses on these assets will not be reflected in the Income Statement – it is equivalent to bringing forward future loan loss provisions charges to the effective merger date. These are illustrated in the table showing 'Exposures subject to Fair Value'

Further information on the movement during the year in impairment provisions is provided in Note 9 to the Annual Report and Accounts.

The Group uses forbearance tools where they are deemed appropriate for an individual customer's circumstances, and are used in line with industry guidance. Forbearance tools which the Group may offer include capitalisation, interest only concessions, arrears arrangements, direct debit suspension and term extensions. The use of account management tools are either fully recognised within provisioning or are low in materiality. Further detail of Forbearance can be found in Note 39 in the Group's Annual Report & Accounts.

4.4.2 Wholesale

Details of accounting policies for impairment losses on debt instruments can be found in Note 1 to the Annual Report and Accounts.

At the statement of financial position date, the Group had an impairment provision of £6.0m on wholesale investments relating to individually assessed CDOs, as shown in Note 15 to the Group's Annual Report and Accounts.

4.4.3 Other

At the statement of financial position date, the Group had an impairment provision of £4.0m on joint venture investments, as shown in Note 41 to the Group's Annual Report and Accounts.

4.5 Credit Risk Concentrations

As a UK residential mortgage lender, the Group is inevitably concentrated in this market. Within this overall concentration however, the Group has put in place controls to mitigate undue concentration risk. Further detail of concentrations can be found in the Risk Management Report and Note 39 in the Group's Annual Report & Accounts.

4.6 Credit Risk Mitigation

The Group uses a range of techniques to manage the credit risk of its retail, commercial and wholesale lending. The most critical of these is performing an assessment of the ability of a borrower to service the proposed level of borrowing without distress. However, the risk is further mitigated by obtaining collateral for the funds advanced.

4.6.1 Loans Secured by Mortgages on Immovable Property

Loans to Individuals

Residential property is the Group's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolios. All current mortgage lending activities are supported by an appropriate form of valuation using either an independent firm of valuers (except low LTV re-mortgage cases valued without independent valuation) or indexed valuation for further advances. All residential property must be insured to cover property risks, which may be through a third party. Additional protection is also available to borrowers through optional payment protection insurance.

Commercial Lending

The Group also lends to commercial parties through the N&P brand. All commercial loans are secured by a first charge over a commercial or semi-commercial property and are valued by a panel approved valuer. The property must be insured in line with the amount recommended by the valuer. Where the Group lends to a limited company, a guarantee is obtained from the directors of that company.

The Group also actively lends to housing associations ('Registered Providers'), via the YBS brand. All of these loans are secured on a portfolio of completed residential properties and are valued by a panel valuer.

4.6.2 Wholesale

Collateral held as security for wholesale assets is determined by the nature of the instrument. Loans, debt securities, treasury and other eligible bills are generally unsecured with the exception of securitisation positions and similar instruments, which are secured by pools of financial assets.

The Group's legal documentation with its counterparties for derivative transactions grants legal rights of setoff for those transactions. Accordingly, for credit exposure purposes, negative market values on derivatives will offset positive market values on derivatives with the same counterparty in the calculation of credit risk, subject to a minimum absolute exposure of zero by counterparty.

International Swaps and Derivatives Association (ISDA) documentation confers the ability to use designated cash collateral to set against derivative credit exposures in the event of counterparty default. Frequent rebalancing of the collateral requirements reduces the potential increase in future credit exposure. For such collateralised exposures, the posting of collateral reduces the impact of the current market value to the difference between the market value of the derivatives and the value of the collateral. This difference is limited by the operational use of "thresholds" and "minimum transfer amounts", which set criteria to avoid the movement of small amounts of collateral.

Credit risk is further mitigated by the use of central counterparties (CCPs). A CCP is a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, where a single bilateral contract between the buyer and seller is replaced with two contracts, one between the buyer and CCP and one between the seller and CCP. In late 2015 the Group has settled eligible derivatives using central counterparties.

4.7 Counterparty Credit Risk for Derivative Contracts

The Group uses derivative instruments to hedge interest rate risk, foreign currency risk or other factors of a prescribed description arising from fixed rate mortgage lending and savings products, funding and investment activities. Derivatives are only used by the Group in accordance with the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes. Counterparty credit risk in the context of this disclosure is the risk that a counterparty to a derivative instrument could default before the final settlement of the transaction's cash flows.

As described in section 4.6.2, risk is mitigated by offsetting the amounts due to the same counterparties (“Netting benefits”) and by cash deposited by the counterparties (“Collateral held”). The following table shows the exposures to counterparty credit risk for derivative contracts at 31 December 2015. Where derivative transactions meet eligibility for clearing at CCP, counterparty credit risk is replaced by an exposure against the CCP.

Table 18 - Counterparty Credit Risk for Derivative Contracts		
£m	**2015**	**2014**
Interest rate contracts	3,215.2	3,451.6
Foreign exchange contracts	2,272.8	1,487.8
Other contracts	278.5	295.8
Gross positive fair value of contracts	**5,766.5**	**5,235.2**
Netting benefits	(5,354.3)	(4,803.7)
Netted current credit exposure	**412.2**	**431.5**
Collateral held	(299.7)	(318.4)
Net derivatives credit exposure	**112.5**	**113.1**
Add on for potential future exposure	160.5	118.5
Total derivatives exposure	**273.0**	**231.6**

The ‘other contracts’ element mainly reflects funds provided to counterparties as collateral and the collateral held incorporates the positions that mitigate this exposure.

The net derivatives credit exposure represents the credit exposure to derivative transactions after taking account of legally enforceable netting agreements and collateral arrangements. The total derivatives exposure includes uplifts for potential future exposure under the mark to market method for assessing counterparty credit risk.

Wrong way risk can occur if exposures to a counterparty are negatively correlated to the creditworthiness of that counterparty. As such, there is potential for the exposure to increase as the creditworthiness decreases. Should such a risk arise, this would be taken into account as part of the counterparty review process which allows management to assess what, if any, appropriate mitigating actions are required. Additionally, the Group mitigates wrong way risk by ensuring that exposures on derivatives are managed via Credit Support Annex (CSA) agreements which are regularly re-margined.

5 Significant Risk Categories - Operational Risk

5.1 Operational Risk Overview

The Group has adopted the standardised approach to operational risk and has defined operational risk as: "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems, and from external events".

This means that for the calculation of minimum capital requirements, the Group calculates its average annual income from prescribed business lines over the past three years. Capital is then held to support operational risk for each business line at prescribed rates from 12% to 18% of its average annual relevant income.

Qualitative requirements for the standardised approach to operational risk have been adopted including:-

- Board and Senior Management oversight of the operational risk management framework.
- Board approved Group wide operational risk management framework and policies in place with framework components including risk identification and assessment activities, control self-assessment, key risk indicators monitoring and loss reporting with oversight and validation activities undertaken as required.
- Upgrade to three lines of defence approach for Operational Risk management being planned.
- Stress testing activities undertaken to define the level of capital required to recover from a 1 in 200 year event.
- Board, committee and Senior Management levels reporting on Enterprise and Operational risks with appropriate actions taken as required.

5.2 Operational Risk Framework

Underpinning the Group's approach to operational risk measurement and management is the enterprise-wide risk map. This covers all key risks to which the Group is exposed, including key operational risks, and therefore incorporates the operational risk framework. Each key risk identified is assigned to a risk owner, all of whom are Chief Officers. As described in the Risk Management Report in the Annual Report and Accounts, the Group is moving towards a 'three lines of defence' model. It is the responsibility of the first-line business functions to manage risks to the operation of the business, with facilitation, coaching and challenge from the second line (Group Risk).

5.3 Operational Risk Oversight and Governance

Oversight and governance arrangements for the setting and management of a robust operational risk management policy and framework are the responsibility of the Board, Group Risk Committee and the Group Operational and Regulatory Risk Committee (GORRC). Each committee has a defined Terms of Reference allocating their accountability and responsibilities.

5.4 Operational Risk Monitoring and Reporting

In support of the enterprise-wide risk map, the Group has in place a risk dashboard supporting each key risk, including operational risks. These risk dashboards integrate all the available information about a risk, and summarise the status of the risk, identifying:

- Whether a key risk may be changing.
- Whether the operational environment is under stress, stable or improving.
- Whether key controls relied on to mitigate the risks are operating effectively.

Operational risk assessments and operational risk management information are reported to the Board via the monthly Board risk report. In addition, there is an operational risk update to the Group Risk Committee every quarter, including a review of the enterprise-wide risk map.

A detailed information pack is provided to the GORRC on a monthly basis to help it fulfil its role of overseeing operational and compliance risks (including conduct risk, i.e. the risk of not delivering fair customer outcomes).

6 Other Significant Risks - Pillar 2

6.1 Pillar 2 Overview

As noted in section 3.2, the Group undergoes its ICAAP at least annually in line with Pillar 2 requirements. The outcome of the ICAAP is presented within an Internal Capital Assessment document (ICA). The Group was subject to the PRA's Supervisory Review and Evaluation Process (SREP) in 2015 and has recently been set an updated Individual Capital Guidance (ICG) by the PRA.

The process is led by the Strategy and Insight department, but involves a wide range of personnel from across the Group, including Chief Officers. The ICA, including underlying individual risk assessments for material risk categories, is reviewed by Chief Officers, executive committees, the Group Risk Committee and the Board.

The purpose of the process is to identify the key risks to which the Group is exposed, the levels of capital and other financial resources that should be held to meet the Group's regulatory requirements during a period of severe stress and the extent to which minimum Pillar 1 requirements do not satisfy the findings of the ICA.

The ICA is prepared at a Group level, and currently identifies the following key risk categories:

- Retail Credit Risk (to individuals secured on immovable property).[1]
- Wholesale Credit Risk. [1]
- Interest Rate & Market Risk.
- Pension Risk.
- Operational, Fraud & Conduct Risk.[1]
- Concentration Risk.
- Commercial Credit Risk.[1]
- Banking Risk.[1]
- Structured Credit Risk.[1]
- Business Risk.

In the case of risk categories that have Pillar 1 capital requirements, stress testing is performed on the exposures to determine whether capital is required over and above the Pillar 1 amounts held. For other risks, stress testing determines the level of Pillar 2 capital required to protect against the risk in a severe stress scenario. See below for further details.

Additional capital is required to be held in the form of the "Capital Planning Buffer" which is the result of a stress test that assesses the capital impact of a "severe but plausible" economic downturn on the Group's strategic plan. Further consideration is provided below within the "Capital Planning Stress Test" section.

[1] These risks are Pillar 1 risks that are considered in detail within Sections 4 and 5 of this document

6.2 Interest Rate Risk

Interest rate risk relates to the impact of re-pricing of assets and liabilities through interest rate movements. Details of interest rate risk can be found in Note 36 to the Group's Annual Report and Accounts; a description of risk appetite and governance can be found in the Risk Management Report of the Annual Report and Accounts.

For assessment of capital requirements, the Group models its interest rate exposure in four areas: repricing risk, prepayment risk, pipeline risk and basis risk. This stress testing involves the consideration of a range of upward or downward rate shocks and forms part of the ICAAP.

6.3 Pension Risk

The Group's defined benefit pension scheme closed to future accrual on 31 December 2015. As the link to final salary was maintained and the liabilities remained unchanged, this has not resulted in a curtailment over 2015.

The risk of the Group's defined benefit pension obligations has been modelled, with the help of external actuaries, by identifying the key factors likely to affect future obligations to fund the existing liabilities, namely:

- Interest rates (the AA corporate bond yield).
- Implied inflation rates.
- Life expectancy assumptions.
- Asset values

The Group has taken these assumptions and stressed them severely to assess the quantity of Pillar 2 capital requirement for pension obligation risk. Details of the Group's pension obligations can be found in Note 26 of the Group's Annual Report and Accounts.

6.4 Concentration Risk

The Group routinely considers concentrations in products, geographies, channels, income streams and funding sources as part of its strategic planning and has stress tested any such concentrations as part of the ICAAP. A degree of concentration risk is inevitable given the Group's focus in the UK residential mortgage market.

6.5 Business Risk

Consideration is given to the risk that the Group is unable to pursue its short term business plan or longer term strategy. This includes the impact of shifts in the economic, market or regulatory environment that could fundamentally impact on the Group's key Income Statement and Balance Sheet metrics. It can include, for example, the impact of credit ratings downgrades on the Group's ability to raise funding at planned levels and cost.

6.6 Capital Planning Stress Test

A Capital Planning Buffer has been generated from the results of the Capital Planning Stress Test. This stress test is defined and articulated with the assistance of key business experts and is set at a severity level that is consistent with the PRA's "severe but plausible" requirement.

The test calculates the impact to both capital requirements and resources across the strategic planning period. Based upon the results (after management actions are considered), an additional amount of capital is held above the proposed regulatory minimum. This Capital Planning Buffer can, in extreme times of stress, be utilised without breaching the regulatory minimum.

6.7 Other Risks

After detailed stress testing, no other risks were considered material from a capital perspective as part of the most recent ICAAP submission.

7 Remuneration

The Pillar 3 disclosures on remuneration are contained in various sections of the Annual Report and Accounts, including the Corporate Governance Report, the Directors' Remuneration Report, the Directors' and Chief Officers' Profiles and the Annual Business Statement.

Glossary of Terms

Basel II Framework / Basel II	The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. The Accord is structured around Pillars 1, 2 & 3, became law in the EU Capital Requirements Directive, and was implemented in the UK in the FSA/PRA Handbook. This framework was in place until 31 December 2013 and all disclosures (with the exception of specific Basel III comparisons in section 3.12) are under the Basel II basis.
Basel III Framework / Basel III	The Basel Committee on Banking Supervision's updated framework on capital adequacy; this came in to force in Europe on 1 January 2014 through the 'CRD IV' legislation.
BIPRU	The Prudential Sourcebook for banks, building societies and investment firms which forms part of the PRA Handbook for Basel II. This has been superseded by CRD IV.
Common Equity Tier 1 (CET1) capital	The highest quality regulatory capital resources, comprising of retained earnings less regulatory adjustments, as defined under CRD IV. Equivalent to Core Tier 1 defined under previous CRD legislation.
Common Equity Tier 1 capital ratio	The ratio of Common Equity Tier 1 Capital to Risk Weighted Assets.
Counterparty Credit Risk	Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.
CQS (Credit Quality Steps)	A credit quality assessment scale as set out in CRD IV.
CRD IV	A package of legislation incorporating a Regulation and a Directive that implements the Basel III framework in Europe.
Credit risk	The risk of financial loss arising from a failure of a customer or counterparty to settle their financial and contractual obligations as they fall due.
Credit risk mitigation	Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.
ECAI	External Credit Assessment Institution. An ECAI (e.g. Moody's, Standard and Poor's, Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.
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.
Financial Conduct Authority (FCA)	The UK conduct regulator which is responsible for regulation of conduct in retail, as well as wholesale, financial markets and the infrastructure that supports those markets. The FCA's objective is to protect consumers, promote competition and enhance market integrity.
Guarantee	An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.
ICA	Internal Capital Assessment – the document produced as a result of the ICAAP.
ICAAP	The Group's internal assessment of the levels of capital that need to be held by the Society to meet its regulatory capital requirements.
ICG	Individual Capital Guidance. The minimum amount of capital the Group should hold as set by the PRA under Basel II Pillar 2.
ILAA	Individual Liquidity Adequacy Assessment. The Group's internal assessment of the levels of liquidity that need to be held by the Group to meet its regulatory liquidity requirements.
Interest rate risk	Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates.
Impaired loans	Loans where there is evidence to suggest a measurable decrease in the present value of cash flows expected which has occurred after initial recognition of the asset, but before the statement of financial position date.
Individually impaired loans	Where retail or commercial mortgages are in arrears by two months or more, they are individually assessed for impairment. Commercial loans less than two months in arrears are also individually impaired where other factors suggest a measurable decrease in the present value of their future cash flows.
IRB	Internal Ratings Based Approach to calculating capital requirements where lenders use their own models of risk to determine the appropriate minimum capital requirement.
ISDA	International Swaps and Derivatives Association is the global trade association for over-the-counter (OTC) derivatives, and providers of the industry-standard ISDA documentation.

Glossary of Terms continued…

Loan-to-value ratio (LTV)	A ratio showing outstanding loan balance as a percentage of the value of the security.
Maturity	The remaining time in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, interest and fees) under the terms of a loan agreement.
Minimum Capital Requirement	The minimum amount of regulatory capital that a financial institution must hold to meet the Pillar 1 requirements for credit and operational risk.
Netting	The ability to reduce credit risk exposures by offsetting the value of any deposits against loans to the same counterparty.
Operational risk	The risk of direct and indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
Past due	Loans which have missed their monthly repayment amount.
PIBS	Permanent Interest Bearing Shares. Unsecured, sterling denominated Tier 1 capital instruments repayable at the option of the Society.
Pillar 1	The part of the Basel II Framework which sets out the regulatory minimum capital requirements for credit and operational risk.
Pillar 2	The part of the Basel II Framework which sets out the processes by which financial institutions review their overall capital adequacy. Supervisors then evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments. This includes all risks (including Pillar 1 risks) – ICG is an outcome from Pillar 2.
Pillar 3	The part of the Basel II Framework which sets out the disclosure requirements for firms to publish details of their risks, capital and risk management. The aims are greater transparency and strengthening market discipline.
Prudential Regulation Authority (PRA)	The UK prudential regulator, which is a part of the Bank of England and alongside the FCA has responsibility for the oversight of building societies, banks and insurers. The PRA's objective is to promote the safety and soundness of regulated firms.
Provisions	Amounts set aside to cover incurred losses associated with credit risks.
Resecuritisation	A securitisation transaction or scheme that includes at least one securitisation within its underlying asset pool.
RWA	Risk weighted assets. A regulatory measure that adjusts the value of assets to reflect their level of risk when calculating capital requirements.
Securitisation	A transaction or scheme where assets are sold to a Special Purpose Vehicle (SPV) in return for immediate cash payment. That vehicle raises the immediate cash payment by issuing debt securities in the form of tradable notes or commercial paper to wholesale investors who receive an income from the underlying assets. Some risk is retained on the balance sheet while the remaining risk is transferred to investors. Securitisations may be purchased or retained.
SREP	Supervisory Review and Evaluation Process, the PRA assessment of a firm's own capital assessment (ICA) under Basel II Pillar 2.
Stress testing	Various techniques that are used to gauge the potential vulnerability to exceptional but plausible events.
Subordinated debt	Tier 2 capital that is subordinated to the claims of all depositors, creditors and members holding shares in the Society (other than holders of PIBS).
The Standardised Approach (credit risks)	The standardised approach to credit risk, calculated by applying varying RWA percentages to credit exposures, depending on the underlying risk.
The Standardised Approach (operational risks)	The standardised approach to operational risk, calculated using three-year historical net income multiplied by a factor of between 12-18%, depending on the underlying business being considered.
Tier 1 (T1) capital	The sum total of Common Equity Tier 1 and Additional Tier 1 capital.
Tier 1 capital ratio	The ratio of Tier 1 capital to Risk Weighted Assets.
Tier 2 (T2) capital	A measure of regulatory capital that includes subordinated liabilities and provisions for collective impairment, less regulatory adjustments.
Total capital ratio	The ratio of total capital to Risk Weighted Assets.

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