Skipton Building Society

Pillar 3 Disclosures

for the year ended 31 December 2009

April 2010

Skipton Building Society

Pillar 3 disclosures for the year ended 31 December 2009

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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 Skipton Building Society 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 investors' deposits. The rules are set out in the 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 specific risks faced by the institution 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 quantitative and qualitative information regarding their risk assessment process and capital resources, and hence their capital adequacy.

1.2 Basis and frequency of disclosure

This Pillar 3 report is based upon the Group's Annual Report and Accounts for the year ended 31 December 2009, unless otherwise stated. Subsequent disclosures will be issued on an annual basis as soon as practicable after the publication of the Group's Annual Report and Accounts.

1.3 Media and location of publication

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 for the disclosures to be audited; however, some of the information within the disclosures also appears in the Group's audited 2009 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).

For prudential and Pillar 3 reporting purposes consolidation is carried out at the following levels:

- Solo consolidation group
- UK consolidation group

However, the risks within the Skipton Group are controlled and managed on a full consolidation level so for Pillar 3 purposes the capital adequacy of the full group has also been disclosed.

Solo consolidation group

As at 31 December 2009 the Solo consolidation group consists of Skipton Building Society, Amber Homeloans Limited, North Yorkshire Mortgages Limited and Skipton Building Society Covered Bonds LLP.

UK consolidation group

As at 31 December 2009 the UK consolidation group (UKCG) consists of the entire Group with the exception of the following entities in accordance with BIPRU 8.5.1:

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

One of the subsidiary companies within the full group and the UK consolidation group is Skipton International Limited which is based in Guernsey and regulated by the Guernsey Financial Services Commission.

On 30 March 2009 the Society merged with the former Scarborough Building Society and therefore all of the figures included within this report as at 31 December 2009 represent the merged position.

3.0 Risk management objectives and policies

3.1 Introduction

The Board understands that risk can arise as a consequence of decisions taken in order to achieve its business objectives but endeavours, through positive mitigation strategies, to manage these in a manner that optimises returns 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 Risk Appetite

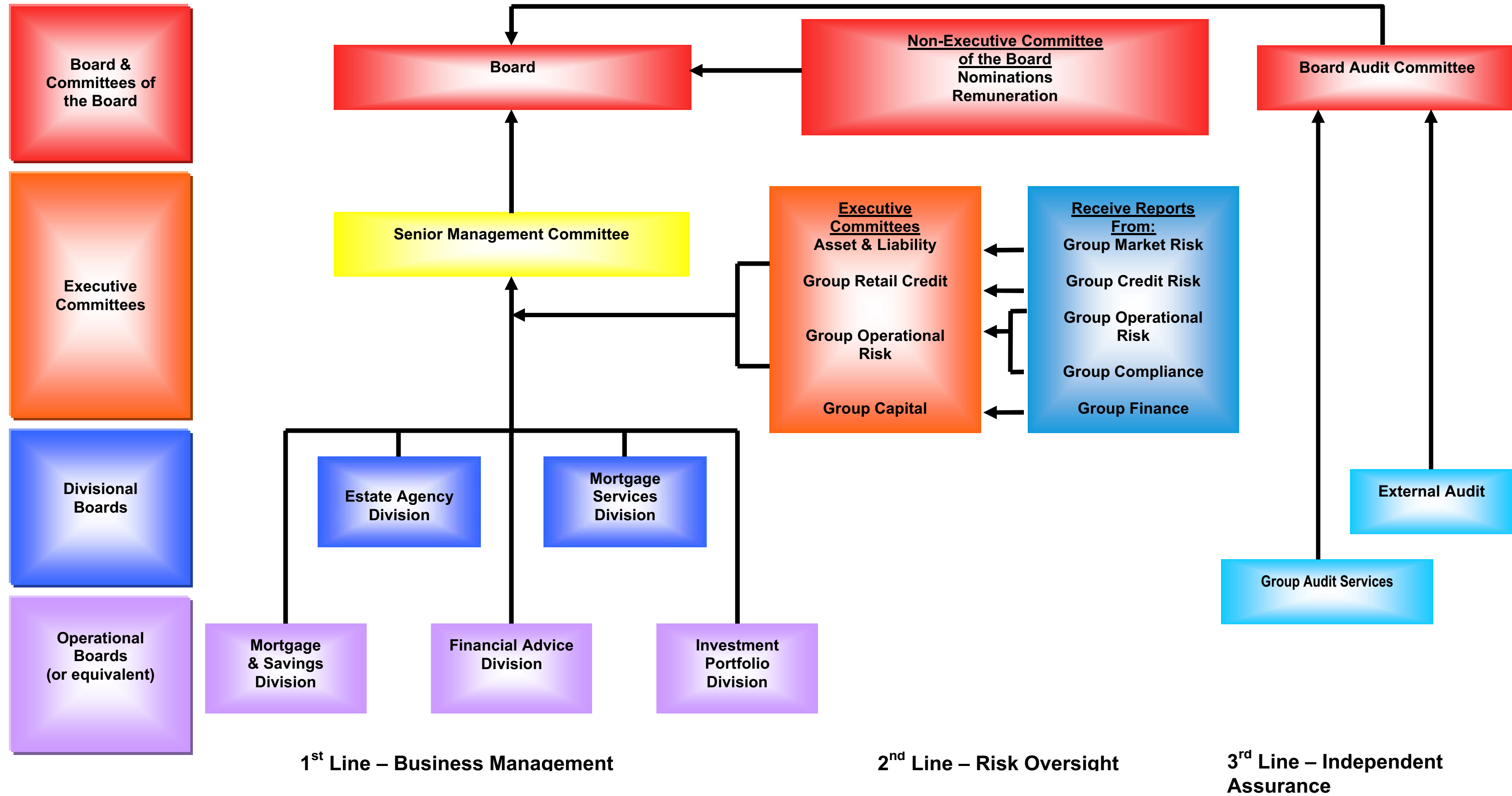
As a mutual organisation the Skipton Board is charged with the protection of member deposits and bases its risk appetite on avoiding strategies or business practices which would in any way threaten member interests.

The Board's risk appetite specifically addresses profit performance, capital adequacy and liquidity position and is supported by a comprehensive range of metrics used to assess business performance and risk exposure against the Board's stated position.

3.3 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 line management within the business which, through the implementation of the organisation's risk framework, identifies, assesses, and manages risk.
- **Second line** of defence comprising independent risk functions (Operational, Credit and Market) and related risk functions including Compliance, Systems Security, Finance and Insurance. These functions challenge, monitor, guide and support the business in managing its risk exposure. The Risk framework includes a number of risk committees (Asset and Liability Committee, Group Wholesale Credit Committee, Group Retail Credit Committee, Group Operational Risk Committee, and the Group Capital Committee) responsible for setting policy and framework and monitoring implementation by the business. The independent Group risk functions are represented on each of the risk committees.
- **Third line** of defence, provided by Group Audit Services, is designed to provide independent assurance to the Board (via the Audit Committee) of the adequacy and effectiveness of control systems within the first and second lines in managing and controlling risk.


Skipton Group Governance Framework
Board & Committees of the Board
Executive Committees
Divisional Boards
Operational Boards (or equivalent)
Board
Non-Executive Committee of the Board
Nominations
Remuneration
Board Audit Committee
Senior Management Committee
Executive Committees
Asset & Liability
Group Retail Credit
Group Operational Risk
Group Capital
Receive Reports From:
Group Market Risk
Group Credit Risk
Group Operational Risk
Group Compliance
Group Finance
Estate Agency Division
Mortgage Services Division
External Audit
Group Audit Services
Mortgage & Savings Division
Financial Advice Division
Investment Portfolio Division
1st Line – Business Management
2nd Line – Risk Oversight
3rd Line – Independent Assurance

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

3.4 Board

- The Board is responsible for oversight of the Group's strategy ensuring that it has an appropriate control framework in place to deliver strategic objectives.
- It ensures that appropriate levels of capital are held to support the business through economic downturn and periods of general business stress.
- To achieve this, the Board receives and considers for approval the Group's Internal Capital Adequacy Assessment Process document (ICAAP) and key risk management policies for all risk categories.

3.5 Senior Management Committee (SMC)

SMC is responsible for oversight of the development and implementation of commercial and balance sheet strategy, monitoring the financial performance of Group companies to ensure Corporate Plan objectives are met and identification and monitoring of strategic risks facing the business. The Committee which meets monthly is chaired by Mr Cutter (Group Chief Executive Officer) and comprises the Group Finance Director, Group Commercial Director, Director of Group Risk and Group Secretary. Individual members of SMC chair the Executive Risk Committees described below.

3.6 Asset and Liability Committee (ALCO)

ALCO is primarily responsible for developing and maintaining policies on structural risk management, liquidity and deposit funding, recommending changes to these policies to the Board, monitoring implementation to ensure that the Group operates within risk limits and that the Society has adequate liquid financial resources to meet its liabilities. Mr Twigg (Group Commercial Director) chairs the Committee which comprises the Group Chief Executive, Group Finance Director, Director of Group Risk and Senior Executives from Treasury, Marketing, Risk and the Group's Mortgages and Savings division.

The Group Wholesale Credit Committee, a sub-committee of ALCO, is primarily responsible for developing and maintaining policies for monitoring and controlling the risks arising from the Group's wholesale counterparty credit exposures, approving new counterparty limits, and recommending any changes to these policies to ALCO and the Board. It ensures that wholesale credit exposures are regularly monitored and within risk limits. Mr Wood (Group Finance Director) chairs the Committee which comprises Senior Executives from Treasury and Group Risk.

3.7 Group Retail Credit Committee (GRCC)

GRCC is primarily responsible for developing and maintaining policies for monitoring and controlling the risks to the Group arising from the credit quality of its retail loan books and the residual values of lending assets, recommending changes to these policies to the Board and monitoring implementation to ensure that the Group operates within risk limits. Mr Wood (Group Finance Director) chairs the Committee which comprises the Group Chief Executive, Group Commercial Director, Director of Group Risk and Group Secretary together with Senior Executives from the Credit Risk team, and the Group's Mortgages and Savings division.

3.8 Group Operational Risk Committee (GORC)

GORC meets bi-monthly and its primary responsibility is to develop and keep under review the Group's operational risk management framework and oversee the management of operational risk across the Group. Mrs Davidson (Group Secretary) chairs the Committee which comprises the Group Finance Director, Group Commercial Director, Director of Group Risk, Senior Executives from each of the divisions and members of the Group Operational Risk team.

3.9 Board Audit Committee (BAC)

The Audit Committee, which meets at least four times a year, comprises four Non-Executive Directors, currently Ms Hay-Plumb (Chairperson) and Messrs Hales, Spence and Thompson. In addition, the Group Chief Executive, Group Finance Director, Director of Group Risk, External Audit representatives and the General Manager, Audit Services, regularly attend meetings, by invitation. The Board is satisfied that the composition of the Audit Committee contains Directors with relevant, recent financial experience to provide appropriate challenge to management. Ms Hay-Plumb is a Chartered Accountant and Mr Spence is a fellow of the Chartered Institute of Bankers in Scotland.

The responsibilities of the Committee are in line with the provisions of the Financial Reporting Council Guidance on Audit Committees. The Audit Committee's primary responsibilities include:

- monitoring the integrity of the Group's financial statements, any formal announcements relating to the Group's financial performance and significant reporting judgments contained in them;
- monitoring the effectiveness of the external audit process and making recommendations to the Board on the appointment, re-appointment and remuneration of the external auditor;
- ensuring that an appropriate relationship between the Group and the external auditor is maintained, including reviewing non-audit services which can be provided and fees; and
- reviewing the effectiveness of the internal audit function. The Committee is responsible for approving, upon the recommendation of the Group Chief Executive, the appointment and removal of the General Manager, Audit Services.

The Board has delegated responsibility for reviewing the effectiveness of the Group's internal controls and risk management systems to the Audit Committee.

3.10 Group Capital Committee (GCC)

GCC meets quarterly and is an executive committee that reviews Group policies in relation to capital and monitors both compliance with these policies and the Group's overall capital adequacy. GCC also reviews and manages the forecast capital adequacy of the regulated entities within the Group to ensure the Group's capital resources are utilised in the most efficient manner to achieve its corporate objectives. Mr Wood (Group Finance Director) chairs the Committee which comprises the Group Chief Executive, Group Commercial Director and Director of Group Risk together with Senior Executives from the Treasury and Group Finance functions.

4.0 Capital resources

4.1 Total capital resources

The table below sets out the capital resources of the full group, UK consolidation group and Solo consolidation group as at 31 December 2009.

	2009 Full group[1] £m	2008 Full group £m	2009 UK group £m	2008 UK group £m	2009 Solo group £m	2008 Solo group £m
Tier 1						
Reserves	**752.2**	703.6	**697.2**	651.0	**639.7**	614.3
Permanent Interest Bearing Shares (PIBS)	**90.0**	25.0	**90.0**	25.0	**90.0**	25.0
Pension fund deficit adjustment	**8.7**	16.7	**3.3**	1.3	**3.3**	1.3
Unrealised losses on available-for-sale debt securities	**6.2**	13.2	**6.2**	13.2	**7.0**	13.2
Unrealised losses on cash flow hedges	**16.0**	21.2	**16.0**	21.2	**16.4**	21.2
Total Tier 1 capital before deductions	**873.1**	779.7	**812.7**	711.7	**756.4**	675.0
Deductions from Tier 1 capital:						
Goodwill	**(159.8)**	(210.9)	**(40.3)**	(96.2)	**-**	-
Intangible assets	**(22.4)**	(31.6)	**(13.3)**	(23.1)	**(4.0)**	(2.8)
Material holdings (50%)	**-**	-	**-**	-	**(35.7)**	(22.5)
Total Tier 1 capital after deductions	**690.9**	537.2	**759.1**	592.4	**716.7**	649.7
Tier 2						
Subordinated debt	**207.8**	180.0	**207.8**	180.0	**220.3**	180.0
Collective impairment allowance	**29.6**	14.0	**29.6**	14.0	**29.6**	14.0
Total Tier 2 capital	**237.4**	194.0	**237.4**	194.0	**249.9**	194.0
Deductions from Tier 1 and Tier 2 capital:						
Investment in subsidiary companies	**-**	-	**(84.0)**	(79.3)	**(108.9)**	(161.2)
Material holdings (50%)	**-**	-	**-**	-	**(35.7)**	(22.5)
Total capital after deductions	**928.3**	731.2	**912.5**	707.1	**822.0**	660.0

4.2 Tier 1 capital

Tier 1 capital comprises internally generated capital from retained profits and issued capital in the form of Permanent Interest Bearing Shares (PIBS). For capital purposes unrealised gains / losses on available-for-sale debt securities and cash flow hedges are removed from reserves in accordance with GENPRU 1.3.36. In addition, an adjustment has been made for the pension fund obligation as permitted by the GENPRU rules.

All PIBS are unsecured and rank pari passu with each other. They are deferred shares of the Society and rank behind the claims against the Society of all subordinated note holders, depositors, creditors and investment members of the Society. Under the FSA rules PIBS are included in the Group's capital resources in accordance with UK GAAP rather than IFRS.

The regulatory capital rules allow the pension fund deficit, which for accounting purposes is deducted from reserves, to be added back to reserves and instead a deduction is made for the cash that is expected to be paid in addition to the normal contributions over the next five years.

Intangible assets are deducted from capital for regulatory purposes.

[1] The Group is not required by the FSA to hold a minimum level of capital at a full consolidation group level.

4.3 Tier 2 capital

Tier 2 capital comprises subordinated debt and collective impairment allowances. Under FSA rules Tier 2 capital cannot exceed 50% of total Tier 1 capital.

The subordinated note holders' rights are subordinated to those of the depositors and other creditors. Further details regarding subordinated debt are set out in note 29 to the Group's 2009 Annual Report and Accounts. Under FSA rules subordinated debt is included in the Group's capital resources in accordance with UK GAAP rather than IFRS. In the last five years to maturity subordinated debt instruments are amortised down to zero on a straight line basis in accordance with the GENPRU rules.

4.4 UK and Solo consolidation

At a Solo consolidation level the cost of investment in material holdings outside the Solo consolidation group is required to be deducted from capital resources. A material holding represents an investment in a financial institution or credit institution which exceeds 10% of the share capital of the issuer, eg the Society's investment in Skipton International Limited. This deduction is split equally between Tier 1 and Tier 2.

At both a UK and a Solo consolidation level the cost of investment in subsidiary companies outside the group is required to be deducted from Tier 1 and Tier 2 capital in accordance with the GENPRU rules.

5.0 Capital adequacy

5.1 Summary of approach to capital adequacy planning

Capital is held by the Group to absorb losses which may occur during the economic cycle. The Internal Capital Adequacy Assessment Process (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 in light of the risks it faces; 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.

Under FSA rules (Pillar 1) a minimum level of capital must be held for credit risk, operational risk and market risk for the Solo and UK consolidation groups. The Group has adopted the standardised approach to calculate the minimum regulatory capital resource requirement for credit risk and operational risk, and market risk has been calculated in accordance with BIPRU 7.

The following table sets out the minimum capital resources requirements (Pillar 1) for the Solo, UK and full consolidation groups, together with their respective capital adequacy positions as at 31 December 2009.

	2009 Full group[1] £m	2008 Full group £m	2009 UK group £m	2008 UK group £m	2009 Solo group £m	2008 Solo group £m
Credit Risk (Standardised)	**454.6**	407.8	**449.1**	402.9	**437.5**	394.5
Operational Risk (Standardised)	**57.8**	67.7	**26.1**	33.2	**4.0**	5.5
Market Risk (Foreign Exchange PRR[2])	**0.6**	0.7	**0.1**	0.2	**-**	-
Total minimum capital requirement	**513.0**	476.2	**475.3**	436.3	**441.5**	400.0
Total capital resources (section 4.1)	**928.3**	731.2	**912.5**	707.1	**822.0**	660.0
Excess of own funds over minimum capital requirement under Pillar 1	**415.3**	255.0	**437.2**	270.8	**380.5**	260.0
Capital ratio (%)	**181.0%**	153.5%	**192.0%**	162.1%	**186.2%**	165.0%

5.2 Capital reporting

The Pillar 1 regulatory capital adequacy of the Solo consolidation and UK consolidation groups are 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 group level is reported to the Board monthly.

The results of the ICAAP are articulated in a single document which is reviewed and approved by the Board and updated at least annually and more frequently should a significant change in the Group's risk profile occur. On a regular basis the Board also receives a summarised update of the ICAAP document.

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 consolidation 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 foreseeable material, practical or legal impediments to the prompt repayment of liabilities among the Society and its subsidiary undertakings.

6.0 Minimum capital requirement – Pillar 1

This section sets out the details of each of the Pillar 1 components: credit risk; operational risk, and market risk. Each subsection includes the minimum capital component for the full consolidation group, the UK consolidation group and the Solo consolidation group.

6.1 Credit risk overview

Credit risk is the risk that a customer or counterparty is unable to honour their obligations as they fall due. The Group faces this risk in respect of:

- individual customers (retail mortgages);
- businesses (through historic commercial lending). The Society ceased new commercial lending in November 2008 when it was concluded that the outlook for commercial property was poor; and
- other financial institutions (wholesale lending).

[1] The Group is not required by the FSA to hold a minimum level of capital at a full consolidation group level.
[2] Position Risk Requirement.

Credit risk within our retail and existing commercial mortgage portfolios is driven by general UK economic pressures, including rising unemployment, deterioration in household finances and further contraction in the UK property market leading to falling property values. A reversal of the economic recovery and the return of falls in house prices and commercial property values would affect the level of impairment losses.

In our residential mortgage business we closely monitor applicant quality, affordability and loan-to-value (LTV) multiples. The credit decision is always managed separately from the sales force originating the business. Retail mortgage credit risks are managed within credit policies and limits set by the Group Retail Credit Committee and loans which show signs of adverse performance are managed by specialist teams who manage the collections and recovery process.

Credit risk within our treasury portfolio assets arises from the investments held by the Group in order to meet liquidity requirements and for general business purposes. The wholesale credit markets remain volatile and dislocated and a further deterioration could lead to additional fair value adjustments in the Group's portfolio of available-for-sale assets coupled with further impairment of our treasury investments portfolio. This element of credit risk is managed by the Treasury team within strict limits set by ALCO with a regular review of credit policies and performance through the Group Wholesale Credit Committee.

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

The following table details the minimum capital requirement for credit risk for the full consolidation group as at 31 December 2009 broken down by exposure value.

	Exposure value £m	**Capital requirement £m**
Corporates – other lending to corporates	27.0	2.2
Retail – debt factoring loans	30.8	1.8
Secured on real estate property	10,245.3	342.8
Past due items	391.0	33.2
Other items	19.0	0.7
Total loans and advances to customers	**10,713.1**	**380.7**
Central governments or central banks	1,893.9	-
Regional governments or local authorities	10.4	0.2
Multilateral development banks	85.3	-
Financial institutions	1,104.6	20.3
Securitisation positions – see section 6.1.8	314.1	7.8
Short-term claims on institutions and corporates	649.8	10.4
Total wholesale lending	**4,058.1**	**38.7**
Other items – eg fixed assets, derivatives, and sundry debtors	541.5	35.2
Total other	**541.5**	**35.2**
Total	**15,312.7**	**454.6**

The following table details the minimum capital requirement for credit risk for the UK consolidation group as at 31 December 2009 broken down by exposure value.

	Exposure value £m	Capital requirement £m
Corporates – other lending to corporates	27.0	2.2
Retail – debt factoring loans	30.8	1.8
Secured on real estate property	10,249.2	342.9
Past due items	391.0	33.2
Other items	17.3	0.6
Total loans and advances to customers	**10,715.3**	**380.7**
Central governments or central banks	1,893.9	-
Regional governments or local authorities	10.4	0.2
Multilateral development banks	85.3	-
Financial institutions	1,098.4	20.2
Securitisation positions – see section 6.1.8	314.1	7.8
Short term claims on institutions and corporates	649.8	10.4
Total wholesale lending	**4,051.9**	**38.6**
Other items – eg fixed assets, derivatives, and sundry debtors.	475.9	29.8
Total other	**475.9**	**29.8**
Total	**15,243.1**	**449.1**

The following table details the minimum capital requirement for credit risk for the Solo consolidation group as at 31 December 2009 broken down by exposure value.

	Exposure value £m	Capital requirement £m
Corporates – other lending to corporates	23.6	1.9
Retail – other	1.2	0.1
Secured on real estate property	9,864.5	329.7
Past due items	391.0	33.2
Other items – deeds accounts	0.6	-
Total loans and advances to customers	**10,280.9**	**364.9**
Central governments or central banks	1,893.3	-
Regional governments or local authorities	10.4	0.2
Multilateral development banks	85.3	-
Financial institutions	1,012.2	18.0
Securitisation positions – see section 6.1.8	314.1	7.8
Short term claims on institutions and corporates	649.8	10.4
Total wholesale lending	**3,965.1**	**36.4**
Other items – eg fixed assets, derivatives, and sundry debtors.	524.0	36.2
Total other	**524.0**	**36.2**
Total	**14,770.0**	**437.5**

6.1.1 Credit risk: loans and advances to customers

Retail mortgage credit risks are managed within the policy set by GRCC which is summarised below:

- The credit risk associated with potential borrowers is evaluated through a combination of lending policy criteria which are regularly reviewed and updated to reflect changing macroeconomic environments, credit scoring, policy rules and underwriting. The primary factors considered are affordability using appropriate stressing, residential status, residential history, credit history, employment history, nature of income and LTV. In addition, confirmation of borrower identity is obtained. When considering applications the primary focus is placed on the strength of the covenants which will determine the willingness and ability to repay;
- The geographic and product segments are monitored to ensure nature limits are adhered to on a monthly basis;
- The maximum loan available is determined by its percentage of the lower of the vacant possession price or open market value, with nature limits for LTV bandings and business distribution reviewed monthly;
- The taking of security against the loan. All mortgages are secured by way of a first legal charge against the property with the current risk appetite predominantly for loans secured against wholly residential properties ; and
- Ongoing monitoring of account performance, including arrears and default emergence by portfolio sectors. 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. Reports on the credit risk exposure and performance of the portfolios are reported to GRCC and the Board on a monthly basis.

In all instances the value of a security to be mortgaged will be assessed prior to the granting of a loan facility and is subsequently updated using house price indices or on a case by case basis by suitably qualified professionals.

The majority of loans and advances to customers are secured on UK residential properties with no particular geographic concentrations. By their nature, our residential lending books comprise a large number of smaller loans, and historically had a low volatility of credit risk outcomes.

The table below sets out the gross credit risk arising from loans and advances to customers.

			2009	
	Full group 08 / 09 average £m	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Total residential mortgages	9,463.8	10,112.0	10,115.9	9,730.9
Commercial loans	525.8	523.9	523.9	523.9
Other lending:				
Debt factoring loans	31.8	32.7	32.7	-
Other loans	47.3	44.5	42.8	26.1
Gross balances	**10,068.7**	**10,713.1**	**10,715.3**	**10,280.9**
Impairment provisions	(64.6)	(85.1)	(85.1)	(84.7)
Fair value adjustment	186.3	185.3	185.3	179.3
Total	**10,190.4**	**10,813.3**	**10,815.5**	**10,375.5**

The maturity of loans and advances to customers from 31 December 2009 is as follows:

	2009		
	Full consolidation group £m	**UK consolidation group £m**	**Solo consolidation group £m**
On call and at short notice	40.7	39.0	6.2
In not more than three months	5.5	5.5	5.5
In more than three months but not more than one year	30.0	30.0	30.0
In more than one year but not more than five years	371.1	371.1	371.1
In more than five years	10,451.1	10,455.0	10,047.4
	10,898.4	**10,900.6**	**10,460.2**
Less: Impairment	(85.1)	(85.1)	(84.7)
Total	**10,813.3**	**10,815.5**	**10,375.5**

6.1.2 Credit risk: commercial lending

The Society ceased commercial lending to new customers in November 2008 and now manages the exposure in run-off.

The remaining commercial lending credit risks are managed within the policy set by GRCC, which placed limits on business volumes as well as the sector, geography, the maximum LTVs permissible, size and seniority of exposures.

Lending decisions were 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. The remaining exposures are subject to regular scrutiny and performance reviews by suitably experienced underwriters. Consideration was also given to risk mitigation measures at inception of the loan which will provide the Group with protection in the event that a loan becomes impaired, 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 and updated assessments of the value of the primary security. 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 individually by specialist teams who oversee the collections and recovery processes. The Board and GRCC review reports on credit risk exposures and performance of the commercial portfolio monthly.

The table below sets out the Skipton Group's commercial loan exposure by industry type. The commercial loan exposures are held by the Society.

	2009 £m
Leisure and hotel	51.3
Retail	18.0
Nursing / residential homes	35.0
Offices	16.4
Commercial investment and industrial units	373.9
Miscellaneous	29.3
Total	**523.9**

6.1.3 Credit risk: wholesale lending

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

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 on a weekly basis. Ongoing monitoring of asset quality and compliance with limits and policies is undertaken by the independent Market Risk function with reports issued to the Group Wholesale Credit Committee, ALCO and the Board on a monthly basis.

The table below sets out the liquidity book by industry sector / asset class.

	Full group 08/09 average £m	Full consolidation group £m	2009 UK consolidation group £m	Solo consolidation group £m
Cash in hand and balances with the Bank of England	815.7	1,272.1	1,272.0	1,272.0
Cash with banks and building societies	750.9	437.4	431.3	409.9
Gilts	131.8	152.7	152.6	152.6
Certificates of deposit	925.0	903.6	903.6	903.6
Local authority investments	7.1	10.4	10.4	10.4
Fixed rate bonds	142.8	283.8	283.8	283.8
Floating rate notes	537.4	684.8	684.8	619.5
Residential mortgage backed securities	249.4	255.9	255.9	255.9
Commercial mortgage backed securities	58.4	58.2	58.2	58.2
Total	**3,618.5**	**4,058.9**	**4,052.6**	**3,965.9**

The table below sets out the maturity of the liquidity book.

	Full consolidation group £m	2009 UK consolidation group £m	Solo consolidation group £m
Loans and advances to credit institutions			
Repayable on demand	135.9	132.2	111.3
In not more than three months	307.7	305.2	305.1
In more than one year	3.9	3.9	3.9
	447.5	**441.3**	**420.3**
Debt securities			
In not more than one year	1,203.8	1,203.8	1,173.0
In more than one year	1,135.5	1,135.5	1,100.6
	2,339.3	**2,339.3**	**2,273.6**
Cash in hand and balances with the Bank of England			
Repayable on demand	1,272.1	1,272.0	1,272.0
	1,272.1	**1,272.0**	**1,272.0**
Total	**4,058.9**	**4,052.6**	**3,965.9**

The table below sets out the capital held for the liquidity book by credit rating.

Rating	Full consolidation group		UK consolidation group		Solo consolidation group	
	Exposure £m	**Capital £m**	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**
Aaa	2,277.1	4.6	2,277.0	4.6	2,272.0	4.5
Aa1	205.9	3.2	204.6	3.2	199.7	3.2
Aa2	276.4	4.4	271.0	4.3	254.9	4.1
Aa3	881.0	14.0	881.6	14.0	843.9	13.4
A1	188.1	4.7	188.1	4.7	180.6	4.0
A2	93.0	1.6	93.0	1.6	93.0	1.6
A3	54.3	2.0	54.3	2.0	38.8	1.4
Baa1	37.5	0.8	37.5	0.8	37.5	0.8
Baa2	6.7	0.5	6.6	0.5	6.6	0.5
Baa3	3.5	0.3	3.5	0.3	3.5	0.3
Ba3	3.5	1.0	3.5	1.0	3.5	1.0
Caa2	3.9	1.1	3.9	1.1	3.9	1.1
Unrated:						
Building societies	17.6	0.3	17.6	0.3	17.6	0.3
Local authorities	10.4	0.2	10.4	0.2	10.4	0.2
Total	**4,058.9**	**38.7**	**4,052.6**	**38.6**	**3,965.9**	**36.4**

The table below sets out the capital held for the liquidity book by geographical region.

Geographical region	Full consolidation group		UK consolidation group		Solo consolidation group	
	Exposure £m	**Capital £m**	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**
UK	3,032.6	21.8	3,033.0	21.8	2,995.2	20.9
Rest of Europe	765.5	11.8	765.5	11.8	731.4	10.9
North America	129.8	2.1	129.7	2.1	124.7	2.0
Australasia	96.2	2.4	89.6	2.3	79.8	2.0
Far East	34.8	0.6	34.8	0.6	34.8	0.6
Total	**4,058.9**	**38.7**	**4,052.6**	**38.6**	**3,965.9**	**36.4**

To obtain the risk weights and hence calculate the minimum credit risk capital requirement for wholesale lending exposures, Skipton uses Moody's, Fitch and Standard & Poor's as External Credit Assessment Institutions (ECAIs). The Group's preference is to use the long-term rating; however, the short-term rating is used if this is unavailable. For asset-backed securities, the issue rating is used. This process is documented within the Treasury Policy and is supported by Treasury credit procedures.

The table below sets out the exposure values and risk weightings associated with each credit quality step under the standardised approach (asset-backed securities are covered in section 6.1.8).

Central Governments and Central Banks				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's[3] ratings**	**Exposure values £m**
1	-	0%	Aaa	**1,893.9**

Regional Governments and Local Authorities				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
Unrated	-	20%	Unrated	**10.4**

Multilateral Development Banks				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	0%	Aaa	**85.3**

Financial Institutions				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	1,369.1
2	Residual / original maturity < 3 months	20%	A1 to A3	156.8
2	Original maturity > 3 months	50%	A1 to A3	174.4
3	Residual / original maturity < 3 months	20%	Baa1 to Baa3	34.9
3	Original maturity > 3 months	50%	Baa1 to Baa3	1.6
Unrated	-	20%	Unrated	17.6
				1,754.4

Residential Mortgage Backed Securities				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	253.7
2	-	50%	A1 to A3	2.2
				255.9

[3] The Group uses Moody's, Fitch and Standard and Poor's, however, the preference is to use Moody's and that is why the table shows Moody's ratings.

Commercial Mortgage Backed Securities				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	37.6
2	-	50%	A1 to A3	2.0
3	-	100%	Baa1 to Baa3	11.2
4	-	350%	Ba1 to Ba3	7.4
	-			**58.2**

Full group total	**4,058.1**

6.1.4 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.

6.1.5 Impairment

Impairment of loans and advances to customers

The Group assesses monthly the trends of balances of those financial assets or groups of financial assets that are impaired, with GRCC and the Board receiving trend and emergence analysis relating to each sector of the secured lending portfolio in respect of residential and commercial assets. At each balance sheet date GRCC considers the level of provisions and takes into account expected macroeconomic factors, such as unemployment, house prices and interest rates, which will impact on the performing portfolios for the calculation of collective impairment, and the quantum assessed to meet any losses which may arise as a result of ultimate foreclosure.

Individual assessments are made of all mortgage loans where objective evidence indicates losses are likely or the property is in possession or where fraud or negligence has been identified. Objective evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficulty, default or delinquency in interest or principal payments, or the debt being renegotiated to reduce the burden on the borrower. Based upon these assessments an individual impairment reduction of these assets is made.

The Group applies a policy of capitalising residential arrears, with the customer's consent, once the customer has made at least six consecutive contractual monthly mortgage repayments following the instance of non-payment. The effect is to bring the loan account up to date and it is therefore no longer past due or individually impaired. If a customer's arrears have previously been capitalised, the customer is required to have made at least 12 consecutive contractual monthly repayments in order to qualify for further capitalisation.

The Society applies a similar policy for its commercial loan book as for its residential book, whereby customer arrears can be capitalised following six consecutive contractual monthly repayments following the instance of non-payment, or 12 such repayments if the account has previously had arrears capitalised.

For the purposes of the information set out in this document 'past due' is defined as one day over the date of which a monthly contractual instalment is due.

The following table shows the balance of those loans that have been renegotiated and would have been past due or impaired if their terms had not been renegotiated:

	Full group £m 2009	Full group £m 2008	UK group £m 2009	UK group £m 2008	Solo group £m 2009	Solo group £m 2008
Residential	**94.3**	27.1	**94.3**	27.1	**88.7**	22.3
Commercial	**11.1**	3.5	**11.1**	3.5	**11.1**	3.5

The table below provides further information on residential loans and advances by payment due status.

	2009		
	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Neither past due nor individually impaired	9,502.1	9,506.0	9,124.2
Past due but not individually impaired:			
Up to 3 months	82.3	82.3	79.6
3 to 6 months	12.8	12.8	12.3
6 to 9 months	5.8	5.8	5.8
9 to 12 months	1.4	1.4	1.4
Over 12 months	4.9	4.9	4.9
Total	**9,609.3**	**9,613.2**	**9,228.2**
Individually impaired	463.4	463.4	463.4
Possessions	39.3	39.3	39.3
Total	**10,112.0**	**10,115.9**	**9,730.9**

The table below provides further information on commercial loans and advances by payment due status.

Full consolidation group, UK consolidation and Solo group	**2009 £m**
Neither past due nor individually impaired	504.9
Past due but not individually impaired:	
Up to 3 months	11.6
3 to 6 months	0.4
6 to 9 months	0.2
9 to 12 months	-
Over 12 months	0.2
Total	**517.3**
Individually impaired	6.6
Total	**523.9**

The table below sets out the impairment losses on loans and advances for the full consolidation group for the year ended 31 December 2009.

	Loans fully secured on residential property	Loans fully secured on land	Other loans	Total
	£m	£m	£m	£m
Group				
At 1 January 2009				
Individual impairment	27.7	0.7	1.7	**30.1**
Collective impairment	13.2	0.8	-	**14.0**
	40.9	**1.5**	**1.7**	**44.1**
Transfer of engagements				
Individual impairment	4.3	-	-	**4.3**
Collective impairment	23.0	-	-	**23.0**
	27.3	**-**	**-**	**27.3**
Amounts written off during the year				
Individual impairment	(29.5)	-	(0.4)	(29.9)
	(29.5)	**-**	**(0.4)**	**(29.9)**
Unwind of merger fair value adjustments				
Collective impairment	(12.5)	-	-	(12.5)
	(12.5)	**-**	**-**	**(12.5)**
Income Statement				
Impairment losses on loans and advances				
Individual impairment	48.7	1.1	1.6	51.4
Collective impairment	0.6	4.5	-	5.1
	49.3	**5.6**	**1.6**	**56.5**
Adjustment to impairment losses on loans and advances resulting from recoveries during the year				
Individual impairment	(0.4)			**(0.4)**
Charge for the year	**36.4**	**5.6**	**1.6**	**43.6**
At 31 December 2009				
Individual impairment	**50.8**	**1.8**	**2.9**	**55.5**
Collective impairment	**24.3**	**5.3**	**-**	**29.6**
	75.1	**7.1**	**2.9**	**85.1**

Impairment of treasury assets

The table below sets out the impairment losses on Treasury assets for the Skipton Group for the year ended 31 December 2009 which is the same for all levels of consolidation.

	£m
At 1 January 2009	
Individual impairment	11.5
Amounts written off during the year	
Individual impairment	(9.4)
Income Statement	
Impairment losses on treasury assets	
Individual impairment	1.7
Adjustment to impairment losses on loans and advances resulting from recoveries during the year	
Individual impairment	(3.0)
Charge for the year	**(1.3)**
At 31 December 2009	
Individual impairment	0.8
	0.8

6.1.6 Credit risk mitigation

The Group has available to it a variety of methods and techniques to reduce the credit risk of its lending predicated on a principle of forbearance where borrowers are experiencing periods of difficulties in servicing their loans. The Group employs staff with considerable experience in individually assessing borrowers' financial capability and to assist borrowers accordingly where it is practical and within a Treating Customers Fairly framework. This may include advising them of interim arrangements open to them to assist in periods of difficulty or recommending external resources that could be accessed including relevant debt counselling services.

Residential mortgages

The ultimate source of collateral and final recourse for credit risk mitigation remains the borrower's property in the event of a loan secured against a residential property. The extent of mitigation is predetermined by the original and current LTV assessed by either a valuation conducted by a suitably qualified professional firm or, in instances of lower LTV lending, by employing an Automatic Valuation Model which is subject to criteria conditions agreed ultimately by GRCC and set within the lending criteria. The lending is secured against the property on the specific condition that it is insured for normal property damage perils and borrowers may also seek to protect against loss of earnings as a result of sickness and unemployment by purchasing an optional mortgage payment protection policy.

Commercial mortgages

The commercial property is the primary source of collateral utilised for credit risk mitigation and in all instances will be secured by way of first legal charge over the freehold or long leasehold property. The primary security may be supplemented, depending on the nature and amount of the loan and the security offered, by other forms of security deemed appropriate and considered on a case by case basis. The forms of additional security could comprise legal undertakings, mortgage debentures, equitable charges and personal guarantees or as sanctioned by the Commercial Underwriting team who are suitably experienced to make these determinations. The Group ceased originations of new commercial lending during 2008 but will consider alterations to present commercial borrowings on a case by case basis.

For all commercial securities, valuations are always undertaken prior to inception of the loan by suitably qualified professionals with relevant expertise in commercial properties and the Group may seek subsequent valuations as it is deemed appropriate. The legal documentation is performed by reference to selected solicitors acting for the Group and appointed to ensure that the covenants are robust and enforceable in addition to the validity of any additional security afforded or required as a condition of our loan.

For a commercial security the requirement for insurance is considered. Such insurance must be taken out and maintained for the duration of the loan in relation to normal property damage perils and must protect against insurable events. Other specialist insurance risk coverage may be requested at the discretion of the Group on a case by case basis.

6.1.7 Credit derivatives

The Group does not currently use credit derivatives for risk mitigation.

6.1.8 Securitisation

The Group does not currently issue securitised assets. However, the Group does have exposure to purchased Mortgage Backed Securities.

6.1.9 Derivative counterparty credit risk mitigation

The Group uses derivative instruments (interest rate, foreign currency and equity) to hedge its exposure to market risk. 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. The CSA counterparties are banks that satisfy the credit assessment process specified in the Society's Wholesale Credit Policy.

The Group measures exposure value on counterparty credit exposures under the CCR[4] mark to market method. This exposure value is derived by adding the net market 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.

The total exposure value on counterparty credit risk exposures at 31 December 2009 was:

Derivative exposures	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Total exposure excluding CSA deposits	155.3	155.3	155.3
Netting benefits	-	-	-
Exclude intra-group exposures	(18.4)	(18.4)	(10.6)
Exclude collateral deposited with the Group	(38.4)	(38.4)	(38.4)
Total exposure	**98.5**	**98.5**	**106.3**

The total exposure value by credit quality step at 31 December 2009 was:

Financial Derivative Exposure Values						
Credit quality step	**Maturity**	**Risk weight**	**Moody's ratings**	**Full consol £m**	**UK consol £m**	**Solo consol £m**
1	-	20%	Aaa to Aa3	92.7	92.7	92.7
2	Original maturity > 3 months	50%	A1 to A3	5.8	5.8	5.8
Unrated	-	20%	Unrated	-	-	7.8
Total				**98.5**	**98.5**	**106.3**

[4] Counterparty Credit Risk

Wrong-way risk may occur when exposure to a counterparty is adversely correlated with credit quality of the counterparty. The Society has minimal exposure.

The Society holds Credit Support Annex agreements with derivative counterparties in which collateral is either placed with a counterparty, if the net market value of the derivatives is in favour of the counterparty, or received by the Society, if the net market value of the derivatives is in favour of the Society. If the Society were to be downgraded, there would be no impact on the collateral required.

6.2 Operational risk

The Group defines operational risk as the risk of loss arising from inadequate or failed internal processes, people or systems, or from external events.

Operational risk management is overseen by an executive Group Operational Risk Committee (GORC) that reviews the Group's Operational Risk Management Framework and Standards, monitors the Group's exposure to operational risks and reviews the framework for measuring and controlling these risks. GORC is also responsible for making recommendations to the Board on what the Operational Risk Appetite should be, which is defined at divisional level.

Through the Operational Risk Management Framework, the Board ensures the management and oversight of the key risk exposures facing the Group in the following risk categories:

- Business Continuity
- Change
- Customer / Client Experience
- Financial Management & Management Information
- Fraud
- Data Security
- Information Technology
- Legal & Regulatory
- People
- Premises
- Process
- Third Party Relationships

At an operational level, the Group manages its operational risk exposures through a framework of internal controls and risk mitigation techniques such as insurance and business continuity planning. Risks are monitored through a risk and control self-assessment process 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 Divisional / Operational Board of each Group entity at least annually.

The Operational Risk Management Framework is underpinned by the independent Group Operational Risk function, which provides oversight of each Group business division in terms of consolidating, analysing and challenging line management in its assessment of risk, proposed actions and timelines. This independent function reports on the key operational risks facing the business to the Group Operational Risk Committee and the Board bi-monthly.

As a business providing a service based on processing customer data the Group is very alert to the threats arising from computer hacking, theft or failed processes allowing unauthorised data disclosure. As would be expected of a leading financial services provider, appropriate organisational and technological controls are implemented. To ensure a robust framework is in place the Group Operational Risk Committee has established Information Security standards which all Group businesses must adhere to. Compliance with these standards is monitored by Group Risk and Group Audit Services.

Given the nature of the regulated sectors in which the Group operates one of the key operational risks is the potential failure to maintain ongoing compliance with relevant external regulation across the Group. Each of the regulated businesses has an established Compliance team which both monitors compliance with existing legislation and considers the impact of new requirements. Oversight is provided by a central Group Compliance function which ensures best practice is adhered to and shared across the Group as appropriate.

6.2.1 Minimum capital resources requirement for operational risk (Pillar 1)

The Skipton Group has adopted the standardised approach for calculating the Pillar 1 capital requirements for operational risk, which is based upon the sum of the average of three years' net income, segmented by business line and multiplied by the published regulatory 'beta factors'.

As at 31 December 2009 this approach resulted in the Pillar 1 minimum capital requirements as follows:

	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Operational risk capital requirement	**57.8**	**26.1**	**4.0**

6.3 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 Group Market Risk function reviews adherence to these daily; these are reviewed by ALCO monthly.

6.3.1 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 Group Market 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 is the risk of loss arising from changes in the relationship between interest rates, which have similar but not identical characteristics, for example, LIBOR and the Bank of England's Base Rate. Basis risk is monitored by the independent Group Market Risk function and is reported 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.

The interest rate exposures during 2009 were as follows:

	As at 31 December £m	Average £m	High £m	Low £m	Board Limit at 31 December £m
Earnings-at-risk	2.9	1.6	3.1	0.5	8.2
Market Value	0.7	0.2	0.7	0.0	6.2
USD LIBOR Value-at-Risk	0.6	0.8	0.9	0.6	n/a
2% Parallel Interest Rate Gap	1.6	7.2	21.7	0.0	25.0

6.3.2 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.
- Skipton International Limited's account savings products.

The Board has a limited appetite for currency risk, and requires all Treasury foreign exchange exposures to be hedged within prescribed 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 immaterial.

The Group's exposure to foreign exchange risk is calculated in accordance with BIPRU 7.5, representing 8% of the net sterling equivalent of the foreign currency assets and liabilities. As at 31 December 2009, the foreign currency risk capital requirement was as follows:

	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Foreign exchange risk capital requirement	**0.6**	**0.1**	**-**

6.3.3 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.

At 31 December 2009, the Group had £118.6m of equity related savings balances all of which were fully hedged. Therefore, the Group's exposure to equity risk, net of hedging, is immaterial.

7.0 Other risks faced by the business

This section sets out the other risks faced by the business above and beyond the Pillar 1 risks set out in section 6 above.

7.1 Business risk

The Skipton Group is almost solely focused in the UK market and the main divisions are in large part exposed to the UK property market. Therefore the general UK macro-economic environment is a key determinant of the success of the Group. The main drivers that impact the Group include:

- interest rates (Base and LIBOR);
- inflation;
- unemployment; and
- the housing market (volume of transactions and house price inflation).

The Mortgage and Savings division currently faces challenges from the low interest rate environment, with an overall reduction in its net interest margin. The margin compression is exacerbated by the dislocation in the retail savings market following the credit crunch and the need for all banks to reduce their reliance on wholesale funding. The weak economy also impacts the division through the increase in the impairment charge driven by rising arrears prompted by increasing unemployment and the reduction in refinancing opportunities, which is compounded by weaker asset prices.

The main risk to the core business is the continuation of the exceptionally low base and LIBOR rates which has resulted in continued margin pressure in the core business. The Society's mortgage standard variable rate (SVR) was capped at 3% above bank base although the Society had the right to remove the cap under exceptional circumstances. In light of the continuation of an exceptionally low base rate and the high cost of retail funding the Society determined objectively that exceptional circumstances do prevail; it has removed the SVR ceiling; and increased its SVR from 3.5% to 4.95% from 1 March 2010 to mitigate this risk. The Society has committed to voluntarily re-impose the cap once exceptional circumstances no longer prevail.

The Mortgage Services division is impacted by the changing dynamic in the lending landscape as the impact of the credit crunch changes the dynamic of competition in the UK mortgage market, with a reduction in the overall level of mortgage lending. Whilst, inevitably, the business has seen a fall in the value of assets it manages, conversely there has been an increase in the incidence of accounts in arrears which has acted, to some extent, as a counter balance.

The performance of the Estate Agency division is principally driven by the volume of property transactions, particularly second hand property sales. This market is heavily influenced by consumer confidence, much of which is borne out of the overall level of unemployment and interest rates. The Estate Agency division has a partial counter-cyclical hedge against the performance of its core business through its Asset Management businesses that assist lenders in their management of non-performing loans.

The Financial Advice division is also exposed to the wider UK economy. The main influence on its performance is consumer confidence and the willingness of customers to invest in longer-term products.

7.2 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 Group Market 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 to meet its obligations as they fall due under such scenarios. Stressed liquidity profiles are reported to ALCO and the Board monthly.

7.3 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 five 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 five 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.

7.4 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.

7.5 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 suitable credit rating as assessed and recommended by our professional advisers.

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 miss-selling of a third party's insurance contracts eg general insurance or life sales, is captured under operational risk.

7.6 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 non executive directors of subsidiary companies and therefore attend Divisional / Operational Board of each business Division;
- the bi-annual assessment of the carrying value of subsidiary investments is reported to the Board; and
- initial and future investment in subsidiary companies must be approved by the Senior Management Committee and / or the Board in accordance with documented mandates.

7.7 Credit rating downgrade

A further decline in the Society's credit rating could result in it becoming more difficult to secure wholesale funding and at a higher cost. In addition, in the short term the Group would also have to increase its level of retail funding. Whilst the Group's strong retail franchise would enable this, such funding would be expected to come at a higher cost to the Group. The impact that a credit rating downgrade would have on liquidity is included in the weekly stress testing carried out by Group Market Risk and is reported to ALCO and the Board on a monthly basis.

8.0 Post balance sheet events

In February 2010, Skipton Building Society announced its intention to merge with Chesham Building Society. Subject to confirmation from the FSA the merger will be finalised on 1 June 2010. The risks associated with this transaction will be carefully controlled and managed by the Project Steering Committee. This Pillar 3 report is based upon the Group's Annual Report and Accounts for the year ended 31 December 2009 and therefore any capital impact associated with the merger has not been included in this document.