Skipton Building Society

Pillar 3 pre-year end qualitative disclosures

December 2008

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1.0 Introduction

1.1. Background

From 1 January 2007 the Capital Requirements Directive (Basel II) came into force in the UK and the Group adopted the capital adequacy rules from 1 January 2008. These rules require building societies and banks to assess the adequacy of their capital resources given the risks they face in order to ensure the continued protection of their members' deposits. The rules are set out in Capital Requirements Directive under three pillars:

Pillar 1 sets out the minimum regulatory capital resources requirement, predominantly comprising credit risk and operational risk.

Pillar 2 covers management's assessment of the additional capital resources required to cover the specific risks faced by the Group that are not covered by the minimum regulatory capital resources requirement set out under Pillar 1. The amount of additional capital requirement is assessed by the FSA during its Supervisory Review and Evaluation Process (SREP).

Pillar 3 requires building societies and banks operating under the Basel II framework to disclose the quantitative and qualitative information regarding their risk assessment process and capital resources, and hence their capital adequacy. This inaugural document satisfies the qualitative requirements of Pillar 3 as it has been produced before the Skipton Group's year-end.

1.2. Frequency of disclosure

The next Pillar 3 report will be issued within the first four months of 2009 and will include, in addition to qualitative information, quantitative information based upon the 2008 year-end financial statements. In subsequent years a report containing both quantitative and qualitative information will be issued at least annually within four months of the year-end (31 December).

1.3. Media and location of publication

This report and subsequent reports of this nature will be published on Skipton Building Society's website (skipton.co.uk).

1.4 Verification of disclosure

These disclosures have been reviewed by the Group's Board Audit Committee. There is no requirement to audit the disclosures except where they also appear in the Group's Annual Report & Accounts.

2.0 Scope of application

For accounting purposes the Society's consolidation group comprises the Society and all of its subsidiaries (ie full group consolidation). The risks within the Skipton Group are controlled and managed on a full consolidation level. For prudential and Pillar 3 reporting purposes consolidation is also carried out at the following levels:

- Solo consolidation group
- UK consolidation group

Solo consolidation group

The solo consolidation group consists of the mortgage lending bodies within the Group, namely Skipton Building Society, Amber Homeloans Limited and Skipton Building Society Covered Bonds LLP.

UK consolidation group

The UK consolidation group consists of the entire Group with the exception of the following entities in accordance with BIPRU 8.5.1:

- Connells Limited
- Jade Software Corporation Limited
- Mutual One Limited
- Northwest Investments NZ Limited
- The Private Health Partnership Limited
- Skipton Trustees Limited

3.0 Risk management objectives and policies

3.1. Introduction

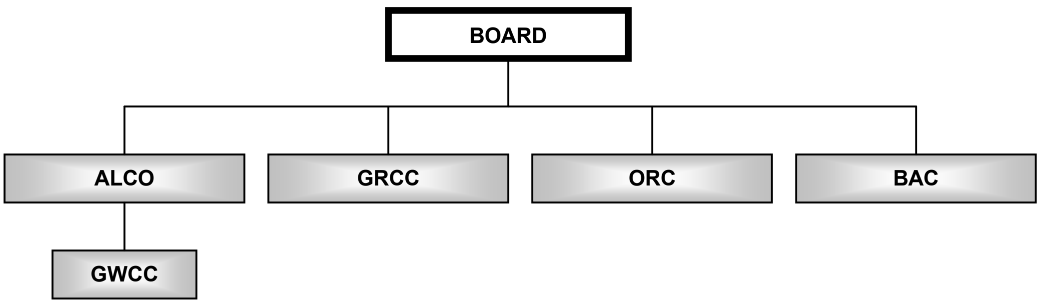
The Board accepts risks as a natural occurrence in order to achieve its business objectives but endeavours, through positive mitigation strategies, to manage these in a manner that optimises returns within the confines of the Corporate Plan whilst protecting members' interests and the Group's reserves. To this end, the Board ensures that an effective risk management framework is maintained to identify, prioritise, manage and report on the risks faced by the Group.

3.2. Group Risk management framework

The Group's risk management framework is formulated within the parameters of the Board's corporate objectives and overall appetite for risk. Essentially the framework is based upon the best practice 'three lines of defence' model, comprising:

- First line of defence being the business which, through the implementation of the organisation's risk framework, identifies, assesses, mitigates and manages risk.
- Second line of defence, comprising the Group risk functions (Operational, Credit, Market & Insurance) and related 'risk' functions eg Compliance, Data Security and Legal. These functions challenge, monitor, guide and support the business in managing its risk exposure. The risk committee structure (eg Asset & Liability Committee (ALCO), Group Retail Credit Committee (GRCC) and Operational Risk Committee (ORC)) also sits within the second line of defence, setting policy and framework and monitoring implementation by the business.
- Third line of defence covers the independent assurance aspects of the model and comprises the Audit Services function, which performs a risk-based programme of audits and reports on these and related risk and control matters to the Board Audit Committee (BAC). The work carried out by Audit Services involves assessing whether controls are in place and working effectively in accordance with Group policies and procedures as well as with laws and regulations.

The diagram below provides an overview of the governance structure surrounding the Skipton Group's risk management framework.



The roles and responsibilities of the Board and the risk management committees are set out in the following paragraphs.

3.3. Board

The Board reviews and approves the Group's Internal Capital Adequacy Assessment Process (ICAAP) and risk management framework, its risk appetite and its key risk management policies for all risk categories.

The Board also monitors the Group's key risk management information and reviews the Group's overall capital adequacy.

3.4. Asset and Liability Committee (ALCO)

ALCO is an executive committee that reviews Group policies in relation to liquidity and funding, market risk (ie interest rate, equity and currency risk) and wholesale credit risk (via sub-committee **Group Wholesale Credit Committee (GWCC)**), and monitors both compliance with these policies and the Group's overall risk exposure in these areas. ALCO recommends changes to these Group policies for formal review and approval by the Board.

3.5. Group Retail Credit Committee (GRCC)

GRCC is an executive committee that reviews Group policies in relation to retail credit risk and monitors both compliance with these policies and the Group's overall risk exposure in this area. GRCC recommends changes to these Group policies for formal review and approval by the Board.

3.6. Operational Risk Committee (ORC)

ORC is an executive committee that reviews the Group's operational risk management policy, monitors the Group's exposure to operational risks and reviews the arrangements for measuring and controlling operational risks. ORC reviews the Group's risk appetite and recommends changes to the Group operational risk policy for formal review and approval by the Board.

3.7. Board Audit Committee (BAC)

BAC is a non-executive committee that approves the Group's financial statements and annual Audit Plan, manages the relationship with the Group's external auditors, reviews internal audit reports on the operation of internal controls and monitors risk and control issues of major significance to the Group.

4.0. Risk categorisation

The most significant risk categories to which the Group is exposed are described below.

4.1. Credit risk overview

Credit risk is the risk that a customer or counterparty is unable to honour its obligations to the Group as and when they fall due. The Group faces this risk in respect of individual customers (retail mortgages), businesses (commercial lending) and other financial institutions (Treasury or wholesale lending).

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent across the Group's lending 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. The Group has established comprehensive risk management methods and processes as part of its overall governance framework to measure, mitigate and manage credit risk within the Group's credit risk appetite.

The Group has adopted the standardised approach for calculating the Pillar 1 capital requirements for all categories of credit risk.

4.1.1. Credit risk: retail mortgages

Retail mortgage credit risks are managed within the policy set by GRCC by:

- the evaluation of the credit risk associated with potential borrowers through a combination of lending policy criteria, credit scoring, policy rules and underwriting. The primary factors considered are affordability, residential status, residential history, credit history, employment history, nature of income and loan-to-value (LTV). In addition, confirmation of borrower identity is obtained. When considering applications the primary focus is placed on the willingness and ability to repay;
- the taking of security against the loan. All mortgages are secured by way of a first legal charge against the property; and
- close ongoing monitoring of account performance, including behavioural scoring. Loans which show signs of adverse performance are managed by specialist teams who manage the collections and recovery processes.

Ongoing monitoring of all retail mortgage exposures is undertaken by the Credit Risk functions within each lending entity, with independent oversight provided by the Group Risk function. Reports on the credit risk exposure and performance of the portfolios are reported to GRCC and the Board on a monthly basis.

4.1.2. Credit risk: commercial lending

Commercial lending credit risks are managed within the policy set by GRCC, which places limits on business volumes as well as the sector, geography, size and seniority of exposures.

Lending decisions are based upon credit risk analysis including a detailed assessment of the borrower's experience, track record, financial strength, ability to repay, transaction structure and security characteristics. Large exposures are subject to further sanction by the Commercial Approvals Group or the Senior Management Committee. Consideration is also given to risk mitigation measures which will provide the Group with protection, such as third-party guarantees or supporting collateral and security where available, robust legal documentation, financial covenants and hedging.

Commercial portfolio asset quality monitoring is based on a number of measures, including financial covenant monitoring. In the event that particular exposures begin to show adverse features such as payment arrears, covenant breaches or business trading losses, a full risk re-appraisal is undertaken with cases being managed by specialist teams who manage the collections and recovery processes. The Board and GRCC review reports on credit risk exposures and performance of the commercial portfolio monthly.

4.1.3. Credit risk: wholesale lending

The Group's Treasury function is responsible for the credit control of assets held by Treasury, as well as for all country, sovereign and financial institution exposures. Wholesale credit risks are managed in accordance with limits, asset quality measures and criteria set out within the policy set by ALCO and approved by the Board.

Lending and investment decisions are based on an independent credit risk assessment including external rating agency analysis. Once on book, all individual exposures are reviewed daily and exposure limits at least monthly. Ongoing monitoring of asset quality and compliance with limits and policies is undertaken by the independent Treasury risk function with reports issued to GWCC, ALCO and the Board on a monthly basis.

For its exposure to Treasury credit risk, Skipton uses Moody's, Fitch and Standard & Poor's as External Credit Assessment Institutions (ECAIs) for sovereign, financial institutions and asset-backed securities. The Group's preference is to use the long-term rating, however, if this is unavailable, the short-term rating is used. For asset-backed securities, the issue rating is used.

The issuer and issue credit assessments provided by ECAI's are one of a number of considerations that form part of the credit assessment process. This process is documented within the policy and is supported by Treasury Credit procedures.

Credit Support Annexes (CSA), that are collateralised with cash, exist for collateralising derivative transactions with counterparties to which the Group has its largest derivatives exposures in order to mitigate the risk of loss on default (ie counterparty credit risk (CCR)). The CSA counterparties are banks that satisfy the credit assessment process in the Society's Wholesale Credit Policy, documented in the Board Treasury Policy. The duration of the derivative and the credit quality of the counterparty are both factored into the internal capital and credit limits for counterparty credit exposures.

The Group measures exposure value on counterparty credit exposures under the CCR mark to market method. This exposure value is derived by adding the gross positive value of the contract (replacement cost) to the contract's potential credit exposure, which is derived by applying a multiple based on the contract's residual maturity to the notional value of the contract.

4.2. Concentration risk

Concentration risk is the risk that the Group suffers losses from being over-exposed to sectoral, geographic, product type or other asset concentrations.

Both retail mortgage and commercial lending concentration risk is managed within the policy set by GRCC, including specific sectoral, geographic and product type limits. GRCC monitors reports on concentration risk monthly.

ALCO sets policy limits to manage Treasury credit risk concentrations. ALCO monitors adherence to aggregate counterparty, geographic, asset class, and economic sector exposures monthly.

4.3. Liquidity risk

Liquidity risk is the risk that the Group is unable to meet its financial obligations as they fall due. These obligations include investors' deposits, both on demand and those with a contractual maturity date, as well as repayments of other borrowings and loan capital. The Group's liquidity policy is to maintain sufficient liquid resources to cover imbalances and fluctuations in funding, to retain public confidence in the solvency of the Group and to enable the Group to meet its financial obligations as they fall due. This is achieved through maintaining a prudent level of high quality liquid assets, through wholesale funding facilities and through management control of the growth of the business.

The Group's Treasury function is responsible for the day-to-day management of liquidity in line with a range of Board limits. Both management and the independent Treasury risk function review exposures daily; these are reviewed by ALCO monthly. The Group's policy is to maintain its holdings of realisable liquid assets in excess of regulatory guidelines, after allowing for the potential outflow of funds.

The Group performs weekly liquidity stress testing based on a range of adverse scenarios, and has a developed liquidity contingency funding plan to ensure that it is able meet its obligations as they fall due under such scenarios. Stressed liquidity profiles are reported to ALCO and the Board monthly.

4.4. Market risk

Market risk is the risk of an adverse change in the Group's income or in the value of the Group's assets and liabilities arising from movements in market rates, including interest rates, currencies and equity prices. ALCO, and ultimately the Board, have adopted a policy which sets out, for each risk, applicable maximum risk limits. The independent Treasury risk function reviews adherence to these daily; these are reviewed by ALCO monthly.

4.4.1. Interest rate risk

Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate due to changes in market interest rates. The Group is exposed to interest rate risk due to the sensitivity of the Group's financial assets and liabilities to movements in interest rates.

The Group manages interest rate risk through the use of appropriate financial instruments, including derivative instruments and cash instruments such as loans, deposits and bonds. The Group uses a number of metrics to monitor interest rate risk: interest rate gap; earnings-at-risk; market value; and value-at-risk. The latter three measures calculate interest rate risk exposure positions based on historical data going back over approximately the last seven years and using 95% confidence intervals. The Board and Operational limits around all these metrics have been set to reflect the Group's low risk appetite.

The independent Treasury risk function monitors the Group's interest rate risk exposure positions against Board and Operational limits weekly and reports to ALCO and the Board monthly.

Basis risk (the risk of loss arising from changes in the relationship between interest rates which have similar but not identical characteristics – such as LIBOR and the Bank of England's Base Rate) is also monitored by the independent Treasury risk function weekly and reports to ALCO and the Board monthly.

The Group manages its exposure to basis risk through the appropriate use of basis risk swaps that are used to swap LIBOR linked assets to bank Base Rate linked assets.

4.4.2. Currency risk

Currency risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. Before applying hedging and other controls the Group is exposed to the following gross foreign exchange risks:

- Foreign exchange risk on its Euro MTN funding scheme
- Equity investments in Jade Software Corporation Limited and Northwest Investments NZ Limited which are denominated in New Zealand dollars

The Board has no appetite for currency risk, and requires all Treasury foreign exchange exposures to be hedged within minimal Treasury limits. ALCO monitors foreign exchange exposure monthly.

The Group does not consider it to be practicable to hedge its equity investments in foreign subsidiaries as the potential volatility in these asset values is considered to be immaterial to the Group.

4.4.3. Equity risk

Equity risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in equity stock markets. The Group's policy is to have no material exposure to equity risk. ALCO monitors any exposure monthly.

4.5. Operational risk

Operational risk is the risk of losses being incurred as a result of inadequate or failed internal processes, people or systems, or from external events. This includes legal risk and reputational risk, a consequence of ineffective risk management. The Board, through the Operational Risk Committee, has issued a Board Operational Risk Management Policy which sets out the Group's Operational Risk Management framework. This document articulates the Board's appetite for operational risk and details the way in which the Group identifies, prioritises, manages and reports to the Board on the full range of operational risks facing the business.

The Group manages its operational risk exposures through a variety of techniques, including monitoring key risk indicators, internal controls and various risk mitigation techniques such as insurance and business continuity planning. Risks are monitored through a risk and control self-assessment process, the use of key risk indicators and analysis of actual loss and near miss data. Operational risk self-assessment is undertaken by each business unit quarterly, specifying the likelihood and financial impact of specific operational risk events (analysed by each operational risk sub-category). Consolidated outputs of the self-assessment process are reviewed by the Operational Board of each Group entity at least annually.

The risk management framework is underpinned by the independent Group Risk function, which provides oversight to the business in terms of co-ordinating, consolidating, reviewing, assessing, analysing and challenging operational risk management. This independent function reports on the key operational risks facing the business to the Operational Risk Committee and the Board bi-monthly.

The Group has adopted the standardised approach for calculating the Pillar 1 capital requirements for operational risk.

4.6. Pension obligation risk

Pension obligation risk is the risk that the Group's obligations towards its pension schemes may lead to the Group not being able to pay its other liabilities as they fall due; and the risk that an increase in the funding requirements results in a significant reduction in the Group's capital resources. The Group's exposure to pension risk emanates from its four defined benefit pension schemes, all of which have been closed to new members for a number of years.

The following controls are in place to limit the Group's exposure to pension obligation risk:

- Senior management and the scheme trustees receive professional advice, from separate actuarial advisers, regarding the management of the pension scheme obligations on a regular basis.
- The pension trustees meet every quarter to monitor and make, in consultation with the principal employer, investment decisions with regard to the plan assets within the four schemes.
- The pension obligation position is updated every quarter and reported to the Board and the pension scheme trustees.

The Group also performs stress testing on the pension scheme liabilities and assets as part of its capital planning methodologies, articulated in the ICAAP.

4.7 Reputational risk

Reputational risk arises from a deterioration in the perception of the Society's or Group's standing in the eyes of either the wholesale markets or the general public. Management has considered how this might arise and what the impact could be. An event threatening the Society's or Group's reputation may result in an increase in retail deposit outflows and/or counterparties withdrawing funding lines to the Group and/or an operational risk event occurring. The first event has been modelled and controlled under the Group's liquidity risk management framework, whilst the potential occurrence of operational risk events is modelled and controlled under the Group's operational risk management framework.

4.8 Insurance risk

Insurance risk is the risk that the Group's insurers will be unable to pay in the event of a legitimate claim being made. This risk is controlled by ensuring that all the Group's insurers have a minimum AA rating.

Insurance risk also relates to the risk that insurance contracts written by a firm are not adequately covered. The Group is not exposed to this risk as it does not write insurance contracts. Any risk relating to mis-selling of a third party's insurance contracts eg general insurance or life sales, is captured under operational risk.

4.9 Investment risk

Investment risk is the risk that a fall in the carrying value of the Group's businesses may result in the Society losing the capital that it has invested in the subsidiary companies.

Investment risk is monitored and managed by the Skipton Group via a series of controls, including:

- monthly review of subsidiary performance by the Board;
- Senior Group Executives act as Chairman of subsidiary companies and therefore attend Operational Board meetings for all Group subsidiaries;
- the bi-annual assessment of the carrying value of subsidiary investments is reported to the Board; and
- capital limits assigned to both the aggregate amount of capital invested in subsidiaries and the individual amount of capital invested in new subsidiaries.

5.0 Capital adequacy

5.1 Summary of approach to capital adequacy planning

The Group's capital is predominately generated through the retention of profits. This is supplemented by Permanent Interest Bearing Shares (PIBS) and subordinated debt issued by the Group. Capital is held by the Group to protect it from losses which may occur during the economic cycle.

The Group undertakes an Internal Capital Adequacy Assessment Process (ICAAP) on an annual basis. The ICAAP is the means by which the Group ensures that:

- it has sufficient levels of capital resources to pursue the corporate objectives as set out in the Group Corporate Plan; and
- it has sufficient capital resources to trade through a severe recession, if necessary by applying appropriate management actions.

In formulating the Group's three year Corporate Plan, the Group considers its overall objectives and evaluates these in light of its risk appetite. The ICAAP is the process by which the Group assesses the adequacy of its capital resources in light of its objectives, and the risks facing it for which capital is required to be held. The results of this process are articulated in a single document which is approved by the Board and updated on at least an annual basis.

5.2 Capital reporting

From 31 March 2008 the capital adequacy of the Society (solo consolidation) and UK consolidation group has been reported to the FSA quarterly and bi-annually respectively. In addition, Pillar 1 capital adequacy (minimum capital adequacy) at both a solo and UK consolidation level is reported to the Board monthly.

5.3 Transferability of capital

In order to ensure the greatest degree of flexibility in the allocation of capital, the Board aims to retain the maximum possible level of capital in the Solo group and UK consolidation group – the regulated entities. However, this broad principle is subject to a number of regulatory, taxation and commercial considerations which are considered before any decisions regarding dividend payments are finalised.

There are no current or foreseen material practical or legal impediments to the prompt repayment of liabilities among the Society and its subsidiary undertakings.