Basel II Pillar 3 Disclosures 2012

PRINCIPALITY
BUILDING SOCIETY

Contents

1. Overview

1.1 Background

The European Union Capital Requirements Directive came into effect on 1 January 2007. It introduced consistent capital adequacy standards and an associated supervisory framework in the European Union based on the BASEL II rules agreed by the G-10.

Implementation of the Directive in the UK was by way of rules introduced by the Financial Services Authority (the FSA). Among them are disclosure requirements applicable to banks and building societies which are known as Pillar 3. These are designed to promote market discipline by providing market participants with key information on a firm's risk exposures and risk management processes. Pillar 3 also aims to complement the minimum capital requirements described under Pillar 1 of BASEL II, as well as the supervisory review processes of Pillar 2.

Principality Building Society (the Society) adopted the Pillar 1 standardised approach to credit risk and operational risk from 1 January 2008; it also became subject to Pillars 2 and 3 from that date. The disclosures in this document are on a standardised basis and in accordance with the rules laid out in the FSA Handbook BIPRU Chapter 11.

The Group is in the process of applying to the FSA for permission to use an Internal Ratings Based (IRB) approach to retail credit risk and capital management. This will allow the Group to use its own estimates of risk, rather than values prescribed by the FSA, after certain conditions have been satisfied, and will further enhance the Group's risk management processes.

1.2 Basis and Frequency of Disclosures

Disclosures will be issued at least annually based on the most recent published Annual Report and Accounts. Unless otherwise stated, all figures are as at 31 December 2012, the Society's financial year end.

1.3 Scope of Application

The Society is regulated by the FSA and the BASEL II Framework therefore applies to the Society and its subsidiary undertakings (the Group). The Group is made up of the following main trading entities:

Principality Building Society
Nemo Personal Finance Limited
Peter Alan Limited

Full details of the principal subsidiary undertakings are included in note 23 to the Annual Report and Accounts for the year ended 31 December 2012.

There is a requirement to calculate and maintain regulatory capital ratios on both a Group basis and on a 'solo consolidation' basis. However, there are no significant differences between the Group and solo consolidation figures. Therefore, this document includes only the Group analysis.

There are no differences in the basis of consolidation for accounting and regulatory capital purposes. Full details of the basis of consolidation can be found in note 1 to the Annual Report and Accounts for the year ended 31 December 2012.

1.4 External Audit

These disclosures are not subject to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Group's audited Annual Report and Financial Statements.

2. Risk Management Objectives and Policies

2.1 Principal Risk Categories

The Group is primarily a producer and retailer of financial products, mainly in the form of mortgages, secured loans and savings. These products give rise to a financial asset or liability and are termed financial instruments. As well as mortgages, secured loans and savings, the Group also uses wholesale financial instruments to invest liquid asset balances, raise wholesale funding and to manage the interest rate risk arising from its operations.

The Group's principal business objective is to provide Members with the benefits of a mutual organisation through the design, manufacture and delivery of attractive savings and mortgage products. The key risks to which the Group is exposed include strategic risk (including reputational risk), credit risk, liquidity risk, market risk, conduct risk, operational risk and pension obligation risk. As a mutual, the Group maintains a relatively low risk appetite.

The ways in which the Group manages these risks include:

- Setting and maintaining a Board approved Statement of Risk Appetite;
- Using models and output from those models to help guide business strategies;
- Producing key risk information and indicators to measure and monitor performance;
- Using Management and Board Committees to monitor and control specific risks; and
- Using limits, and triggers to control portfolio composition.

Primary responsibility for the identification, control and mitigation of risk rests with each business unit. Oversight and governance are provided through specialist support functions including Group Risk, Group Finance and Group Business Conduct. The role of these functional specialists is to maintain and review policies, establish limits and qualitative standards which are consistent with the Group's risk appetite, monitor and report on compliance with those limits and standards, and generally to provide an oversight role in relation to the management of risk.

Credit risk

Credit risk is the potential risk that a customer or counterparty will fail to meet its financial obligations to the Group as they become due.

Credit risk arises primarily from loans to residential customers, loans to commercial customers and from the assets held by Group Treasury in order to meet liquidity requirements and for general business purposes.

The controlled management of credit risk is critical to the success of the Group's lending strategy and investment portfolio management. The quality of individual lending decisions, subsequent management and control, together with the application of a credit policy that reflects the risk appetite of the business, has a direct impact on the achievement of the financial objectives of the Group.

Each business area, residential first and second charge lending, commercial lending and treasury has its own individual Credit Risk Policy Statement setting out its risk appetite which includes policy scope, structures and responsibilities, definitions of risk and risk measurement and approach to monitoring. In addition, each business area has its own detailed Procedure Manual setting out operating rules and standards.

Day-to-day management of credit risk is undertaken by specialist teams working in each business area using credit risk management techniques adopted as part of the Group's overall approach to the measurement, mitigation and management of credit risk in a manner consistent with the risk appetite approved by the Group Risk Committee (GRC) and Board. Credit risk portfolios are subject to regular stress testing to simulate outcomes and assess the potential impact on capital requirements.

Market risk

Market risk is the risk that the value of, or income arising from the Group's assets and liabilities changes as a result of changes in market prices, the principal elements being interest rate risk including the use of derivatives, and foreign currency risk.

The Group Treasury Department is responsible for managing the Group's exposure to all aspects of market risk within the operational limits set out in the Group's Treasury Policies. Oversight is provided by the Treasury Committee, Asset and Liability Committee (ALCO), Group Management Committee (GMC) and GRC which receive regular reports on all aspects of market risk including interest rate risk and foreign currency risk. Reporting lines and terms of reference are set out clearly by the Board which also receives monthly reports from the Group Finance Director covering significant issues dealt with by ALCO.

The Group is exposed to interest rate risk, principally arising from the provision of fixed rate lending and savings products. The various features and maturity profiles for these products, and the use of wholesale funds to support their delivery, create interest rate risk exposures due to the imperfect matching of interest rates between different financial instruments and the timing differences on the re-pricing of assets and liabilities.

Another significant form of interest rate risk arises from the imperfect correlation between re-pricing of interest rates on different assets and liabilities, often referred to as basis risk. The basis risk on the Group's statement of financial position arises from administered rate liabilities, the pricing of which is influenced by competition for retail funds and which are used to fund mortgages and other assets priced relative to the Bank of England base rate albeit for relatively short durations.

Liquidity risk

Liquidity risk is the risk that the Group is not able to meet its financial obligations as they fall due, or can do so only at excessive cost. The objective of the Group's liquidity policy is to maintain sufficient liquid assets at all times to cover cash flow imbalances and fluctuations in funding, to maintain full public confidence in the Group and to ensure all financial obligations are met.

The day-to-day management of liquidity is the responsibility of the Group Treasury Department, which oversees the Group's portfolio of liquid assets and wholesale funding facilities.

ALCO exercises control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving regular reports on current and projected liquidity positions including the impact of stress testing.

The Group conducts an Individual Liquidity Adequacy Assessment (ILAA) at least annually. This is used to assess the Group's liquidity adequacy and determine the levels of liquid assets required to support the current and future liquidity risks in the Group. The most recent ILAA was approved by the Board in December 2012. The Group's ILAA includes stress tests that consider a range of severe scenarios and their impact on the Group, particularly with respect to retail saving outflows. The ILAA concludes that the Group's liquidity reserves are adequate to sustain the Group over an extended severe stress during which contingent actions aimed at stabilising the situation would be deployed.

Conduct Risk

Conduct risk is the risk of the Group treating its retail customers unfairly and delivering inappropriate outcomes.

The sustainability of the Group's business model, and achievement of its longer term strategy are dependent upon the consistent and fair treatment of customers. The FSA's move towards a 'twin peaks' regime reflects the increasing regulatory scrutiny of the measures adopted by firms in relation to business conduct and has been mirrored by the Society's approach towards the governance of conduct risk. The Group's newly established Customer and Conduct Committee forms part of the overall governance and control framework and is responsible for ensuring adherence to the risk strategy and the conduct risk appetite statement.

Operational risk

Operational risk is the risk of a loss arising from inadequate or failed internal processes or systems, human error or external events. It also includes IT and Legal and Compliance risk.

The Group's operational risk management framework sets out the strategy for identifying, assessing and managing operational risk with senior management having responsibility for understanding the nature and extent of the impacts on each business areas and for embedding the appropriate controls to mitigate those risks.

The framework is reviewed periodically to take account of changes in business profile, new product development and the external operating environment. Oversight is provided by the Group Operational Risk Committee.

Reputational Risk

This is the risk of loss through damage to the Group's reputation caused by the crystallisation of other risk factors such as regulatory censure, brand contamination, market pricing etc.

The Group's comprehensive risk management framework provides for the management of the key risks which may lead to damage to the Group's reputation.

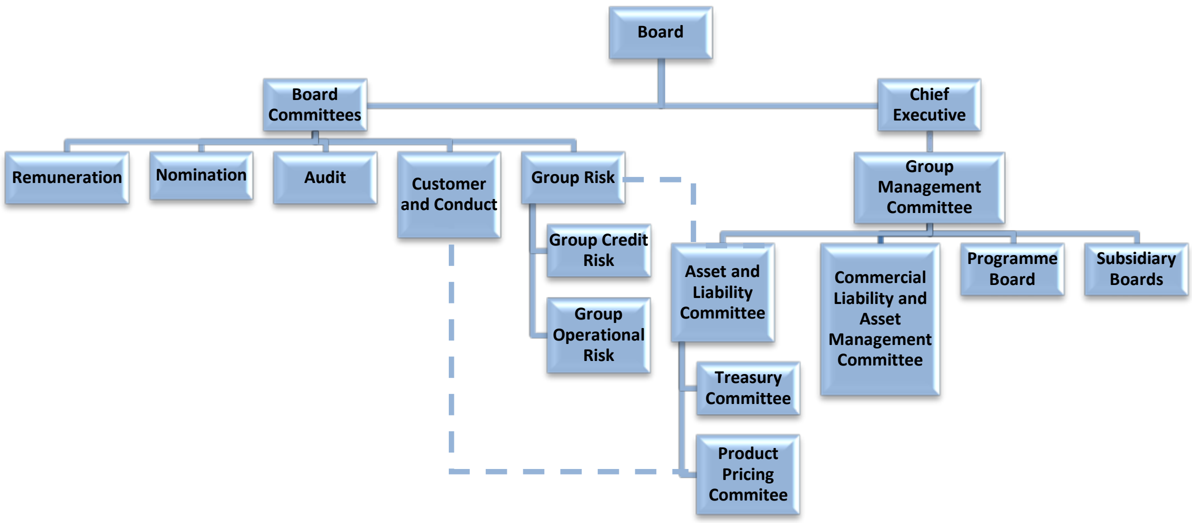
Pension obligation risk

The Group has funding obligations for a defined benefit scheme which is closed to new entrants. It was closed to future accrual on 31 July 2010. Pension risk is the risk that the value of the Fund's assets, together with ongoing employers and member contributions, will be insufficient to cover the projected obligations of the Fund over time. The return on assets, which includes equities and bonds, will vary with movements in equity prices and interest rates. The projection of the Fund's obligations includes estimates of mortality, inflation and future salary rises, the actual out-turn of which may differ from the estimates. The fund is also exposed to possible changes in pension legislation.

To mitigate these risks, management, together with the Trustees of the Fund, regularly review reports prepared by the Fund's independent actuaries and takes appropriate actions which may, for example, include adjusting the investment strategy and/or contribution levels. In September 2012 the Society purchased an annuity 'buy-in' arrangement for pensioners currently in payment in order to mitigate future uncertainty regarding ongoing costs and liabilities associated with its closed defined benefit pension scheme. Further information on the buy-in can be found in note 12 to the 2012 Annual Report and Accounts.

2.2 Risk Governance

The responsibility for the overall framework of risk governance and management lies with the Board of Directors. The Board is responsible for determining risk strategy, setting the Group's risk appetite and ensuring that risk is monitored and controlled effectively. It is also responsible for establishing a clearly defined risk management structure with distinct roles and responsibilities. Within that structure, line managers are responsible for the identification, measurement and management of the risks within their areas of responsibility.



The current terms of reference of the Group's Board committees are published on the Society's website. The following summaries have been extracted from committee terms of reference as at December 2012.

2.2.1 Board Committees

The Board focuses on strategic issues, control of the business, review of operational and management performance, oversight of subsidiary companies and maintaining a system of effective corporate governance. The Board operates through its regular meetings and five committees – Remuneration, Nomination, Audit, Customer and Conduct, and Group Risk Committees.

Remuneration Committee

The principal responsibilities of the Remuneration Committee include ensuring that remuneration policy of the Group is consistent with regulatory requirements, the Group's financial situation and future prospects, taking account of current and future risk as appropriate, the approval of the terms of the annual pay review for Group management and staff, the approval of the level of remuneration for the executive directors of the Society and managing directors of subsidiary companies together with determining and agreeing with the Board the framework and policy for the remuneration of those individuals. The Committee is appointed by the Board from amongst the non-executive directors, and comprises not less than three members.

Nomination Committee

The Nomination Committee assists the Board in the appointment of non-executive directors, and is responsible for making recommendations for the appointment of the Chief Executive and other executive directors. The Committee is appointed by the Board from amongst the non-executive directors and comprises not less than three members.

Audit Committee

The Audit Committee assists the Board through monitoring the integrity of the financial statements and formal announcements relating to the Group's financial performance and reviews relevant accounting policies and any significant financial judgements they contain. The Committee also reviews the effectiveness of the Group's systems and controls framework (including risk management and compliance with financial services legislation and regulations), and monitors progress to ensure that any required remedial action has been or is being taken in respect of any identified weaknesses. The Committee is appointed by the Board from amongst the non-executive directors and comprises not less than three members.

Customer and Conduct Committee

The Customer and Conduct Committee is chaired by a non-executive director. Membership includes two further non-executive directors and the Group Chief Executive.

The Committee is responsible for ensuring that an effective Business Conduct Strategy is developed, embedded and maintained across the Group, ensuring that the needs of its customers are central to the Group's operations and ensuring that a clear, customer focussed culture is established. This culture needs to be embedded and maintained across the Group and supported through an appropriate education and awareness programme at all levels.

This Committee is also responsible for defining, assessing and setting the standards leading to fair outcomes for customers across the Group and ensuring that the level of exposure to business conduct risks are managed within the framework of limits and triggers established to support the Business Conduct Appetite Statement.

Group Risk Committee

The Group Risk Committee (GRC) is chaired by a non-executive director. The membership includes one further non-executive director, the Group Chief Executive, the Group Finance Director, the Group Secretary, the joint Managing Director of Nemo Personal Finance Limited and the Director of Group Risk.

The Committee is responsible for considering and recommending the Group's risk appetite, capital and liquidity adequacy to the Board. It is responsible for maintaining an appropriate governance structure to ensure that risks across the Group are identified and managed effectively and for monitoring and reviewing internal and external risks including the assessment and quantification of all material prudential risks to support current and future estimation of regulatory capital requirements.

Group Credit Risk Committee

The Group Credit Risk Committee (GCRC) is a management committee, chaired by the Director of Group Risk. Membership includes the Group Finance Director, the Customer Director, the Head of Group Asset Management, the Director of Risk Commercial Lending, the Director of Marketing, the Commercial Director Nemo Personal Finance Limited, the Head of Risk Nemo Personal Finance Limited, the Head of Group Credit Risk, the Head of Member Services, the Director of Commercial Underwriting and the Head of Group Business Conduct.

The Committee is responsible for the management of the Group's Retail and Commercial credit risk in line with the Board approved Group Risk Appetite statement. The functions of the committee include review and approval of the Retail and Commercial credit risk policies together with the development of detailed limits and triggers for credit risks within the Group's overall risk appetite and for monitoring credit risk exposures. The Chairman of the Committee reports on the Committee's activities to the Group Risk Committee.

Group Operational Risk Committee

The Group Operational Risk Committee (GORC) is a management committee, chaired by the Director of Group Risk and membership includes a number of senior managers across the Group.

The Committee is responsible for the Operational Risk Framework and its implementation. The duties of the committee include the development and implementation of a robust operational risk framework and operational risk policies together with oversight of the key operational risk exposures facing the Group. The Chairman of the Committee reports on the Committee's activities to the Group Risk Committee.

2.2.2 Group Management Committee

The Group Management Committee (GMC) is the principal management committee of the Group. It is chaired by the Group Chief Executive and membership includes all the Executive Directors, the Customer Director, the Group Human Resources Director, the Director of Group Risk, the Deputy Group Finance Director, the Managing Director Principality Commercial, the Managing Director Nemo Personal Finance Limited, the Managing Director Peter Alan Limited and the Group Secretary. The functions of GMC are to agree strategy and policies for recommendation to the Board and agree new business initiatives and associated investment appraisal for submission to the Board for approval. This Committee is also responsible for overseeing strategy implementation, monitoring performance of the Society and its subsidiaries, and approving changes to interest rates for Society savings and mortgage accounts.

Asset and Liability Committee

The Asset and Liability Committee (ALCO) is chaired by the Group Finance Director and membership includes the Group Chief Executive, the Director of Group Risk, the Head of Capital and Liquidity Risk Management, the Deputy Group Finance Director, the Director of Marketing, the Customer Director and the Treasurer. Its functions include monitoring the interest rate characteristics of retail, commercial and wholesale assets and liabilities, ensuring that the Society's liquidity meets the statutory obligations and remains within limits approved by the Board, monitoring the credit risk of assets held for liquidity purposes and monitoring the performance of the funding and liquid asset portfolios. The minutes and actions are reviewed by the Board, GMC and Group Risk Committee.

Treasury Committee

The Treasury Committee is chaired by the Group Finance Director and membership includes the Director of Group Risk, the Deputy Group Finance Director, the Treasurer, the Head of Capital and Liquidity Risk Management, the Assistant Treasurer and the Money Market Dealer.

The Committee has delegated responsibility for monitoring the Group's Treasury Counterparty Credit Risk, Liquidity Risk and Interest Rate Risk in line with the Risk Appetite as set by the ALCO, Group Risk Committee and Board. The minutes and actions are also reviewed by ALCO.

Commercial Liability and Asset Management Committee

The Commercial Liability and Asset Management Committee (CLAMCO) is chaired by the Group Finance Director and membership includes a non-executive director, the Group Chief Executive, the Head of Finance Business Partnering, and senior management from the Commercial Lending Division. Its functions include monitoring the performance of the Society's commercial lending portfolio, reviewing new lending, high-risk and non-performing assets and provisioning requirements, review and approval of changes in connection with the level of Commercial Lending Base Rate and to review and makes recommendations to GCRC in connection with material amendments to procedures, policy, and documentation. The minutes and actions are also reviewed by EXCO and the Board.

Since December 2012 this committee has ceased to operate. The responsibilities of this committee have been transferred to a newly formed Property Committee which commenced in January 2013.

2.3 Remuneration

In compliance with the requirements set out in the FSA's Policy Statement PS10/21 'Implementing CRD3 requirements on the disclosure of remuneration' issued in December 2010, the following tables display the 2012 remuneration for the Group's managers and members of staff whose actions have a material impact on the risk profile of the Society (Code Staff). This includes executive and non-executive directors.

The Report of the Remuneration Committee contained within the 2012 Annual Report and Accounts contains the following:

- The decision making process used for determining the remuneration policy
- The link between pay and performance
- The most important remuneration design characteristics

Aggregate Group Remuneration, broken down by business area

Details of remuneration paid to all Group staff (including Code Staff) are as follows:

	Fixed remuneration £'k	Variable remuneration £'k	Total remuneration* £'k	Proportion of variable remuneration to total remuneration %	Number of beneficiaries
Retail financial services	21,898	1,960	23,858	8	833
Commercial lending	988	40	1,028	4	21
Secured personal lending	4,635	618	5,253	12	132
Property services	5,345	1,025	6,370	16	256
	32,866	**3,643**	**36,509**	**10**	**1,242**

Aggregate Code Staff remuneration data

Details of remuneration paid to Code Staff are as follows:

	Fixed remuneration £'k	Variable remuneration £'k	Total remuneration* £'k	Proportion of variable remuneration to total remuneration %	Number of beneficiaries
Group	2,739	1,008	3,747	27	21

* *Total remuneration = fixed remuneration, variable remuneration, director fees, car allowance, pension and benefits in kind.*

3. Capital Resources

3.1 Total Available Capital

As at 31 December 2012 and throughout the year, the Group complied with the capital requirements that were in force as set out by the FSA. The following table shows the breakdown of the total available capital for the Group as at 31 December 2012:

	Notes	2012 £m	2011 £m
Tier 1 Capital			
General reserve	1	337.0	324.8
Permanent Interest Bearing Shares (PIBS)	2	59.3	59.3
		396.3	**384.0**
Deductions from Tier 1 Capital			
Intangible assets	3	(2.6)	(2.5)
Total Tier 1 Capital		**393.7**	**381.5**
Tier 2 Capital			
Subordinated notes	4	64.6	96.3
Total Capital Resource		**458.3**	**477.8**

3.2 Notes and General Information on Capital Resources

1. The general reserve represents the Group's accumulated profits and the Group's pension scheme deficit less associated tax as per the regulatory capital rules.

2. Permanent interest bearings shares (PIBS) are unsecured deferred shares and rank behind the claims of all subordinated note holders, depositors, creditors and investing Members of the Society. Further details about PIBS are provided in note 36 to the 2012 Annual Report and Accounts.

   The Group has no innovative Tier 1 instruments.

3. Intangible assets include software development costs where they meet certain criteria. Intangible assets do not qualify as capital for regulatory purposes and therefore have been deducted from capital.

4. Subordinated notes are unsecured and rank behind the claims of all depositors, creditors and investing Members (other than holders of PIBS) of the Society. Under FSA rules, qualifying subordinated notes cannot exceed 50% of the total of Tier 1 capital, and Tier 2 capital cannot exceed Tier 1 capital. The subordinated notes, as a lower Tier 2 instrument, started amortising out of regulatory capital over five years from July 2011 under GENPRU 2.2.196.

   With the permission of the Financial Services Authority, in 2012 the Society repurchased £14.7m of subordinated liabilities at a discount. The Group has benefited from a one-off gain of £1.5m (2011: repurchase of £3.0m of subordinated liabilities with a gain of £1.0m).

   Further details of the subordinated notes are included in note 35 to the 2012 Annual Report and Accounts.

3.3 Reconciliation of Regulatory Capital

A reconciliation of total capital to regulatory capital is presented below:

	2012 £'m	2011 £'m
Total capital	**509.0**	**509.1**
Adjusted for:		
Other reserves not eligible for inclusion in regulatory capital	(3.4)	(2.0)
Intangibles	(2.6)	(2.5)
Fair value adjustments to subordinated liabilities	(17.0)	(16.1)
Amortisation adjustments to subordinated liabilities	(27.7)	(10.7)
Regulatory capital	**458.3**	**477.8**

4. Capital Adequacy

4.1 Capital Management

The Group has adopted the standardised approach to both credit and operational risk since 1 January 2008 in order to calculate the BASEL II Pillar 1 minimum capital requirement.

Pillar 1 capital adequacy is reviewed and approved monthly with capital forecasts formally reviewed and approved at least annually. Pillar 2 risks are considered at least quarterly with the exception of pension funding risk which is considered annually. Actual capital levels are considered monthly by ALCO.

The Group's minimum capital level is that which the Board considers necessary to protect unsecured creditors from loss and reflects the Group's planned activity as a whole, set in the competitive and economic environment in which it operates. The assessment of the minimum capital requirement is a combination of model outputs from its standardised systems, supplemented by the use of internal ratings systems and other risk models, together with judgement, exercised by the Board.

4.2 Internal Capital Adequacy Assessment Process

The Group conducts an Internal Capital Adequacy Assessment Process (ICAAP) at least annually. This is used to assess the Group's capital adequacy and determine the levels of capital required to support the current and future risks in the business. The ICAAP covers all material risks to determine the capital requirements over a five-year horizon and includes stress scenarios which are intended to meet regulatory requirements. The capital requirements are presented to the Board for approval with the most recent review being completed in December 2012. The ICAAP is used by the FSA to determine and set the Group's Individual Capital Guidance (ICG).

The amounts and composition of the Group's capital requirements are determined by assessing the Basel II Pillar 1 minimum capital requirement, and the impact of stress and scenario tests under Pillar 2 and the ICG. The Group manages its capital above the minimum ICG threshold, including a capital planning buffer, at all times. Capital levels for the Group are reported to, and monitored by, the Board on a monthly basis.

The Group currently adopts the Standardised approach and is in the process of applying to the FSA for permission to use an Internal Ratings Based (IRB) approach to retail credit risk and capital management. This will allow the Group to use its own estimates of risk, rather than values prescribed by the FSA, after certain conditions have been satisfied, and will further enhance the Group's risk management processes.

4.3 Capital Requirement

The Group's Pillar 1 capital requirement based on 8% of its risk-weighted assets is derived from capital held against risks from the following exposure classes.

	2012 Average Risk Weights %	2012 £'m	2011 £'m
Retail exposure classes			
Retail financial services	36%	118.3	106.8
Secured personal lending	47%	20.3	22.5
Past due items	101%	6.5	6.7
		145.1	**136.0**
Commercial exposure classes			
Commercial lending	72%	53.8	56.2
Past due items	97%	1.1	1.2
		54.9	**57.4**
Other exposure classes			
Financial institutions	27%	7.6	9.1
Other			
Fixed and other assets	98%	8.4	8.6
Credit risk minimum capital requirement		**216.0**	**211.1**
Operational risk (Standardised)		15.0	15.1
Total capital required		**231.1**	**226.2**
Total own funds (per section 3.1)		458.3	477.8
Excess of own funds over minimum capital requirement under Pillar 1		**227.2**	**251.6**

5. Credit Risk Measurement, Mitigation and Reporting

5.1 Credit Risk Overview

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent across most of the Group's activities. Adverse changes in the credit quality of borrowers or a general deterioration in UK economic conditions could affect the recoverability and value of the Group's assets and therefore its financial performance. Comprehensive risk management methods and processes have been established as part of the overall governance framework to measure, mitigate and manage credit risk within the Group's risk appetite.

Exposures

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

	Average to December 2012 £'m	As at December 2012 £'m
Retail financial services	3,970.8	4,151.5
Secured personal lending	593.3	577.5
Commercial lending	962.2	942.9
	5,526.3	**5,671.9**
Treasury		
Central governments or central banks	696.2	691.3
Multilateral development banks	71.7	107.4
Financial institutions	343.3	357.2
	1,111.2	**1,155.9**

The geographical distribution of these exposures at 31 December 2012 is as follows:

	UK £'m	Other European Countries £'m	North America £'m	Rest of the World £'m	Total £'m
Retail financial services	4,151.5	-	-	-	4,151.5
Secured personal lending	577.5	-	-	-	577.5
Commercial lending	942.9	-	-	-	942.9
	5,671.9	**-**	**-**	**-**	**5,671.9**
Treasury					
Central governments or central banks	691.3	-	-	-	691.3
Multilateral development banks	-	107.4	-	-	107.4
Financial institutions	357.2	-	-	-	357.2
	1,048.5	**107.4**	**-**	**-**	**1,155.9**

The following table shows the residual maturity of the exposures at 31 December 2012:

	Up to 12 months £'m	1-5 years £'m	More than 5 years £'m	Total £'m
Retail financial services	139.7	559.5	3,452.3	4,151.5
Secured personal lending	30.6	164.0	382.9	577.5
Commercial lending	295.9	240.2	406.8	942.9
	466.2	**963.7**	**4,242.0**	**5,671.9**
Treasury				
Central governments or central banks	496.3	165.5	29.5	691.3
Multilateral development banks	-	107.4	-	107.4
Financial institutions	258.1	76.6	22.5	357.2
	754.4	**349.5**	**52.0**	**1,155.9**

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

5.2 Retail Financial Services Credit Risk

Credit risk is inherent in the Group's retail mortgage book. Credit risk is assessed both for the Group's existing mortgage assets and also for mortgage lending to which the Group is committed, for example through a firm commitment to lend against a mortgage offer or through a facility to increase the amount of lending on an existing mortgage.

A series of specific limits and thresholds have been established and reflect the Group's view of and appetite for risk in relation to the retail mortgage portfolio. These limits are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Board's retail lending risk appetite. The Group Credit Risk Committee reviews comprehensive risk based information on a monthly basis and has robust controls in place to ensure that new lending complies with the Board's stated risk appetite. Limits and triggers are reviewed regularly by Group Risk Committee and annually by the Board, and adjusted in the light of prevailing external conditions and internal experience, which reflects the profile of new business written, portfolio performance, and trends in arrears and crystallised losses.

The Group's residential loan portfolio is managed using a rating system which has been developed in line with BASEL II IRB principles and is therefore more sensitive at measuring risk than the Standardised methodology, as used in the ICAAP.

The detailed controls in place to manage credit risk in the retail mortgage book include:

- clear credit approval criteria;
- strict management of product offerings;
- application of risk parameters, product and geographic limits;
- restricted criteria for acceptance of interest only applications;
- maximum advance for loans secured by 'new build' properties and apartments, limited by LTV;
- restricted criteria for 'buy to let' products by reference to LTV and geography;
- restricted availability of products between 75% and 95% LTV;
- use of an affordability model based on prudent criteria reviewed and adjusted as appropriate;
- robust and fair arrears management processes which comply with TCF and business conduct principles;
- application of reasonable and appropriate account management and forbearance options for borrowers experiencing financial difficulty.

Mortgage intake is monitored daily by reference to product type, LTV and channel. Criteria are adjusted, or products withdrawn, if trends are inconsistent with risk appetite.

Credit risk under Pillar 1 is calculated using the Standardised methodology with the Society's IRB model being used to support the Standardised calculations. In line with BIPRU 3.4, non-defaulted retail mortgage assets up to 80% LTV attract a 35% risk weighting, whilst the proportion above 80% LTV attracts a 75% risk weighting. Mortgages in default attract a risk weighting of 100% if no provisions are held and LTV is less than or equal to 80%, and 150% where the LTV is greater than 80% and no provisions are held.

5.3 Secured Personal Lending Credit Risk

The Group's subsidiary, Nemo Personal Finance Limited (Nemo), offers loans to individuals secured by way of a second charge over residential property. All customers therefore have an existing first mortgage, and a typical borrower is seeking to finance the purchase of chattels or to consolidate existing debts. Depending on the borrower's status, loans are available from £7,500 to £200,000 and are repayable over terms between three and twenty-five years.

The Board's overall appetite for credit risk in secured personal lending is reflected in the Group's business plan and asset growth targets over the planning horizon. The strategy for secured personal lending is to continue to manage the business prudently, but not seeking to grow the level of the loan book. Limits and tolerance thresholds are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Board's risk appetite. These are subject to regular review by Group Risk Committee and adjusted in the light of prevailing external conditions and internal experience, which reflects the profile of new business written, portfolio performance, and trends in arrears and crystallised losses.

Risk appetite is articulated through Nemo Board approved specific portfolio limits which measure aggregate exposure through the proportion of new lending made in various LTV bands and this is monitored monthly by comparison to internal targets.

Management Information is presented regularly to Nemo Board, Group Risk Committee and the Group Board. This ensures that the risk appetite, exposure and portfolio limits, product design and arrears management performance can be reviewed in the light of emerging trends.

Credit risk assessment of individual new loans is based on comprehensive policy rules primarily based on credit history, customer profile, affordability, and LTV. Other considerations include, but are not confined to, credit score, property type, the market standing of the first mortgage lender, the nature of the first mortgage, and the extent of available credit history. Exceptions are individually assessed by experienced underwriters.

Credit risk under Pillar 1 is calculated using the Standardised methodology, and risk weightings of 35% and 75% are applied to non-defaulted exposures, depending on the LTV. At the point of application no LTV is greater than 100% although historically it has been possible for capitalised PPI premiums to raise the LTV above 100%. Defaulted exposures attract a risk weighting of between 50% and 150% depending on the LTV and the level of provisions held. Adjustments to the exposure calculated under the Effective Interest Rate methodology of IAS 39 are treated as unsecured.

5.4 Commercial Lending Credit Risk

Commercial lending activity is split between lending to private sector landlords and property investors, registered social landlords, and funding for commercial projects.

The following table provides an analysis of commercial lending exposure by industry sector as at 31 December 2012:

	Drawn commitments £m	Un-drawn commitments* £m	Total £m
Registered social landlords	173.9	13.9	187.8
Residential investments	216.7	1.7	218.4
Retail outlets, offices and industrial	526.3	10.4	536.7
	916.9	**26.0**	**942.9**

*after the application of the appropriate credit conversion factors

Limits and tolerance thresholds are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Board's commercial lending risk appetite. These are subject to monthly review by GCRC and quarterly review by Group Risk Committee. They are adjusted in the light of prevailing external conditions and internal experience, which reflects the profile of new business written, portfolio performance, and trends in arrears and crystallised losses. The Group remains cautious with regard to commercial lending which is undertaken on a prudent basis. Management continues to pursue a strategy geared towards reducing the overall exposure to development finance and larger, single counterparty loans.

The Commercial Lending Division operates a relationship management approach. Each customer has a specific lending manager who is responsible for submitting credit applications for that customer (whether existing or new customer) and for managing the customer/lender relationship. Each lending manager is a highly experienced property lender with a strong track record gained in a traditional banking environment and/or within the division itself over the past 8 years.

Commercial lending exposures are underwritten judgementally against comprehensive and well established criteria which are articulated in the Division's Policy Manual. A risk grading framework has been developed, and the entire portfolio is risk graded.

Credit risk capital for the Society's commercial lending under Pillar 1 is determined by reference to the Standardised methodology. Risk weights of 100% are applied to lending secured on commercial property and risk weights of 35% or 100%, depending on LTV, are applied to residential lending. Exposures to registered social landlords are risk weighted at 35%.

5.5 Treasury Credit Risk

The Group has exposures to banks, building societies and sovereigns in its non-trading book treasury portfolio. The Group does not operate a trading book. Exposures in the treasury portfolio are held for liquidity purposes or in the case of fair value exposures on derivatives, for hedging purposes. The Group's policy is to carry sufficient liquid assets to meet both FSA requirements in terms of liquidity buffer-eligibility, and internal requirements calculated using stress testing and having regard to seasonality within the risk exposure caused by savings maturities and other planned business events. Overall, the amount of liquid assets held to meet these requirements is expected generally to operate in a range equivalent to between 16% and 20% of savings, deposits and loans (SDL).

The Board's policy on managing credit risk relating to treasury exposures is set out in detail within the Group's Treasury Policy Statement (TPS). In particular, credit limits are set for individual counterparties based on external credit ratings (Moody's and/or Fitch). However other factors are taken into account such as credit default swap (CDS) levels, the current share price, the annual report and account statements, as well as associated macro-economic factors, for example sovereign CDS levels, GDP, fiscal deficits. Institutions, including building societies which do not have external ratings, are individually assessed and approved by the Board. Limits are also in place for instrument type and country to mitigate against concentration risk arising in the treasury portfolio.

Limits and tolerance thresholds are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Board's risk appetite. Treasury counterparty lines of credit are reviewed on a weekly basis by the Treasury Committee and on a monthly basis by ALCO. This entails an analysis of the counterparties' financial performance, their ratings status and recent market intelligence to ensure that limits remain consistent with the Group's risk appetite. Changes to lines and limits are approved by ALCO and EXCO.

The management of credit risk relating to treasury exposures is set out in detail within the Group's TPS. In particular:

- credit ratings are obtained for all bank or sovereign counterparties;
- investment is limited to counterparties on a list approved by ALCO;
- exposures are monitored on a real-time basis, with exposure reports run at the end of each day;
- ALCO receives reports at the end of every month of exposures and limits for all counterparties; and
- The TPS defines clearly the responsibilities of individuals involved in the management of treasury assets and the action plans and escalation processes in place in relation to credit rating downgrades and other indicators of worsening credit risk.

The following tables show the exposure values calculated under the Standardised Approach broken down by Credit Quality Step as specified by the Standardised Approach rules:

Central governments or central banks

Credit quality step	Risk weighting	Moody's ratings	Fitch's ratings	Exposure values £m
1	0%	Aaa to Aa3	AAA to AA-	691.3

Multilateral development banks

Credit quality step	Risk weighting	Moody's ratings	Fitch's ratings	Exposure values £m
1	0%	Aaa to Aa3	AAA to AA-	107.4

Financial Institutions

Credit quality step	Risk weighting	Moody's ratings	Fitch's ratings	Exposure values £m
1	20%	Aaa to Aa3	AAA to AA-	70.7
2	20%/50%	A1 to A3	A+ to A-	269.4
3	20%/50%	Baa1 to Baa3	BBB+ to BBB-	4.0
n/a	20%/50%	Unrated	Unrated	13.0
				357.2

Note: the unrated exposures relate to fixed rate deposits held with Building Societies with no Fitch or Moody's ratings. As per BIPRU 3.4 unrated institutions attract a risk weight of 20% or 50% depending on the term of exposure.

Credit Risk from derivatives and repurchase agreements are mitigated, where possible, through netting agreements whereby assets and liabilities with the same counterparty can be offset. All netting arrangements are legally documented through ISDA and GMRA master agreements with each counterparty. This provides the contractual framework within which dealing activities across a full range of 'Over The Counter' (OTC) products are conducted and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or other predetermined events occur.

Collateral is obtained against derivative assets (with any collateral taken in respect of OTC exposures being subject to a discount), which is negotiated at the time of signing the collateral agreement. The collateral document is the ISDA or GMRA Credit Support Annex (CSA). The collateral document gives the Group the power to use any collateral placed with it in the event of the failure of the counterparty. The collateral obtained for derivatives is cash denominated in Sterling.

5.6 Impairment Provisions

Assets held at amortised cost

The Group assesses at each balance sheet date whether, as a result of one or more events that occurred after initial recognition, there is objective evidence that a financial asset or group of financial assets are impaired. Evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficultly, default or delinquency in interest or principal payments or the debt being restructured to reduce the burden on the borrower.

The Group first assesses whether objective evidence of impairment exists either individually for assets that are separately significant or collectively for assets that are not separately significant. If there is no objective evidence of impairment for an individually assessed asset it is included in a group of assets with similar risk characteristics and collectively assessed for impairment.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the carrying amount of the assets and the present value of estimated future cash flows, discounted at the asset's original effective interest rate. The resultant provisions are deducted from the appropriate asset values in the balance sheet.

The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any difference between loss estimates and actual experience.

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 provision is adjusted and the amount of the reversal is recognised in the income and expenditure statement.

Where a loan is not recoverable, it is written off against the related provision for loan impairment once all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the impairment loss recorded in the income and expenditure statement.

Loans subject to individual impairment assessment are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

The following table shows the net past due loans and provisions for impaired exposures (equivalent to value adjustments) and charges to the income and expenditure statement for the year to 31 December 2012.

	Retail financial services £m	Secured personal lending £m	Commercial lending £m	Total £m
Neither past due nor impaired	4,031.9	519.9	934.4	5,486.2
Past due:				
Up to 3 months	88.8	27.5	1.5	117.8
3 to 6 months	16.5	6.7	0.3	23.5
6 to 12 months	9.5	7.0	1.3	17.8
Over 12 months	0.9	16.4	0.3	17.6
Possessions	3.9	-	5.1	9.0
	119.6	**57.6**	**8.5**	**185.7**
Total exposures	**4,151.5**	**577.5**	**942.9**	**5,671.9**
Provisions	7.1	31.0	29.0	67.1
Charge for the year	**1.8**	**3.5**	**11.0**	**16.3**

For the purposes of this table, past due is defined as one day or over. The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due. Past due loans, impaired loans and provisions are all UK based.

The following table summarises the movement in impairment provisions for the year ended 31 December 2012.

	Fully secured on residential property		Fully secured on land		
	Individual provision £m	Collective provision £m	Individual provisions £m	Collective provision £m	Total £m
Balance at 1 January 2012	44.1	15.1	4.0	-	63.2
Charge for the year	7.0	5.8	3.5	-	16.3
Write-offs	(12.4)	-	-	-	(12.4)
Balance at 31 December 2012	**38.7**	**20.9**	**7.5**	**-**	**67.1**

Available for sale assets

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets are impaired. As at 31 December 2012, none (2011: none) of the treasury portfolio exposure was either past due or impaired. There are no assets that would otherwise be past due or impaired whose terms have been renegotiated. In assessing impairment, the Group evaluates among other factors, the normal volatility in valuation, evidence of deterioration in the financial health of the investee, industry and sector performance and operational and financing cash flows.

Other than £107.4m of AAA rated Supranational Bonds issued by the European Investment Bank and the Council of Europe and effectively guaranteed by the European Union member states, the Group does not hold any direct bank exposures outside the UK. The Group has indirect exposures through bank counterparties that themselves have direct exposures to Greece, Italy, Portugal, Spain, Ireland and Cyprus. Based on available information, an assessment has been made of the Society's key counterparties regarding the potential levels of indirect exposure to distressed Eurozone economies. After such an assessment, the Board has concluded that no impairment provisions are required for indirect exposures to Eurozone sovereign debt.

5.7 Credit Risk Concentrations

Policy limits have also been set to enable the management of treasury credit risk concentration. These limits are actively monitored and relate to aggregate counterparty, country and asset class exposures.

For residential mortgages, LTV concentration limits are set within policy. Geographic concentration of risk is also monitored. The Group operates across the majority of the UK with a bias towards Wales. As at 31 December 2012, approximately 31.6% of retail and secured personal lending loans exposures by account and 33.5% by value were concentrated in Wales.

By their nature, residential mortgages comprise a large number of intrinsically highly diversified small loans and have a low volatility of credit risk outcomes.

For commercial lending, exposure to each of the principal lending categories is monitored and total portfolio exposures constrained via an internal limit set at 15% of the Society's total assets. Limits are also set restricting the aggregate exposure to any single counterparty or group of closely connected counterparties. Concentration of risk within the portfolio is monitored using indicators such as maturity profile, industry sector and geography. In terms of counterparty concentration, the largest single commercial customer, including un-drawn commitments, represents circa 4% of the commercial book.

5.8 Credit Risk Mitigation

The Group uses a wide range of techniques to reduce credit risk associated with its lending. The most basic of these is performing an assessment of the ability of the borrower to service the proposed level of borrowing without distress. However the risk is further mitigated by obtaining security for the funds advanced.

Residential mortgages

Residential property is the Group's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolio. All mortgage lending activities are supported by an appropriate form of valuation using typically either an independent firm of valuers for mortgages and loans outside Wales or in-house valuation for loans and mortgages within Wales.

Collateral values are updated at the date of each statement of financial position based on the best information publically available. Land Registry data is used in the Retail Financial Services sector with Hometrack being used in the Secured Personal Lending sector. Both indices take account of the geographical location of the collateral. External valuations are used to estimate commercial security values and future cash flows.

All residential property must be insured to cover property risks and this may be effected through a third party. Additional protection is also afforded to borrowers through optional payment protection insurance.

Commercial mortgages

Commercial property is the Group's main source of collateral and means of mitigating credit risk inherent in its commercial mortgage portfolio. Collateral for the majority of commercial loans comprises first legal charges over freehold and long leasehold property but guarantees may also be taken as security. Guarantees and other off-balance sheet security are not used in the calculation of Pillar 1 capital requirements therefore the exposure values before and after credit risk mitigation are identical.

For property-based lending, supporting information such as professional valuations are an important tool to help determine the suitability of the property offered as security and, in the case of investment lending, generating the cash to cover interest and repay the advance. All valuations are undertaken by members of an approved panel of independent valuers.

A syndication strategy may be adopted to avoid large concentrations of risk. Hedging strategies are considered as part of the approval process and unless borrowers have chosen fixed rates, their exposure to interest rate movements must be deemed acceptable.

Insurance requirements are always fully considered as part of the application process and the Society ensures that appropriate insurance is taken out to protect the property.

Treasury

The credit limits for each counterparty are derived using a matrix based on external credit ratings. The limits are then calculated by reference to the general reserves of the Group, where the maximum exposure for each institution will be determined by the external rating. Typically all banks will have a minimum rating of A-/A3 and all building societies will be assessed individually. Specific limits may not exceed 10% of the institution's equity without prior approval of the Board. Subsidiaries of any institution will be assessed as a separate entity according to its own ratings. However, in those circumstances the overall exposure cannot exceed the aggregate group limit.

The exposure value of derivatives before netting as at 31 December 2012 was an asset of £43.6m with £26.0m deposited with financial institutions as collateral.

6. Market Risks

6.1 Market Risk Overview

Market risk is the risk that the value of income arising from the Group's assets and liabilities varies as a result of changes in interest rates or exchange rates and typically arises from imperfect matching and different interest rate features, re-pricing dates and maturities of mortgages, savings, and wholesale products.

Market risk incorporates a range of risks, but the most significant elements are interest rate risk and foreign currency risk.

6.2 Interest rate risk

Interest rate risk is the risk of loss resulting from adverse movements in market interest rates.

The Group is exposed to interest rate risk principally arising from the fixed rate mortgage and savings products that it offers. The various interest rate features and maturities on these products, and the use of wholesale funds to support these products, create interest rate risk exposures due to the imperfect matching of interest rates between different financial instruments and the timing differences on the re-pricing of assets and liabilities.

Another significant form of interest rate risk arises from the imperfect correlation between re-pricing of interest rates on different assets and liabilities – often referred to as basis risk. The basis risk on the Group's balance sheet arises from mortgage and other assets that are priced relative to base rate, but are funded by a combination of liabilities priced relative to LIBOR and administrated rate savings.

Use of derivatives

The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, interest rate options and interest rate caps.

The Group uses derivatives in accordance with the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes and, accordingly, they are used exclusively to reduce the risk of loss arising from changes in interest rates, foreign exchange rates or other factors specified in the legislation.

The Group's Treasury Policy Statement describes processes and controls in place to manage interest rate risk, including:

- monthly agreement at ALCO of the Group's view of the interest rate outlook to act as a basis for liquidity investment and hedging decisions for the coming month;
- day to day review of exposures and market outlook by both the Treasury Front and Middle Office teams and fine-tuning of ALCO's view as appropriate, with agreement from the Group Finance Director;
- all new mortgage and savings ranges reviewed by the Treasury Front and Middle Office teams to determine appropriate hedging activity;
- all new mortgage and savings ranges signed by either the Group Finance Director or Head of Capital and Liquidity Risk Management, to ensure appropriate pricing and to ensure risks are appropriately identified;
- weekly review of interest rate risk exposures by Treasury Committee;
- monthly full review of interest rate risk exposures and hedging by the Treasury Middle Office team, to review actual outcomes against plans for the month and allow hedging proposals to be formed;
- monthly reporting to ALCO, chaired by the Group Finance Director and attended by senior managers including the Group Chief Executive; and
- the Treasury Front and Middle Office teams involved in interest rate risk management have gained extensive experience and are monitored closely through robust governance processes.

In assessing interest rate risk exposure relating to fixed-rate mortgage assets it is necessary to make assessments of likely prepayment. The risk of prepayment assumptions being inaccurate is mitigated if too low, by additional unexpected early redemption charges, and if too high through additional interest income. These effects broadly offset each other; although timing of cash flows differ (early repayment charges not received in year 1 will be offset by additional margin over several years).

The Group uses interest rate gap sensitivity analysis to assess exposure to interest rate risk. This analysis shows the Group's exposure to interest rate risk in terms of the net risk after taking account of management action to hedge inherent exposures. The Group's Finance function is responsible for reporting monthly the Group's interest rate risk exposure to ALCO.

At 31 December 2012, the Group's interest rate gap sensitivity given a 200bp parallel shift in interest rates was £6.85m, taking account of the effect of derivatives.

6.3 Currency risk

Currency risk is the risk of a loss resulting from movements in foreign exchange rates or changes in foreign currency interest rates, particularly on the Group's non-sterling funding.

Currency risk is managed through the use of derivatives, primarily in the form of cross currency swaps.

In line with the prudential guidance applying to all building societies, and after taking account of foreign currency derivatives, the Group has no substantial net exposure to foreign exchange rate fluctuations or changes in current interest rates.

7. Operational Risk

The Group has adopted the standardised approach to operational risk management and applies the industry standard definition namely: 'the risk of loss arising from inadequate or failed internal processes, people and systems or from external events'. This approach underpins the operational risks captured in the Group corporate risk registers and supports appropriate oversight of the key risk exposures facing the Group.

Risk appetite for all prudential risk categories is expressed by the Board by reference to the most significant net risks recorded in the Group's risk registers. Each risk on the risk register is assessed using a 'Probability/Impact' matrix which is used to quantify, in financial terms, potential risk to the Group, before and after taking into account the effectiveness of management controls, and other forms of mitigation.

The risk registers are subject to regular review by each risk owner and Group Risk Department with the highest scoring risks for the Group as a whole reported to the Board each month. For individual risks which are deemed unacceptable, remedial action is taken, where such falls within the Group's control (this is particularly relevant in relation to other prudential risk categories e.g. strategic risk, which may be influenced by macroeconomic factors) and will include introducing or enhancing the operational controls and/or risk mitigants related to the individual risk, or taking appropriate action to eliminate the risk altogether.

The risk registers and risk assessment framework are subject to review by Group Internal Audit. The focus and prioritisation of the Internal Audit annual programme is linked closely to an assessment of the risk registers and highest scoring risks.

The effectiveness of management controls are reviewed by the Director of Group Risk and the Group Operational Risk Manager by reference to key risk indicators and operational loss reports. Where appropriate, initial challenge to the risk owners' assessment is provided by Group Risk and subsequently by GMC prior to completion of the Group key risk report which is submitted to the Board each month.

Operational losses are recorded as they arise, and reported to Group Risk Department each month. A report of all operational losses and 'near misses' is submitted to GORC on a quarterly basis. Group Risk Committee will determine whether any review of internal procedures or controls is required in order to mitigate against any potential recurring operational losses.

Under the Basel Capital Accord, for the standardised approach to operational risk, gross income is regarded as a proxy for the operational risk exposure within each business line. The capital charge for operational risk is calculated separately, based upon gross income over the preceding three years.

8. Securitisation

8.1 Retained securitisation positions

In 2011 the Group entered into a Residential Mortgage Backed Security (RMBS) issue to raise funding for the Group. The RMBS issue involved the formation of a special purpose entity, Friary No.1 plc, which purchased beneficial interests in a portfolio of residential mortgages that are funded by the issue of floating rate mortgage backed securities (the Notes).

The Notes were issued by Friary No.1 plc to external counterparties and to the Group, either for the purposes of creating collateral to be used for funding or for subsequent sale of the Notes to investors outside the Group. Principality Building Society is both originator and servicer of the issue. Other roles fulfilled by the Group are fully described in the Friary No.1 plc base prospectus, a copy of which can be found at www.euroabs.com.

The equity of Friary No.1 plc created for this securitisation is not owned by the Group. However, to comply with the Building Societies Act 1986 (International Accounting Standard and Other Accounting Amendments) Order 2004 and Standing Interpretations Committee (SIC) 12, Friary No.1 plc is included in the consolidated financial statements of the Group.

The Notes are serviceable firstly from cash flows generated by the mortgage assets and thereafter from the proceeds of the subordinated loans. The Group receives the excess spread on the transactions as deferred consideration, after Friary No.1 plc has met its liabilities and repaid the subordinated loan.

As at 31 December 2012, £622.2m (2011:£764.2m) of mortgages issued by the Society had been transferred to Friary No.1 plc which remains on the statement of financial position of the Society as it retains the risks and rewards. These assets are treated as encumbered. The amortised value of the bond was £657.0m (2011:£814.0m), with £422.9m (2011:£514.0m) retained by the Group. These self-issued securities are capable of repo financing either directly with the market or with central banks to which the Group has access. During 2012 the Society sold a further £50m of Class A2 Notes to external investors at par. The Group provided a subordinated loan to its securitisation structure of £32.5m at issue.

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 continue to be calculated in line with BIPRU 3 requirements. Securitisation positions held by the Society are valued at Fair Value by Note Class. There have been no changes to the methods and key assumptions used to value the securitisation positions held.

The balances of assets subject to securitisation and notes in issue as at 31 December 2012 are as follows:

Securitisation Company	Type	Date of Securitisation	2011 External Notes in Issue £m	2011 Current Balance £m	2012 External Notes in Issue £m	2012 Current Balance £m
Friary No.1 plc	Residential mortgage securitisation	11 August 2011	814.0	764.2	657.0	622.2

Note Class	2011 Current Balance £m	2012 Current Balance £m
A1	229.0	37.2
A2	457.0	457.0
B	128.0	128.0

The Class B Notes were taken up by the Group at the time of the securitisation transaction and were effectively a credit enhancement. There has been one loss of £13k (2011: nil) on the loans in the year and there are 33 (2011: nine) accounts with arrears of three months or more.

Fitch and Moody's, both recognised ECAI's, rated the Notes under the securitisation.

The credit risk of the underlying mortgage pool is monitored by the Credit Risk Department. The market risk associated with the Notes is monitored by the Treasury function. Interest rate swaps are in placed between the Group and Friary No.1 plc to hedge interest rate risk.

In October 2012, the Group became a member of the FLS which allows the Group the ability to pledge mortgage assets with the Bank of England in return for Treasury bills which are capable of repo financing either directly with the market or with central banks to which the Group has direct access. Based on the base stock of loans and mortgages as at 30 June 2012, the Group has an initial borrowing allowance of £270.4m, representing 5.0% of the core statement of financial position. No assets have been pledged into the scheme at the end of the year and no funds have been drawn-down.

8.2 Purchased securitisation positions

Since May 2012 the Society has selectively purchased senior tranches of positions in Residentiall Mortgage Backed Securities (RMBS). The Society's total exposure to purchased securitisation positions at 31 December 2012 was £32.3m based on market values, with the exposures consisting entirely of residential mortgage-backed securities. Such purchased securitisation positions provides the Society with a diversified, capital-efficient source of investment income. Investments are undertaken within a clearly defined credit risk policy.

The aggregate fair values are calculated based on quoted market prices.

The purchased securitisation positions are all in the most senior tranches of the issued note classes of each securitisation. The following table shows the breakdown of the exposures by credit quality steps with indicative external credit assessment ratings:

	Ratings			Exposures	
Credit quality step	S&P	Moody's	Fitch	2012 Exposure Value £m	2012 Exposure Weighted Average RW %
1	AAA	Aaa	AAA	32.3	20

The purchased securitisation positions are all residential mortgages which have all been originated and issued in the UK.

9. Glossary of Terms

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. Basel II became law in the EU Capital Requirements Directive and was implemented in the UK via the FSA Handbook.
BIPRU	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. Basel II become law in the EU Capital Requirements Directive and was implemented in the UK via the FSA Handbook.
Code Staff	Executive and non-executive directors, senior management and members of staff whose actions have a material impact on the risk profile of the Group.
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 BIPRU 3.4 (Risk weights under the standardised approach to credit risk) and BIPRU 9 (Securitisation).
Credit risk	The risk that a borrower or counterparty fails to pay the interest or to repay the capital on a loan. Credit risk is the largest risk category to which the Group is exposed and sub-divided as follows: retail lending, commercial lending, and Treasury credit risks.
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 and Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.
FSA	Financial Services Authority. The financial services industry regulator in the UK.
Guarantee	An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.

ICAAP	Internal Capital Adequacy Assessment Process. The Group's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events.
ICG	Individual Capital Guidance. The minimum amount of capital the Group should hold as set by the FSA under Basel II Pillar 2.
ILAA	Individual Liquidity Adequacy Assessment. The Group's own assessment of the levels of liquidity that it needs to meet its current and financial obligations. These are assessed under normal and stressed condition.
Interest rate risk	Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates.
IRB	Internal Ratings Based approach. A Basel II approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk-sensitive than the Standardised Approach and may only be used with FSA permission.
LIBOR	London Inter Bank Offered Rate.
LTV	Loan To Value. A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).
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 Basel II 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 loss arising from inadequate or failed internal processes, people and systems, or from external events.
PIBS	Permanent Interest Bearing Shares. Unsecured, deferred shares of the Society that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, creditors and investing members of the Group. Also known as subscribed capital.
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.
Provisions	Amounts set aside to cover losses associated with credit risks.
Securitisation	A process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose vehicle (SPE) which then issues securities back by the assets. The Group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.
SPE	Special Purpose Entities. Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses an SPE set up under securitisation issue. Where the Group has control of these entities or retains the risks and rewards relating to them they are consolidated within the Group's results. This term is used interchangeably with SPV (special purpose vehicle).
Stress testing	Various techniques that are used by the Group to gauge the potential vulnerability to exceptional but plausible events.
Subordinated debt	A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing Members but before the claims of holders of permanent interest-bearing shares.
The Standardised Approach (credit risks)	The basic method used to calculate credit risk capital requirements under Basel II. In this approach the risk weights used in the capital calculation are determined by FSA supervisory parameters. The standardised approach is less risk-sensitive than IRB.
The Standardised Approach (operational risks)	The standardised approach to operational risk, calculated using three year historical net income multiplied by a factor of 12-18%, depending on the underlying business being considered.
Total Remuneration	The sum of fixed pay, variable pay, director fees, car allowance, pension and benefits in kind.