Skipton Building Society

Pillar 3 Disclosures
for the year ended 31 December 2013

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1.0 INTRODUCTION

This document presents the consolidated Pillar 3 disclosures of the Skipton Building Society Group (‘the Group’) as at 31 December 2013.

1.1 Background

On 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 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 Prudential Regulation Authority (PRA) 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 processes and capital resources, and hence their capital adequacy.

The Group adopted the Pillar 1 standardised approach to credit risk and operational risk from 1 January 2008; it also became subject to Pillar 2 and 3 from that date. The disclosures in this document are on a standardised basis and in accordance with the rules laid out in the PRA handbook BIPRU Chapter 11.

From 1 January 2014 Basel II was replaced by Basel III. Basel III is implemented in Europe through the Capital Requirements Regulation (CRR) and the Capital Requirements Directive, hereafter collectively referred to as ‘CRD IV’. CRD IV has introduced changes to the capital framework and the required disclosures. As this report is based on the 31 December 2013 position it has been prepared under Basel II. However due to the significance of this regulatory change a summary of the key changes, under CRD IV, and their impact has been considered in Section 8.0 of this document.

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 2013, unless otherwise stated. Disclosures are issued on an annual basis as soon as practicable after the publication of the Group’s Annual Report and Accounts.

The Society will produce interim disclosures should there be any significant changes to its risk profile.

1.3 Media and Location of Publication

These Pillar 3 disclosures are published on Skipton Building Society’s website (www.skipton.co.uk).

1.4 Verification of Disclosure

These disclosures have been reviewed by the Group’s Internal Audit Function, to ensure consistency with the underlying books and records, and Board Risk Committee. There is no requirement for the disclosures to be externally audited; although some of the information within the disclosures also appears in the Group’s 2013 Annual Report and Accounts which are externally audited.

2.0 SCOPE OF APPLICATION

For accounting purposes the Society's consolidation group comprises the Society and all of its subsidiaries (i.e. 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 Board controls and manages the risks within the Skipton Group on a full consolidation level so the capital adequacy of the full group has also been disclosed in this Pillar 3 report.

Solo Consolidation Group

At 31 December 2013 the Solo consolidation group comprised of Skipton Building Society, Amber Homeloans Limited (Amber), North Yorkshire Mortgages Limited (NYM), Darrowby No.1 plc, Darrowby No. 2 plc and Beckindale No.1 Limited. Beckindale No.1 Limited was a dormant company at the 31 December 2013 and was dissolved on 18 February 2014.

Following the introduction of CRDIV on 1 January 2014 Darrowby No.1 Plc and Darrowby No.2 plc will no longer be included within the Solo consolidation group. This adjustment will not result in a material change to the capital position of the Solo consolidation group.

UK Consolidation Group

At 31 December 2013 the UK consolidation group (UKCG) consisted of the entire Group with the exception of the following entities in accordance with BIPRU 8.5.1:

- Connells Limited and subsidiary companies
- Jade Software Corporation Limited
- Northwest Investments NZ Limited
- The Private Health Partnership Limited
- 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.

Following the introduction of CRDIV on 1 January 2014 the UKCG will be called the prudential consolidation group. This will have no impact on the subsidiaries that are consolidated within the group. Under CRDIV there is no deduction for the cost of investment in subsidiaries outside the prudential group, instead we hold 8% of the cost of investments. We have therefore considered whether we need to hold additional capital under Pillar 2A when drafting our Individual Capital Adequacy Assessment Process (ICAAP).

2.1 Regulatory Developments

The Basel III regulations have been written in to European law through the Directive CRDIV which came in to force on 1 January 2014. These rules make material changes to the definition of capital resources and the capital resource requirement. The Group's PIBS (Permanent Interest Bearing Shares) cease to be eligible as Tier 1 capital and will be phased into Tier 2 capital over a 10 year period in line with the new regulations.

The CRD IV regulations also include the introduction of a new capital leverage ratio defined as the ratio of Tier 1 capital to total exposure i.e. non risk adjusted assets as per the statement of financial position, (subject to amendments e.g. derivatives and intangible assets, as per the CRDIV regulations).

3.0 RISK MANAGEMENT OBJECTIVES AND POLICIES

3.1 Introduction

The Board understands that risks arise naturally 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' and customers' interests and the Group's long term capital position. 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 threaten member interests.

The Board's risk appetite, inter alia, specifically addresses the maintenance of stakeholders' confidence, profit performance, capital and liquidity adequacy, fair treatment of customers and the operational control framework and is supported by a comprehensive range of metrics used to assess business performance and risk exposure against its risk appetite.

3.3 Group Risk Management Framework

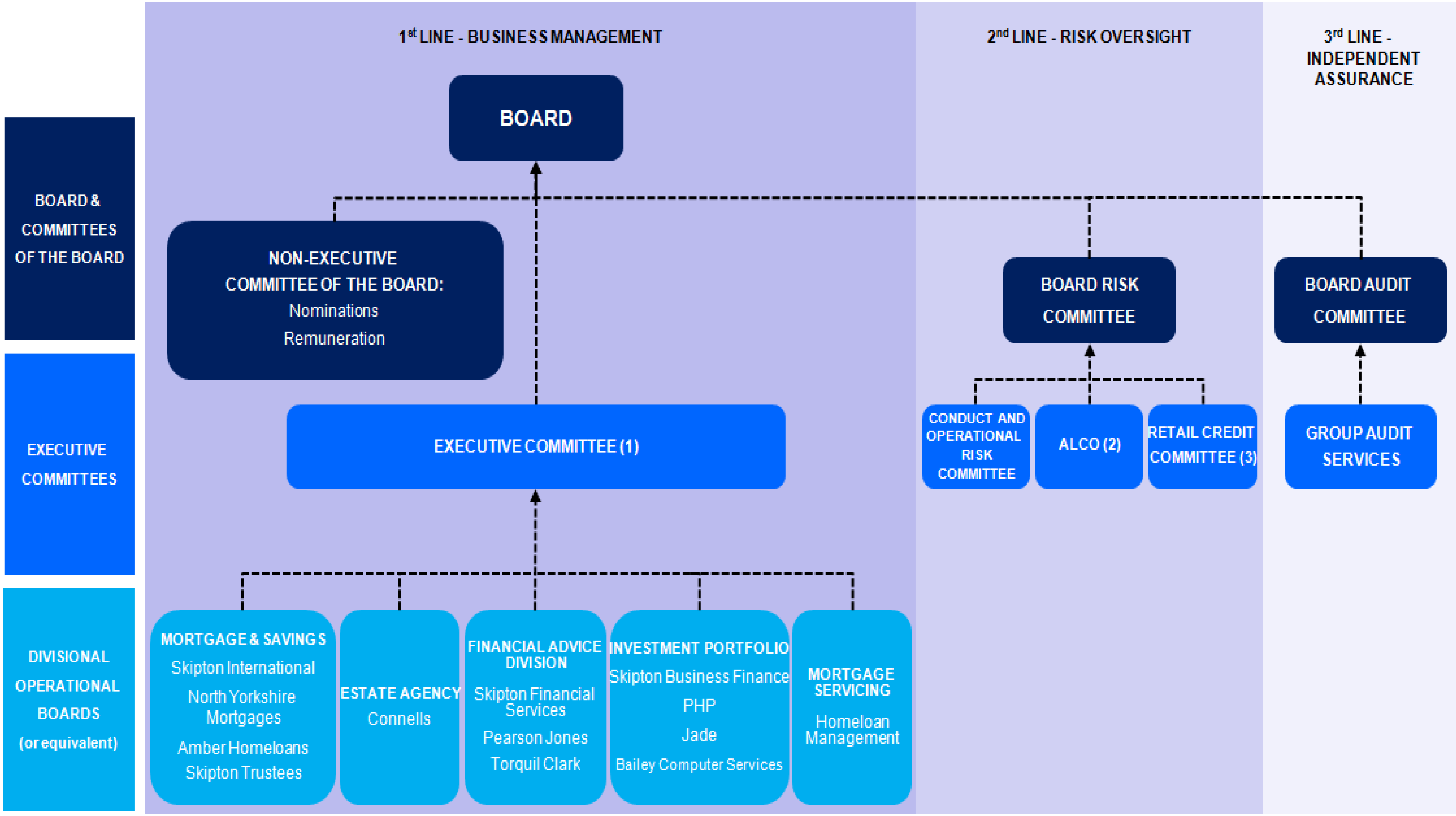
Through the Group's risk management framework and governance structure, the Group has a formal mechanism for identifying and addressing risks throughout the business. This framework is designed to deliver the Corporate Plan in line with the Board's overall risk appetite and is based upon the best practice 'three lines of defence' model, as follows:

- **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, Market and Liquidity) and related independent Compliance and Information Security functions. 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 (ALCO), Retail Credit Committee (RCC) and Conduct and Operational Risk Committee (CORC)) responsible for setting and monitoring the Group's adherence to policy. The independent Risk functions are represented on each of these risk committees. A Board Risk Committee, headed by a Non-Executive Chairman, is responsible for oversight of the risk management framework and monitoring of the business risk profile against Board approved risk appetites.

- **Third line** of defence, provided by Audit Services, is designed to provide independent assurance to the Board (via the Audit Committee) of the adequacy and effectiveness of control systems operating within the first and second lines in identifying and managing risk.

Skipton Group Governance Framework as at 31 December 2013



1. The Executive Committee receives reports from the Project Prioritisation Approval Group, Products Approval Group, Health, Safety & Security Working Group and Society Operational Risk Committee to assist in the execution of its duties
2. ALCO receives reports from the Group Wholesale Credit Committee and Secured Funding Committee to assist in the execution of its duties
3. The Retail Credit Committee receives reports from the Credit Risk Working Group, Credit Risk Modelling Group and Credit Risk Provisions Group to assist in the execution of its duties

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

3.4 Board

The Board's terms of reference clearly set out its responsibility for the overall stewardship of the Group within the context of the Society's 'Principles of Governance':

1. **Governing Body -** The Society is headed by an effective Board which is collectively responsible for the long term success of the Group.

   The Board formulates strategy and establishes the Society's risk appetite and balance sheet strategy. It has a proper understanding of, and competence to deal with, the current and emerging issues facing the business of the Group, effectively reviewing and challenging the performance of management and exercising independent judgement.

2. **Management and Oversight -** The Society's management and oversight framework enables the Board to provide strategic guidance for, and effective oversight of, management throughout the Group.

   The framework clarifies the respective roles and responsibilities of Directors and Senior Executives in order to facilitate Board and management accountability to both the Society and its members and ensures a balance of authority such that no single individual has unfettered powers. It has clear, risk-based, lines of sight into activities to support challenge and oversight enabling the Board to ensure that assurance is obtained over the integrity of reporting and the adequacy of the control framework and control activities.

3. **Recognition and Management of Risk** - The Board has a sound system of risk oversight, risk management and internal control.

   This framework identifies, assesses, manages and monitors risk. It informs Senior Executives and the Board of material changes to the risk profile of the Society or any of its divisions, and monitors and provides assurance over the effectiveness of the control framework and the integrity of reporting.

The Board has established a framework of authorities which maps out the structure of high level delegation below Board level and specifies those issues which remain the responsibility of the Board. The Board also has a general duty to ensure that the Group operates within the Society's rules, relevant laws, rules and guidance issued by relevant regulatory authorities and that proper accounting records and effective systems of internal control are established, maintained, documented and audited.

The Board has agreed a formal schedule of matters which are reserved to it, and has also delegated authority in other matters to a number of Board Committees, as described below. The Board has set clear terms of reference for each of these Committees, and has established an organisational structure with clearly defined and documented delegated authority to Executive management, together with reporting systems for financial results, risk exposure and control assessment.

All Directors have access to independent professional advice, if required, and have the benefit of appropriate liability insurance cover at the Society's expense.

The Board meets at least ten times per year and the Non-Executive Directors also meet, without Executive Directors present, at least once a year.

3.5 Executive Committee

The Executive Committee is responsible for ensuring that the Group meets its strategic and operational objectives as defined in the corporate plan. Mr Cutter (Group Chief Executive) chairs the Committee which comprises the Executive Directors and other senior executives.

3.6 Asset and Liability Committee

The Asset and Liability Committee is primarily responsible for developing and maintaining policies on structural risk management, liquidity, funding and wholesale credit, recommending changes to these policies to the Board Risk Committee, monitoring implementation to ensure that the Group operates within risk limits and that the Society has adequate liquid financial resources to meet its liabilities. The Group Finance Director chairs the Committee which comprises the Group Chief Executive, Commercial Director and senior executives from Treasury, Finance, Risk and the Group's lending businesses.

3.7 Retail Credit Committee

The Retail Credit Committee 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 other assets. It also recommends changes to these policies to the Board Risk Committee and monitors implementation to ensure that the Group operates within risk limits. The Group Chief Executive chairs the Committee which comprises the Group Finance Director, Commercial Director and senior executives from Risk and the Group's lending businesses.

3.8 Conduct and Operational Risk Committee

The Conduct and Operational Risk Committee is primarily responsible for developing and reviewing the Group's conduct and operational risk management frameworks and monitoring management of the risks arising in these areas. The Committee also recommends changes to the conduct and operational risk appetites and associated policies to the Board Risk Committee. The Chief Conduct Risk Officer chairs the Committee which comprises senior executives from each of the divisions and the Operational Risk and Compliance teams.

3.9 Audit Committee

The Audit Committee is appointed by the Board and comprises four Non-Executive Directors, currently:

Ms Cassoni, Non-Executive Director (Committee Chairman)
Mrs Black, Non-Executive Director
Mr Picken, Non-Executive Director
Mr Thompson, Non-Executive Director

The Committee met six times during 2013 and the attendance of its members is set out on page 36 in the Report on Corporate Governance within the annual accounts. The Committee also held private discussions with the external auditors and the Chief Internal Auditor.

In addition to its members, the Chairman, Group Chief Executive, Group Finance Director, Chief Conduct Risk Officer, Chief Financial Risk Officer, external audit representatives and the Chief Internal Auditor regularly attend meetings, by invitation.

The Board is satisfied that the composition of the Audit Committee contains a Director with relevant, recent financial experience to provide appropriate challenge to management. Ms Cassoni has held senior finance appointments with a number of large organisations, most recently as Group Finance Director at the John Lewis Group prior to her retirement in 2012.
Role and responsibilities of the Committee

The responsibilities of the Committee are delegated by the Board and are set out it its written terms of reference. These are in line with the provisions of the Financial Reporting Council (FRC) Guidance on Audit Committees (the 'Smith Guidance') which was updated in September 2012 and is applicable to this year end. The Committee's primary responsibilities are:

- To monitor the integrity of the Group's financial statements, any formal announcements relating to the Group's financial performance and review significant reporting judgements;

- To provide advice, to the Board, on whether the Annual Report and Accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for members to assess the Group's performance, business model and strategy;

- To monitor the relationship with the external auditors, including agreeing their remuneration and terms of engagement, monitoring their independence, objectivity and independence, ensuring that the policy to provide non-audit services is appropriately applied and to make recommendations to the Board on their appointment, re-appointment or removal;

- To review the effectiveness of the internal audit function and review its material findings;

- To keep under review the effectiveness of the Society's internal controls, including financial controls and risk management systems;

- To review the effectiveness of the Compliance Monitoring function and review its material findings; and

- To report to the Board how it has discharged its responsibilities.

3.10 Board Risk Committee

The Board Risk Committee is responsible for considering and recommending the Group's risk appetite, capital adequacy and liquidity management policies to the Board. It is also responsible for ensuring that the Group maintains an effective risk governance structure to ensure that internal and external risks across the Group are identified, reviewed and managed accordingly. As at 31 December 2013 the members of the Committee were:

Mr Hales, Non-Executive Director (Committee Chairman)
Mr Cutter, Group Chief Executive
Mr East, Non-Executive Director
Mr Picken, Non-Executive Director
Mr Twigg, Group Finance Director

In addition, the Chairman, the Chief Conduct Risk Officer and Secretary, Chief Financial Risk Officer and Chief Internal Auditor, regularly attend meetings by invitation.

Under CRD IV it is recommended that the Risk Committee should be a 'non-executive' committee. The implementation of these recommendations mean that the Group Chief Executive and Group Finance Director are no longer members and attend by invitation from the Committee.

In 2013, the Committee met six times in the execution of its responsibilities and, inter alia, considered the following:

- Scenario and stress testing reports;
- Conduct, operational and regulatory risk reports;
- Wholesale, commercial and residential Credit Risk reports;
- Treasury, liquidity and contingency funding reports;
- Risk appetite reports;
- Chief Financial Risk Officer's Prudential Risk reports; and
- Chief Conduct Risk Officer's Conduct and Operational Risk reports.

3.11 Remuneration Committee

The Remuneration Committee is responsible for determining, on behalf of the Board, the Group's Remuneration policy, reviewing its adequacy, effectiveness and compliance with regulatory requirements. The Committee specifically:

- Sets remuneration for the Chairman and the Executive Directors;
- Approves the Remuneration policy for senior managers who have a material impact on the Society's risk profile (Code Staff);

- Reviews recommendations from the Group Chief Executive for approval of the remuneration for key executives in the Group;
- Agrees the design and overall targets for any short or longer term variable pay schemes applicable to senior executives and Code Staff.

The Committee currently comprises three Non-Executive Directors, Messrs Thompson (Chairman) and East and Ms Stevenson. The Chairman, Group Chief Executive, Chief Conduct Risk Officer and Chief Human Resources Officer regularly attend meetings by invitation and external advisers are invited to attend meetings as and when appropriate.

Further details regarding the remuneration policy are set out in the Director's Remuneration Report in the 2013 Annual Report and Accounts.

Code staff

Remuneration disclosures around 'Code Staff' are disclosed separately, in accordance and in compliance with PRA PS10/21, within the Directors' Remuneration Report in the 2013 Annual Report and Accounts.

3.12 The Non-Executive Remuneration Committee

The Non-Executive Remuneration Committee is responsible for the review of the fees to be paid to Non-Executive Directors other than the Chairman, in accordance with the Society rules. As at 31 December 2013 the members of the Committee were:

Mr Ellis, Chairman (and also Committee Chairman)
Mr Cutter, Group Chief Executive
Mr Twigg, Group Finance Director

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 2013.

	2013 Full group[1] £m	2012 Full group[1] £m	2013 UK group £m	2012 UK group £m	2013 Solo group £m	2012 Solo group £m
Tier 1						
Reserves	922.3	827.7	811.6	760.2	780.6	724.7
Permanent Interest Bearing Shares	90.0	90.0	90.0	90.0	90.0	90.0
Pension fund deficit adjustment	23.4	13.6	12.9	7.8	12.9	7.8
Unrealised (gains) / losses on available-for-sale debt securities	(20.5)	2.3	5.5	2.3	5.5	4.3
Unrealised losses on cash flow hedges	11.0	14.6	10.9	14.6	10.9	14.6
Total Tier 1 capital before deductions	**1,026.2**	**948.2**	**930.9**	**874.9**	**899.9**	**841.4**
Deductions from Tier 1 capital:						
Goodwill	(156.4)	(172.8)	(20.3)	(34.7)	-	-
Intangible assets	(17.8)	(23.4)	(10.2)	(10.7)	(1.5)	(1.5)
Material holdings (50%)	-	-		-	(30.9)	(33.2)
Total Tier 1 capital after deductions	**852.0**	**752.0**	**900.4**	**829.5**	**867.5**	**806.7**
Tier 2						
Subordinated debt	82.7	188.9	82.7	188.9	82.7	188.9
Collective impairment allowance	24.0	11.1	24.0	11.1	24.0	11.1
Net gain from change in fair value	26.0	-	-	-	-	-
Total Tier 2 capital	**132.7**	**200.0**	**106.7**	**200.0**	**106.7**	**200.0**
Deductions from Tier 1 and Tier 2 capital:						
Investment in subsidiary companies	-	-	(97.5)	(97.7)	(115.1)	(121.3)
Material holdings (50%)	-	-	-	-	(30.9)	(33.2)
Total capital after deductions	**984.7**	**952.0**	**909.6**	**931.8**	**828.2**	**852.2**

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 pension fund obligations as permitted by GENPRU 1.3.9; see below.

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, payables and investing members of the Society. These shares are measured at amortised cost. Further details regarding PIBS are set out in note 31 of the Group's 2013 Annual Report and Accounts. One tranche of PIBS with a par value of £50m has future call dates commencing on 13 April 2017 providing the Society with an opportunity to buy back the shares from investors. The remaining PIBS do not have call dates. Under the PRA rules, PIBS are included in the Group's capital resources in accordance with UK GAAP rather than IFRS.

Under the new CRDIV regulations implemented on the 1 January 2014 PIBS will be phased from Tier 1 capital into Tier 2 Capital over a transitional 10 year period.

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

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.

Goodwill and intangible assets are deducted from capital for regulatory purposes.

4.3 Tier 2 Capital

Tier 2 capital comprises subordinated debt and collective impairment allowances. Under GENPRU 2.2.46, Tier 2 capital cannot exceed 50% of total Tier 1 capital. As set out in the table on the previous page this requirement is satisfied at all three levels of consolidation.

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 30 of the Group's 2013 Annual Report and Accounts. Under PRA 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 GENPRU 2.2.196.

4.4 Capital Buy Back

During 2013, the Society undertook a tender offer for certain tranches of subordinated notes to retire capital that, under new CRD IV rules, cease to be eligible regulatory capital. Market conditions allowed the Society to buy back £14.7m of fixed rate notes due in 2018 and £2.0m of fixed rate notes due in 2015, which generated a profit of £2.6m. In December 2013, the Society also repaid, at par, £75.0m of fixed rate notes repayable in 2018 by exercising its first call option.

4.5 UK and Solo Consolidation

At a Solo consolidation level the cost of investment classed as 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, e.g. 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, to the extent it is not deducted as a material holding, in accordance with the GENPRU 2.2.216A.

5.0 CAPITAL ADEQUACY

5.1 Summary of Approach to Capital Adequacy Planning

The Group holds capital to absorb losses which may occur in the economic cycle. The Individual Capital Adequacy Assessment Process (ICAAP) is the means by which the Group ensure 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
- Sufficient capital resources to trade through a variety of scenarios, including a severe recession, if necessary by applying appropriate management actions.

In formulating the Group's five year Corporate Plan, the Board considers its overall objectives and evaluates these in light of its agreed risk appetite statements.

Under PRA rules a minimum level of capital (Pillar 1) 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. Market risk has been calculated under the Position Risk Requirement (PRR) approach.

The table below sets out the minimum capital resources requirements (Pillar 1) for the Solo, UK and full consolidation groups, together with their capital adequacy positions as at 31 December 2013.

	2013 Full group[2] £m	**2012 Full group[2] £m**	**2013 UK group £m**	**2012 UK group £m**	**2013 Solo group £m**	**2012 Solo group £m**
Credit Risk (Standardised)	431.9	417.4	421.7	410.7	404.4	394.0
Operational Risk (Standardised)	61.7	60.1	27.1	26.0	10.0	7.5
Market Risk (Foreign Exchange PRR)	1.3	0.3	0.1	0.1	-	-
Total minimum capital requirement	**494.9**	**477.8**	**448.9**	**436.8**	**414.4**	**401.5**
Total capital resources (section 4)	**984.7**	**952.0**	**909.6**	**931.8**	**828.2**	**852.2**
Excess of own funds over minimum capital requirement under Pillar 1	**489.8**	**474.2**	**460.7**	**495.0**	**413.8**	**450.7**
Capital ratio (%)	**199.0%**	**199.2%**	**202.6%**	**213.3%**	**199.9%**	**212.2%**

Capital resources fell within the UKCG and Solo groups between 2012 and 2013 due to the buy-back of £89.7m of subordinated debt that will no longer be eligible as capital following the introduction of the new CRD IV rules on 1 January 2014 as noted in Section 4.

The increase in Market Risk capital resources requirement during 2013 is a result of the floatation of Wynyard Group Limited on the New Zealand Stock Exchange on 19 July 2013. For further information please see section 7.4 and Page 95 of the Annual Report & Accounts.

5.2 Capital Reporting

The Pillar 1 regulatory capital adequacy of the Solo and UK consolidation groups is reported to the PRA quarterly and bi-annually respectively. Pillar 1 minimum capital adequacy at both a Solo and UK consolidation group level is also reported (actual and forecast) 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.

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

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 taken into account before decisions regarding dividend payments from group entities are finalised. The Board considers that there is 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 of suffering financial loss should borrowers or counterparties default on their contractual obligations to the Group.

The Group faces this risk from its lending to:

- Individual customers (retail mortgages);
- Businesses (through past commercial lending and current debt factoring and invoice discounting). The Society ceased new commercial lending in November 2008; and
- Wholesale counterparties (including other financial institutions). Credit risk within our treasury portfolio arises from the investments held by the Group in order to meet liquidity requirements and for general business purposes.

Credit Risk is driven by the quality of our lending decisions and the performance of the economy. Whilst the economy is improving slowly, the risks around the emergence of a housing bubble, particularly in the South East and London, together with the risk of interest rate susceptibility as interest rates start to increase, means that the Group maintains a cautious approach to new lending. In particular all new lending carried out by the Group is to prime customers with income verified. In addition, the Society has no appetite for any new unsecured lending or commercial lending, except for debt factoring and invoice discounting delivered through Skipton Business Finance.

Whilst the wholesale markets are less volatile than during the Global Financial Crisis, the Group remains cautious and has reduced the number of counterparties to whom it lends, and the amounts it is willing to lend to these counterparties, to levels appropriate with the perceived risk.

The management of credit risk is critical to the Group's overall strategy. The Group has therefore embedded a comprehensive and robust risk management framework with clear lines of accountability and oversight as part of its overall governance framework. The Group has effective processes and policies to monitor, control, mitigate and manage credit risk within the Group's Credit Risk Appetite for which the Retail Credit Committee provides oversight to the effectiveness of this. ALCO, through the Wholesale Credit Committee, similarly manages Treasury credit exposures.

Managing liquidity and capital remains important, however we will continue to enhance and embed our credit risk models to ensure effective pricing, provisioning and use of capital, and aim to submit our Internal Ratings Based (IRB) waiver application during 2014. This will provide us with better tools to understand the dynamics of our existing loan books under different scenarios, and improve pricing capability and arrears management strategies in a market anticipated to be more competitive.

The following tables detail the minimum capital requirement for credit risk for the full group, UK consolidation group and Solo consolidation group as at 31 December 2013 broken down by exposure value.

Full Group	**Exposure Value £m**	**Capital Requirement £m**
Corporates – other lending to corporates[3]	15.0	1.2
Retail – debt factoring loans / invoice discounting	44.6	2.7
Secured on real estate property[4]	11,065.3	352.4
Past due items[5]	251.5	20.6
Other items	40.3	1.2
Total loans and advances to customers	**11,416.7**	**378.1**
		-
Central governments or central banks	1,380.2	-
Multilateral development banks	151.1	-
Financial institutions	542.8	13.1
Securitisation positions – see section 6.1.8	279.6	6.6
Short-term claims on institutions and corporates	26.0	0.4
Total wholesale lending	**2,379.7**	**20.1**
Other items – e.g. fixed assets, derivatives, and sundry debtors	504.2	33.7
Total other	**504.2**	**33.7**
Total	**14,300.6**	**431.9**

UK Consolidation Group	**Exposure Value £m**	**Capital Requirement £m**
Corporates – other lending to corporates	15.0	1.2
Retail – debt factoring loans / invoice discounting	44.6	2.7
Secured on real estate property	11,070.8	352.7
Past due items	251.5	20.6
Other items	39.9	1.1
Total loans and advances to customers	**11,421.8**	**378.3**
Central governments or central banks	1,380.2	-
Multilateral development banks	151.1	-
Financial institutions	534.8	13.0
Securitisation positions – see section 6.1.8	279.6	6.6
Short term claims on institutions and corporates	26.0	0.4
Total wholesale lending	**2,371.7**	**20.0**
Other items – e.g. fixed assets, derivatives, and sundry debtors	376.2	23.4
Total other	**376.2**	**23.4**
Total	**14,169.7**	**421.7**

[3] Corporates includes £14.5m of debt factoring loans and invoice discounting.
[4] The full group is less than the UKCG due to consolidation adjustments made to eliminate intra-group trading.
[5] For capital purposes, past due items in these tables relate to those accounts greater than 90 days in arrears.

Solo Consolidation Group	Exposure Value £m	Capital Requirement £m
Corporates – other lending to corporates	0.5	-
Retail – other	0.2	-
Secured on real estate property	10,422.5	334.1
Past due items	250.3	20.5
Other items	-	-
Total loans and advances to customers	**10,673.5**	**354.6**
Central governments or central banks	1,380.2	-
Multilateral development banks	151.1	-
Financial institutions	480.3	12.1
Securitisation positions – see section 6.1.8	279.6	6.6
Short term claims on institutions and corporates	26.0	0.4
Total wholesale lending	**2,317.2**	**19.1**
Other items – e.g. fixed assets, derivatives, and sundry debtors	431.8	30.7
Total other	**431.8**	**30.7**
Total	**13,422.5**	**404.4**

6.1.1 Credit Risk: Loans and Advances to Customers

The Group currently lends in the prime residential UK mortgage market, including buy-to-let, through the Society, and via Skipton International to borrowers in the Channel Islands and to Guernsey residents mortgaging properties in the UK.

We have established comprehensive risk management processes in accordance with the Board's credit risk appetite which defines a number of limits regarding customer and collateral credit quality to which all lending activity must adhere. The Group maintains a low risk approach to new lending and will continue to do so.

The credit decision process utilises automated credit scoring and policy rules within lending policy criteria supporting manual underwriting. All aspects of the credit decision process are subject to regular independent review and development ensuring they support decisions in line with the Board's risk appetite.

The Group also has credit exposures through Amber and North Yorkshire Mortgages (NYM) which comprise residential UK mortgages, including buy-to-let, across prime and non-prime lending markets. In light of the then deteriorating economic conditions, we ceased new lending in these portfolios in early 2008.

The Group's collections and recoveries functions aim to provide a responsive and effective operation for the arrears management process. We seek to engage in early communication with borrowers experiencing difficulty in meeting their repayments, to obtain their commitment to maintaining or re-establishing a regular payment plan. We consider forbearance options on a case-by-case basis in line with industry guidance and best practice. The level of forbearance activity is reported in the annual accounts and is in line with defined policies and procedures.

The table below sets out the gross credit risk arising from loans and advances to customers at 31 December 2013.

	Full group 12/13 Average £m	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Total residential mortgages	10,407.4	10,906.8	10,912.3	10,262.8
Commercial loans	424.1	409.8	409.8	409.8
Other lending: Debt factoring loans / invoice discounting	53.6	58.9	58.9	-
Other loans	51.3	41.2	40.8	0.9
Gross balances	**10,936.4**	**11,416.7**	**11,421.8**	**10,673.5**
Impairment provisions	(66.0)	(59.1)	(59.1)	(58.3)
Fair value adjustments	184.8	159.3	159.3	159.3
	11,055.2	**11,516.9**	**11,522.0**	**10,774.5**

Commercial Lending
The Society has a commercial loan portfolio which is UK based and, following a reduction in the Group's risk appetite, was closed to new lending in November 2008. We have retained an appropriately skilled team of people to manage these loans. We consider forbearance options on a case-by-case basis in line with industry guidance and best practice. The impact of any such forbearance is recognised within our provisioning policy. The table below sets out the Skipton Group's commercial loan exposure by industry type at 31 December 2013.

	2013 £m	2012 £m
Leisure and hotel	40.2	42.5
Retail	14.9	15.7
Nursing / residential homes	20.2	22.0
Offices	12.1	14.2
Commercial investment and industrial units	301.5	321.9
Miscellaneous	20.9	21.9
Total	**409.8**	**438.2**

Debt factoring / invoice discounting
These loans principally comprise loans made by our factored debt and invoice discounting business, Skipton Business Finance, which continue to be managed by appropriately skilled teams.

6.1.2 Credit Risk: Wholesale Lending

The Group's wholesale credit risk arises principally from assets held for prudential liquidity and general business purposes. The risk is that counterparties with whom the Group invests fail to repay the capital or interest obligations when they fall due. This element of credit risk is managed by the Treasury function within the limits set by ALCO, with a regular review of credit policies and exposures through the Wholesale Credit Committee (a sub-committee of ALCO). The processes for limit allocation and credit assessment are documented within the Treasury Policy.

Netting and collateralisation agreements are used to reduce credit exposure, which are discussed further under section 6.1.7. The table below sets out the liquidity book by industry sector / asset class as at 31 December 2013.

	Full group 12/13 average £m	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Cash in hand and balances with the Bank of England	937.1	859.4	859.4	859.4
Cash with banks and building societies	354.7	326.2	318.3	273.9
Gilts	378.7	478.8	478.8	478.8
Treasury bills	11.6	-	-	-
Certificates of deposit	58.9	62.6	62.6	62.6
Fixed rate bonds	213.2	170.6	170.6	170.6
Floating rate notes	201.7	203.7	203.7	193.7
Residential mortgage backed securities	278.2	261.2	261.2	261.2
Commercial mortgage backed securities	22.5	19.6	19.6	19.6
Total	**2,456.6**	**2,381.1**	**2,373.2**	**2,318.8**

This table shows that the Group has a suitably varied liquidity portfolio and does not have significant exposures concentrated to one specific asset class outside of Buffer requirements, as per BIPRU 12.7. The table below sets out the maturity of the liquidity book as at 31 December 2013.

	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Loans and advances to credit institutions			
Repayable on demand	224.3	230.3	186.0
In not more than three months	78.5	64.6	64.6
In more than one year	23.4	23.4	23.4
	326.2	**318.3**	**274.0**
Debt securities			
In not more than one year	186.4	186.4	181.5
In more than one year	1,009.1	1,009.1	1,003.9
	1,195.5	**1,195.5**	**1,185.4**
Cash in hand and balances with the Bank of England			
Repayable on demand	859.4	859.4	859.4
	859.4	**859.4**	**859.4**
Total	**2,381.1**	**2,373.2**	**2,318.8**

The table below sets out the capital held for the liquidity book by credit rating. During 2013 this approach has been reviewed and a new approach deemed more prudent and in line with the new CRD IV regulations has been employed. Previously Skipton used Moody's ratings primarily and Fitch ratings if no Moody's rating was available. For 31 December 2013 figures below we now use the lower of Moody's or Fitch ratings if both rate the same asset.

	Full consolidation group		**UK consolidation group**		**Solo consolidation group**	
Rating	**Exposure[6] £m**	**Capital £m**	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**
Aaa	400.8	3.8	400.8	3.8	400.8	3.8
Aa1	1,401.3	0.4	1,401.3	0.4	1,401.3	0.4
Aa2	69.4	1.1	69.0	1.1	69.0	1.1
Aa3	202.9	3.3	188.1	3.1	164.5	2.6
A1	23.9	0.7	23.9	0.7	23.9	0.7
A2	145.2	4.1	155.8	4.2	125.6	3.8
A3	106.9	3.7	103.6	3.6	102.9	3.6
Baa1	18.8	0.8	18.8	0.8	18.8	0.8
Baa2	5.2	0.4	5.1	0.4	5.1	0.4
Baa3	-	-	-	-	-	-
Ba1	1.7	0.1	1.7	0.1	1.7	0.1
Ca	1.6	1.6	1.6	1.6	1.6	1.6
Unrated (Other)	2.0	0.2	2.0	0.2	2.0	0.2
Total	**2,379.7**	**20.1**	**2,371.7**	**20.0**	**2,317.2**	**19.1**

The Group's treasury investments are held to provide actual liquidity and 98.7%, at a full group level, of these investments are rated A3 or better (as shown above). The movement of assets held from Aaa to Aa1 in 2013 is due to the downgrade of UK sovereign debt during the year.

The Group's policy is that initial investments in treasury assets must be investment grade or above.

Within the treasury investments portfolio, the Group had no direct sovereign exposure to Greece, Ireland, Italy, Portugal, Cyprus and Spain at 31 December 2013.

The table below sets out the capital held for the liquidity book by geographical region as at 31 December 2013.

	Full consolidation group		**UK consolidation group**		**Solo consolidation group**	
Geographical region	**Exposure[7] £m**	**Capital £m**	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**
UK	1,986.1	15.3	1,997.5	15.3	1,949.0	14.7
Rest of Europe	286.7	2.6	286.7	2.6	281.7	2.5
North America	36.3	1.1	36.1	1.1	36.1	1.1
Australasia	70.6	1.1	55.4	0.9	50.4	0.8
Total	**2,379.7**	**20.1**	**2,371.7**	**20.0**	**2,317.2**	**19.1**

To obtain the risk weights and hence calculate the minimum credit risk capital requirement for wholesale lending exposures, the Society uses Moody's and Fitch as External Credit Assessment Institutions (ECAIs).

[6] The total exposure balances do not include the Group's £460m Treasury Bills drawn under the Funding for Lending Scheme as these are considered Off-Balance Sheet items. Due to the nature of the Treasury Bills, the Group is not required to hold capital against them.
[7] The total exposure balances in the tables above differ to the accounting balances held for liquidity on page 19 as cash in hand is not included in the tables above.

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 exposure values and risk weightings associated with each credit quality step under the standardised approach.

Central Governments and Central Banks				
Credit quality step	**Maturity**	**Risk weighting**	**Credit ratings**	**Exposure values £m**
1	-	0%	Aaa-Aa3	**1,380.2**

Multilateral Development Banks				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	0%	Aaa-Aa3	**151.1**

Financial Institutions				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	279.6
2	Residual / original maturity < 3 months	20%	A1 to A3	110.0
2	Original maturity > 3 months	50%	A1 to A3	156.6
3	Original maturity > 3 months	50%	Baa1 to Baa3	18.9
4	-	100%	Ba1 to Ba3	1.7
Unrated	-	1250%	**-**	2.0
				568.8

Residential Mortgage Backed Securities				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	252.7
2	-	50%	A1 to A3	8.4
				261.1

Commercial Mortgage Backed Securities				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	10.8
2	-	50%	A1 to A3	1.0
3	-	100%	Baa1 to Baa3	5.1
5	-	1250%	B1 and below	1.6
				18.5

Full group total	**2,379.7**

6.1.3 Concentration Risk

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

Both retail mortgage and commercial lending concentration risk is managed within the risk appetite set by the Board, including specific sectoral, geographic and product type limits. RCC monitors and reports on concentration risk monthly. Exposure limits are monitored and controlled within the operational underwriting area via system driven limits and strong mandate controls. These are independently reviewed by the Policy and Risk Framework team within Credit Risk.

Credit exposures are well diversified geographically at a regional level, are controlled via risk appetite limits and are subject to regular review.

ALCO (under delegated authority from the Board) sets policy limits to manage Treasury credit risk concentrations. Compliance with these limits is monitored daily, and formally reported to the Group Wholesale Credit Committee and ALCO monthly.

6.1.4 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 Retail Credit Committee and the Board receiving trend and emergence analysis relating to each sector of the secured lending portfolio in respect of residential and commercial assets.

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 is experiencing significant financial difficulty, default or delinquency in interest or principal payments, or the debt being renegotiated to reduce the burden on the borrower. The key drivers influencing the objective evidence predominantly relate to affordability issues driven by unemployment and increased costs of living. Based upon these assessments an individual impairment provision for these assets is made.

In addition, a collective impairment provision is made against the remaining group of loans and advances where objective evidence indicates that credit losses have been incurred but not yet identified at the reporting date. The impairment value is calculated by applying various economic factors to pools within our mortgage portfolio that have similar characteristics. These factors take into account the Group’s experience of default rates, loss emergence periods, the effect of regional movements in house prices based on a recognised index, and adjustments to allow for ultimate forced sales values and realisation costs. In addition, the collective impairment provision takes into account the level of forbearance applied to loans such as payment reductions, term extensions, conversion to interest only and capitalisation of arrears, and reflects the relative performance of each of these forbearance options. The impairment provision also considers macro-economic indicators affecting affordability such as unemployment rates and interest rates.

For the purposes of the information set out in this document ‘past due’ is defined as greater than or equal to one month in arrears, unless otherwise stated. The analysis of residential loans has been enhanced this year to provide further analysis of those assets which are individually impaired. Low risk accounts in the tables overleaf relate to loans with an indexed loan-to-value of less than or equal to 70%. High risk accounts relate to loans either with an indexed loan-to-value of more than 70%, or where other factors indicate that these loans are considered high risk.

The table below provides further information on residential loans and advances by payment due status across each level of consolidation as at 31 December 2013.

	Full consolidation group	**UK consolidation group**	**Solo consolidation group**
Neither past due nor individually impaired	10,484.9	10,490.4	9,843.9
Past due but not impaired:			
Up to 3 months	1.8	1.8	-
3 to 6 months	0.6	0.6	-
	10,487.3	**10,492.8**	**9,843.9**
Individually impaired:			
Low risk	159.9	159.9	159.9
High risk	240.8	240.8	240.2
Possessions	18.8	18.8	18.8
Total	**10,906.8**	**10,912.3**	**10,262.8**

The overall exposure is greater at a UK consolidation group level than a full group level due to consolidation adjustments made to eliminate intra-group trading.

The table below provides further information on commercial loans and advances by payment due status as at 31 December 2013.

	2013 £m	**%**
Neither past due nor individually impaired	**395.1**	**96.5**
Past due but not impaired	**-**	**-**
	395.1	**96.5**
Individually impaired:		
Low risk	**10.0**	**2.4**
High risk	**4.7**	**1.1**
	409.8	**100.0**

Where appropriate for customers' needs, the Group applies a policy of forbearance and may grant a concession to borrowers. This may be applied where the actual or apparent financial stress of the customer is considered to be short term with a potential to be recovered. A concession may involve arrears capitalisation, a reduction in the monthly payment, a conversion to interest only or a mortgage term extension. These strategies are undertaken in order to achieve reduced long term arrears and work towards the best outcome for both the customer and the business, through dealing with arrears at an early stage. Possession balances represent loans against which the Group has taken ownership of properties pending their sale.

Possession is generally only considered as a last resort once all other options for the customer have been exhausted. As at 31 December 2013, the balance of residential loans where the property in question has been taken into possession represents 0.2% of total outstanding loans for the Group (31 December 2012: 0.2%), and 0.1% of total outstanding loans for the Society (31 December 2012: 0.1%). The Group does not occupy repossessed properties for business use, or use assets acquired in its operations. All customer accounts are monitored to ensure that these strategies remain appropriate.

The table below provides further information on residential mortgages at 31 December 2013 by the type of account renegotiations applied to customers over the last two years. This includes renegotiations regardless of whether or not the customer has experienced financial difficulty in making repayments. For clarity, this table includes all accounts where we have renegotiated terms during the last two years, regardless of whether the renegotiation is still in place or whether the loan has reverted to its original terms.

Group	2013 £m	Capitalisation £m	Reduced payment £m	Transfer to interest only £m	Term extension £m	Total renegotiations £m	%
Neither past due nor individually impaired	**10,484.9**	14.2	101.7	58.9	117.2	**292.0**	**2.8**
Past due but not impaired:							
Up to 3 months	**1.8**	-	-	0.3	-	**0.3**	**16.7**
3 to 6 months	**0.6**	-	-	0.4	-	**0.4**	**66.7**
	10,487.3	**14.2**	**101.7**	**59.6**	**117.2**	**292.7**	**2.8**
Individually impaired:							
Low risk	**159.9**	2.3	12.3	6.8	4.6	**26.0**	**16.3**
High risk	**240.8**	3.9	15.3	11.6	4.8	**35.6**	**14.8**
Possessions	**18.8**	0.1	1.1	0.7	-	**1.9**	**10.1**
	10,906.8	**20.5**	**130.4**	**78.7**	**126.6**	**356.2**	**3.3**
Collective impairment	**(18.6)**	(0.1)	(0.2)	(0.2)	(0.1)	**(0.6)**	**3.2**
Individual impairment	**(29.9)**	-	(2.0)	(1.4)	(0.7)	**(4.1)**	**13.7**
	10,858.3	**20.4**	**128.2**	**77.1**	**125.8**	**351.5**	**3.2**

The Society applies a similar policy for its commercial loan book and the table below provides further information on the commercial loans at 31 December 2013 by the type of account renegotiations applied to customers over the last two years. This includes renegotiations regardless of whether or not our customer is experiencing financial difficulty in making repayments. For clarity, this table includes all accounts where we have renegotiated terms during the last two years, regardless of whether the renegotiation is still in place or whether the loan has reverted to its original terms.

Group and Society	2013 £m	Capitalisation £m	Transfer to interest only £m	Total renegotiations £m	%
Neither past due nor individually impaired	**395.1**	1.8	21.4	**23.2**	**5.9**
Past due but not impaired	**-**	-	-	**-**	**-**
	395.1	**1.8**	**21.4**	**23.2**	**5.9**
Individually impaired:					
Low risk	**10.0**	0.1	7.4	**7.5**	**75.0**
High risk	**4.7**	-	2.7	**2.7**	**57.4**
	409.8	**1.9**	**31.5**	**33.4**	**8.2**
Collective impairment	**(5.4)**	-	(0.2)	**(0.2)**	**3.7**
Individual impairment	**(4.1)**	-	(2.8)	**(2.8)**	**68.3**
	400.3	**1.9**	**28.5**	**30.4**	**7.6**

Where forbearance has been applied this is assessed to determine whether it is a potential indicator of impairment. This is then taken account of within the loan impairment provisions made by the Group.

The table below sets out the impairment losses on loans and advances for the full group and UK consolidation group for the year ended 31 December 2013.

Group	**Loans fully secured on residential property £m**	**Loans fully secured on land £m**	**Other loans £m**	**Total £m**
At 1 January 2013				
Individual impairment	37.8	3.7	20.2	61.7
Collective impairment	9.8	1.3	-	11.1
	47.6	**5.0**	**20.2**	**72.8**
Amounts written off during the year, net of recoveries				
Individual impairment	(14.8)	(1.0)	(19.3)	(35.1)
Collective impairment	(0.1)	-	-	(0.1)
	(14.9)	**(1.0)**	**(19.3)**	**(35.2)**
Income Statement				
Impairment losses on loans and advances				
Individual impairment	7.2	1.4	0.1	8.7
Collective impairment	8.9	4.1	-	13.0
	16.1	**5.5**	**0.1**	**21.7**
Adjustment to impairment losses on loans and advances resulting from recoveries during the year				
Individual impairment	(0.3)	-	0.1	(0.2)
Charge for the year	**15.8**	**5.5**	**0.2**	**21.5**
At 31 December 2013				
Individual impairment	29.9	4.1	1.1	35.1
Collective impairment	18.6	5.4	-	24.0
	48.5	**9.5**	**1.1**	**59.1**

The Group's impairment charge on loans and advances increased year-on-year to £21.5m (2012: £12.3m) and is broken down as follows:

	2013 £m	2012 £m
Residential mortgages	**7.5**	8.9
Equity release mortgages	**8.3**	0.5
Commercial and other loans	**5.7**	2.9
	21.5	12.3

The overall increase in the impairment loss charge is largely due to an £8.3m (2012: £0.5m) charge against the Society's equity release portfolio, acquired when we merged with Scarborough Building Society in 2009. Losses on this portfolio are a function of the interrelationship between long term house price rises and retail price inflation, and during the year, we have revised our assumptions of these metrics.

The performance of the Society's prime residential mortgage book remains good and arrears levels within the specialist residential mortgage portfolios held in Amber and NYM have also fallen. Consequently, the year-on-year charge for residential loan impairment has fallen.

Whilst the arrears levels within our commercial lending portfolio remain low, ongoing pressures on commercial property values led us to review the levels of provisions held against these loans and consequently increase the amount set aside for future losses.

The mortgage book in our Guernsey based subsidiary, Skipton International remains of high quality and the charge for loan impairment losses remained low at £0.2m (2012: nil) for the year. Loan impairment losses arising from our factored debt and invoice discounting business, Skipton Business Finance, also remained low at £0.2m (2012: £0.2m). Skipton International and Skipton Business Finance are the only lending entities that sit outside the Solo consolidation group. The overall impairment at a Solo consolidation level for the year ended 31 December 2013 was therefore only £0.3m lower than the full group and UK consolidation group which are set out in the table on page 25.

Impairment of Treasury Assets

The table below sets out the Treasury asset loan impairment position for the Skipton Group for the year ended 31 December 2013 which is the same for all levels of consolidation. The table highlights an additional £0.7m impairment which was taken during the year in respect of a legacy exposure to a UK Commercial Mortgage Backed Security (CMBS) and £0.5m against a Financial Institution asset.

Full consolidation group, UK consolidation and Solo group	**£m**
At 1 January 2013	
Individual impairment	4.8
Amounts written off during the year	
Individual impairment	-
Income Statement	
Impairment losses on treasury assets	
Individual impairment	1.2
Adjustment to impairment losses on loans and advances resulting from recoveries during the year	
Individual impairment	-
Charge for the year	1.2
At 31 December 2013	
Individual impairment	6.0
	6.0

6.1.5 Residential and Commercial 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 results in fair outcomes for the customers concerned. 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

Typically, residential lending secured against a property is only permitted if the property is insured for normal property damage perils. 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.

The ultimate source of collateral and final recourse for credit risk mitigation remains the borrower's property in the event of a borrower defaulting on their loan. The extent of mitigation is predetermined by the original and current loan-to-value (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 conditions and key assumptions agreed ultimately by Retail Credit Committee and set within the lending criteria.

Commercial Mortgages

The commercial property is the primary source of collateral utilised for credit risk mitigation and in all instances is 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 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 considers alterations to present commercial borrowings on a case by case basis.

For all commercial securities, valuations were undertaken prior to inception of the loan by suitably qualified professionals with relevant expertise in commercial properties. The Group may seek subsequent valuations as deemed appropriate. 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.

6.1.6 Wholesale Counterparty Credit Risk Mitigation

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

For repurchase agreements, the Global Master Repurchase Agreement (GMRA) document is utilised to mitigate credit risk. Valuations are agreed with the relevant counterparties and collateral is then exchanged in order to bring the credit exposure within agreed tolerances.

Derivative counterparty credit risk mitigation is discussed under the following section.

6.1.7 Derivative Counterparty Credit Risk Mitigation

The Group uses derivative instruments (interest rate, foreign currency and equity) to hedge its exposure to market risk. Derivatives are only used to limit the extent to which the Group will be affected by changes in interest rates, foreign exchange rates or other indices which affect fair values or cash flows. Derivatives are therefore used exclusively by the Group in accordance with the Building Societies Act 1986 to hedge risk exposures only and are not used for trading or speculative purposes. The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, interest rate options and foreign exchange contracts.

A credit exposure could arise in respect of derivative contracts entered into by the Group if the counterparty was unable to fulfil its contractual obligations. The Group addresses this risk by using legal documentation for counterparty derivative transactions that grants legal rights of set-off for those transactions. Accordingly, the credit risk associated with such contracts is reduced to the extent that negative mark to market valuations on derivatives will be offset by positive mark to market values on derivatives, subject to a minimum exposure of zero.
International Swaps and Derivatives Association (ISDA) documentation confers the ability to use designated cash collateral to set against derivative credit exposures in the event of counterparty default. Frequent (at least weekly) rebalancing of the collateral reduces the potential increase in future credit exposure. For such collateralised exposures, the posting of collateral reduces the impact of the current market value to the difference between the market value of the sensitivities

and the value of the collateral. The difference is limited by the operational use of 'thresholds' and 'minimum transfer amounts' which set criteria to avoid the movement of small amounts of collateral.

The Group measures derivative counterparty credit exposure values using the counterparty credit risk mark to market method. This exposure value is derived for each counterparty by adding the net market value of the derivatives (replacement cost) to the derivatives' potential credit exposure, which is calculated by applying a multiple based on the derivative's residual maturity to the notional value of the derivative.

The exposure value on derivative counterparty credit risk exposures at 31 December 2013 was:

Exposure to Derivative Counterparty Credit Risk	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Interest rate contracts	135.4	135.4	137.0
Foreign exchange contracts	6.9	6.9	6.9
Other contracts	61.4	61.4	61.4
Gross positive fair value of contracts	**203.7**	**203.7**	**205.3**
Netting benefits	(82.9)	(82.9)	(80.9)
Netted current credit exposure	**120.8**	**120.8**	**124.4**
Collateral held	(43.2)	(43.2)	(43.2)
Net derivative credit exposure	**77.6**	**77.6**	**81.2**

Note 14 of the statutory accounts, disclosures Mark To Market's MTM's on all derivatives and the notionals (face value of the contracts). The purpose of pillar 3 is to disclose replacement costs of those derivatives and, therefore, we include calculated add-ons to the MTM hence the difference in value. The add-ons are currently calculated based on their notionals and type of contract as per current requirements.

The net exposure value to derivatives at 31 December 2013 was £77.6m for both full and UK consolidation group, and £81.2m for the Solo group.

As at 31 December 2013, the external counterparties with whom the Group held derivative instruments had Moody's or equivalent credit ratings ranging from Aaa to Baa1.

If the Society is downgraded, there would be no material impact on the collateral required. Wrong-way risk may occur when an exposure to a counterparty is adversely correlated with the credit quality of the counterparty. The Society is not exposed to this type of risk.

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

6.1.8 Securitisation

The Group has securitised certain residential mortgage loans by the transfer of the loans to two special purpose vehicles (SPVs), named Darrowby No. 1 plc and Darrowby No. 2 plc, which constituted wholesale funding of £505m at the end of 2013. Our securitisation capability allows the Group to access this source of funding and provides another option for wholesale funding in the future. The SPVs are fully consolidated into the Group's 2013 Annual Report and Accounts.

The Group also has exposure to its investment in Mortgage Backed Securities (see section 6.1.2).

6.2 Conduct and Operational Risk

6.2.1 Conduct Risk Definition and Approach

Conduct risk is the risk that the Society or Group firms' behaviours, culture and approach lead to poor outcomes for customers.

The Society and its large Estate Agency business provide advice on mortgages and general insurance. In addition, the group owns three advisory firms specialising in Pensions and Investments advice. Given this inherent risk profile great emphasis is placed on appropriately managing conduct risk through the maintenance of a robust product governance framework to ensure that the Group develops and markets products and services designed to meet the needs of the target market. Strong control over the provision of advice and efficient administration of services is also maintained.

6.2.2 Operational Risk Definition and Approach

Operational Risk is the risk of financial loss or reputational damage arising from inadequate or failed internal processes or systems or human error.

The Skipton Group has adopted the standardised approach to operational risk, compliant with the requirements of BIPRU 6.

With a diverse business model and an ever more competitive operating environment, the Board acknowledges that the Group is exposed to increased levels of operational risk, for example in terms of systems capability and staff competencies. The financial services sector also faces growing levels of fraud and financial crime, particularly in relation to e-distribution channels, which require increasingly sophisticated controls.

6.2.3 Conduct and Operational Risk Framework

Through the Conduct and Operational risk framework, the Board ensures the management and oversight of the key operational risk exposures facing the Group in the following risk categories:

- Business Continuity
- Change
- Conduct
- Financial Management and Management Information
- Fraud
- Information Security
- Information Technology
- Legal and Regulatory
- People
- Premises
- Process
- Third Party Relationships

The Group's Conduct and Operational risk framework sets out the strategy for identifying, assessing and managing such risks. Senior management are responsible for understanding the nature and extent of the impact on each business area and for embedding appropriate controls to manage or mitigate those risks. The framework is updated periodically to take account of changes in business profile, new product development, and the external operating environment.

The Operational Risk and Conduct Risk Framework reflects common risk themes, for example, Financial Crime and Information Security, where customer assets and/or customer data are at risk of compromise. The Group continues to invest in, and further enhance, its conduct and operational risk management processes and oversight arrangements.

6.2.4 Conduct and Operational Risk Oversight and Governance

Oversight and governance arrangements for the setting and management of a robust conduct and operational risk management policy and framework are the responsibility of the Board, Board Risk Committee and the Conduct and Operational Risk Committee. Each committee has defined Terms of Reference detailing their accountability and responsibilities.

The role of the Conduct and Operational Risk Committee (CORC) is to ensure that appropriate frameworks are in place to identify, assess and manage the risks that could impact the ability of the Group to meet its business objectives and serve our customers, whilst protecting its reputation. The Committee also monitors whether Group businesses are operating within the Board approved Conduct and Operational risk appetite statements.

CORC provides oversight and assesses the Group’s exposure to conduct and operational risks based on both quantitative and qualitative considerations. The crystallisation of risks is captured through the recording and analysis of customer outcomes and risk events which are used to identify any potential systemic weaknesses in operating processes.

Given the nature of the regulated sectors in which the Group operates it is key to ensure ongoing compliance with relevant external regulation across the Group. To manage this, 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 the Society’s Compliance function which ensures best practice is adhered to and shared across the Group as appropriate.

6.2.5 Minimum Capital Resources Requirement for Operational Risk (Pillar 1)

Through its adoption of the standardised approach to operational risk management, the Skipton Group calculates its Pillar 1 capital requirement for operational risk, based upon the sum of the average of three years’ net income, segmented by business line and multiplied by the published regulatory risk factors, known as ‘beta factors’.

As at 31 December 2013 this approach resulted in the Pillar 1 minimum capital requirements as follows:

Pillar 1	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Operational Risk Capital Requirement	**61.7**	**27.1**	**10.0**

6.3 Market risk

Market risk is the risk that the value of, or income arising from, the Group’s assets and liabilities changes as a result of changes in market prices, the principal elements being interest rate risk; foreign currency risk; and equity risk. The Society is not impacted by commodity price risk. Market risk arises only in the banking book (apart from the Group’s defined benefit pension schemes which is managed by the Trustees of the schemes – see section 7.5) as the Group does not have a trading book.

The Society’s Treasury function is responsible for managing the Group’s exposure to all aspects of market risk in the banking book within the operational limits set out in the Group’s Treasury Policy. The Market and Liquidity Risk function (second line of defence) monitors the interest rate exposure of the Group through a variety of interest rate risk metrics e.g. static earnings at risk and historical value at risk.

ALCO approves the Group’s Treasury Policy and receives regular information on all relevant aspects of market risk exposure, including the continuing effectiveness of hedges. Currency risk is included in the Society’s Pillar 1 capital requirement calculations; other market risks are considered under Pillar 2 capital requirements.

6.3.1 Currency Risk

Currency risk is the risk of loss because of changes in foreign exchange rates.

Throughout the year, the Group had no material direct exposure to foreign currency exchange fluctuations. The Group's currency risk appetite is low and any issuance denominated in foreign currency is immediately swapped into Sterling.

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 2013, the foreign currency risk capital requirement was as follows:

Pillar 1	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Foreign exchange risk capital requirement	**1.3**	**0.1**	**-**

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

Business risk is the risk of changes in the environment in which the Group operates or the occurrence of events which damage the franchise or operating economics of the Group's businesses. The Group addresses these risks within its Corporate Plan which is approved by the Board which is regularly provided with updates on the Group's key strategies and plans to ensure progress is consistent with the Group's risk appetite.

If the Group does not deliver its plans as anticipated, its earnings could grow more slowly or decline. In addition, potential sources of business risk include revenue volatility due to factors such as macroeconomic conditions, inflexible cost structures, uncompetitive products or pricing and structural inefficiencies.

7.2 Liquidity Risk

Liquidity risk is the risk that the Group is unable to meet its current and future financial obligations as they fall due, or is only able to do so at excessive cost. The Group has, therefore, developed comprehensive funding and liquidity policies to ensure that it maintains sufficient liquid assets to be able to meet all financial obligations and maintain public confidence.

The Group's Treasury function is responsible for the day-to-day management of the Group's liquidity and wholesale funding. The Board sets limits over the level, composition and maturity of liquidity and deposit funding balances, reviewing these at least annually. Compliance with these limits is monitored daily by Finance and Risk personnel (i.e. independent of Treasury) and additionally, a series of liquidity stress tests are performed weekly by the Market Risk team and formally reported to ALCO and the Board, to ensure that the Group maintains adequate liquidity for business purposes even under stressed conditions.

The Group's liquidity and funding policies have been fundamentally reviewed and enhanced in line with the PRA's liquidity regime *PRA Policy Statement 09/16 'Strengthening Liquidity Standards'* and, since June 2010, the Group has reported its liquidity position against Individual Liquidity Guidance (ILG) provided by the PRA for regulatory purposes. The Group continues to exceed both the ILG requirement and satisfy its own internal liquidity risk appetite. Liquidity regulation is changing towards the international CRD IV measures, namely the Liquidity Coverage Ratio and the Net Stable Funding Ratio. The Society has already been measuring and monitoring its compliance against these ratios, and is in a good position for when the regulations come into force in 2015 and 2018 respectively. Liquidity stress testing is carried out against a number of scenarios including those prescribed by the PRA, considering a wide range of liquidity and economic factors. Early warning indicators are regularly assessed by a variety of functions across the Society to pre-empt potential outflows.

During this year, the Group has been using the Funding for Lending Scheme with the Bank of England. However, the Group's main source of funding is retail deposits, which accounted for 84.6% (2012: 83.1%) of the total funding.

The Group also maintained the quality of the liquidity portfolio by focussing on high quality UK Government issued debt and, at 31 December 2013, the proportion of our treasury assets rated A3 or above was 98.7% (2012: 99.6%). We continue to maintain a close watching brief on the money markets and hold prudent levels of liquidity.

7.3 Interest Rate Risk

Interest rate risk is the risk of losses arising from adverse movements in market interest rates. Interest rate risk arises from the mortgage, savings and other financial products that the Group offers. This risk is managed through the use of appropriate financial instruments, including derivatives, with established risk limits, reporting lines, mandates and other control procedures.

Other interest rate risk exposures, such as basis risk (the risk of loss arising from changes in the relationship between interest rates which have similar but not identical characteristics, for example, LIBOR and Bank of England Base Rate) are also monitored closely and regularly reported to ALCO. This risk is managed where appropriate, through the use of derivatives, with established risk limits and other control procedures.

Derivatives are only used to limit the extent to which the Group will be affected by changes in interest rates, foreign exchange rates or other indices which affect fair values or cash flows. Derivatives, are therefore, used exclusively to hedge risk exposures. The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, interest rate options and foreign exchange contracts.

The Group's forecasts and plans take account of the risk of interest rate changes and are prepared and stressed accordingly, in line with PRA guidance.

The Group uses a number of different metrics to monitor interest rate risk and details of these are set out below.

Repricing Gap Analysis
To assess the Pillar 2 capital requirement for interest rate risk, the Group determines the effect on the Group's asset and liability gap positions of a 2% parallel shift in interest rates for all maturities. Results are compared to Board and Operational limits weekly and formally reported to ALCO and the Board monthly.

An analysis of repricing dates is performed to ensure that excessive net assets or liabilities repricing within a given time period is avoided. Key assumptions used in the repricing gap analysis include that net free Reserves are assumed to re-price proportionately across repricing bands (up to six years); that small amounts of mortgage loan prepayments will occur; and that fixed assets and other liabilities are classified as having 'non-specific' repricing.

Earnings-at-Risk and Market Value Sensitivity
Other interest rate risk metrics employed by the Group incorporate earnings-at-risk and market value methodologies, which calculate interest rate risk exposure positions, based on 250 historical data observations going back over approximately the last seven years. All of these approaches employ 95% confidence intervals and are multi-currency. Additionally, 99% confidence intervals are shown for information. These advanced interest rate risk measurement exposures, which are compared to Board and Operational limits weekly and formally reported to ALCO and the Board monthly, are used to guide interest rate risk management decisions.

Although these measures provide valuable insights to the market risk to which the Group is exposed, they need to be viewed in the context of the following limitations:

- Historical data is not necessarily a good guide to future events;
- The use of 95% confidence levels, by definition, does not take account of changes that may occur beyond this level of confidence and therefore may not fully take into account extreme events, as previously mentioned, 99% confidence levels are also monitored to try to mitigate this limitation;
- Exposures are calculated on static Statement of Financial Position positions and, therefore, future changes in the structure of the Statement of Financial Position are ignored; however, analysis on dynamic positions is now being performed.

Balance Sheet Structure Analysis
Further interest rate risk exposures, such as basis risk (the risk of loss arising from changes in the relationship between interest rates which have similar but not identical characteristics, for example, LIBOR and Bank of England Base Rate) are also monitored closely and regularly reported to ALCO. This risk is managed where appropriate, through the use of derivatives, with established risk limits and other control procedures.

The interest rate exposures during 2013 were as follows:

	As at 31 December £m	**Average £m**	**High £m**	**Low £m**
Static Earnings-at-risk	2.9	2.1	3.2	1.1
Historical Value-at-risk	1.8	1.8	3.0	1.1
2% Parallel interest rate shift	8.6	7.5	17.9	2.2

7.4 Equity risk

This is the risk of loss due to movements in equity markets. The Group offers savings products where the return to the customer is linked to the performance of equity markets and hedges this risk through the use of derivative contracts.

As at 31 December 2013 the Group had £229m of equity related savings balances which were appropriately hedged.

Following its flotation in July 2013, the Group held a 24.5% stake in Wynyard Group Limited at 31 December 2013, which is listed on the New Zealand Stock Exchange. The equity risk of this investment is not hedged.

7.5 Pension Obligation Risk

The Group has funding obligations for five defined benefit schemes which are all now closed to new entrants and to future accrual of benefit. Pension risk is the risk that the value of the schemes' assets, together with ongoing contributions, will be insufficient to cover their obligations over time. The return on assets, which includes equities and bonds, will vary with movements in equity prices and interest rates. The projection of the schemes' obligations includes estimates of mortality, inflation and future salary increases, the actual outturn of which may differ from the estimates. The schemes are also exposed to possible changes in pension's legislation.

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

- The Board regularly reviews the Group's pension risk strategy.
- The Board and the pension scheme Trustees receive professional advice from different actuarial advisers.
- The pension Scheme Trustees meet quarterly to monitor and make investment decisions, liaising with the principal employer in accordance with the scheme rules.
- The pension obligation position is updated every quarter and reported, along with key pension risk metrics, to the Board Risk Committee and the pension scheme Trustees.

The Group also performs stress testing on the pension scheme liabilities and assets as part of the pension risk metrics for the Board Risk Committee and also in its capital planning methodologies articulated in the Individual Capital Adequacy Assessment Process (ICAAP). Note 29 of the 2013 Report and Accounts sets out details of the Group's pension obligations and details the steps management have undertaken to manage the Group's pension risk exposure. Initiatives aimed at managing the funding deficit and associated long-tail risk include early retirement exercises and enhanced pension transfer exercises which resulted in £20.8m of the liability being extinguished in early 2011 and a further £3.1m in 2013. Additionally, action has been taken to reduce the volatility of growth assets held by the schemes and the Trustees have increased the level of hedging in place to protect the schemes against interest rates and inflation.

7.6 Reputational Risk

Reputational risk is the risk to earnings, liquidity or capital arising from negative market or public opinion. Management has considered how this might arise and what the impact could be. The consequences would adversely impact the future prospects of the Group and could expose the Group to litigation and financial loss. Reputational risk is inherent across the Group. Senior Management manage this risk in the following ways:

- By maintaining and investing in its control structures;
- A continued focus on customer outcomes;
- Promoting the Society's reputation through marketing and external communications; and
- Through the risk management framework which has reputational risk as a key consideration.

7.7 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 mis-selling of a third party's insurance contracts e.g. general insurance or life sales, is captured under operational risk.

7.8 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 independent directors of subsidiary companies and, therefore, attend the Operational Board's of each business;
- 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 Executive Committee and / or the Board in accordance with documented mandates.

7.9 Taxation Risk

Taxation risk is the risk associated with changes in tax law or in the interpretation of tax law. It also includes the risk of changes in tax rates and the risk of failure to comply with procedures required by tax authorities. Failure to manage tax risks could lead to an additional tax charge. It could also lead to reputational damage or financial penalties. The Group has effective, well-documented and controlled processes in place to ensure compliance with tax disclosure and filing obligations and employs its own tax professionals who take appropriate advice from reputable professional firms when necessary.

The Group takes a responsible approach to the management, governance and oversight of its tax affairs which is documented in a Tax Policy approved by the Board which requires tax risks to be reviewed and assessed as part of the Group's formal governance processes. The Group has adopted the Code of Practice on Taxation for Banks, which requires banks to have proper governance around tax, integrated into business decision making, to establish an appropriate working relationship with Her Majesty's Revenue & Customs (HMRC) and to undertake tax planning only to support business operations and not to achieve unintended tax advantages. The Group will continue to be co-operative and transparent in its dealings with the tax authorities and has embedded the terms of the Code into its Tax Policy.

7.10 Regulatory Risk

Regulatory risk is the risk that the Group does not adhere to the changing regulatory environment in which it operates. Key changes on the horizon include the implementation of those recommendations made by the Independent Commission on Banking reforms which the Government chooses to bring into law, the replacement of Basel II by CRD IV (Basel III) and the impact upon our capital base and the Mortgage Market Review. The Group has allocated resource to ensure continued compliance in these and other areas and we believe we are well placed to meet the new requirements.

7.11 Credit Rating Risk

A decline in the Society's credit rating could result in it becoming slightly more difficult to secure wholesale funding and at a higher cost. In addition, in the short term it is likely that the Group would also have to slightly 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 the Market and Liquidity Risk function, and is reported to ALCO and the Board on a monthly basis.

8.0 CRD IV

8.1 Capital Impact of CRD IV

From 1 January 2014, the Basel II regulation, upon which the prior sections capital calculations are based, was replaced by the CRD IV regulation. CRD IV introduces a number of changes to the capital framework which impact how our capital adequacy is calculated. The impact of CRD IV in some areas was immediate; however in some cases the impact is being phased in under transitional arrangements up to 2022. Under the new framework the key level at which we monitor our capital is at a prudential consolidation group level; the equivalent consolidation group under Basel II was the UK consolidation group. The prudential consolidation group comprises the entire Group except a number of entities, including Connells, whose activities are not closely aligned with the core business of financial services.

The capital ratios for the prudential consolidation group on a CRD IV transitional basis and 'fully loaded' basis as at 1 January 2014 are set out below. The fully loaded position represents the CRD IV end-point definition applicable from 1 January 2022, when all rules have been fully implemented.

The key impacts of the CRD IV transitional rules on capital resources are:

- The full pension deficit is recognised under CRD IV; under Basel II an amount equivalent to five years of pension deficit contributions was recognised;
- A proportion of the deferred tax asset is deducted from common equity tier one capital (CET1) under CRD IV;
- A proportion of the additional Tier 1 and Tier 2 instruments become ineligible as capital under CRD IV pursuant to the grandfathering rules, i.e. certain instruments are phased out.

The key impacts on capital resources of the CRD IV fully loaded rules are as above for the pension deficit and deferred tax, however all existing additional Tier 1 and Tier 2 instruments that become ineligible as capital are excluded in full.

	Prudential consolidation group	
	01.01.14 Transitional	**01.01.14 Fully loaded**
Common Equity Tier 1 ratio (%)	**14.14**	**14.23**
Tier 1 ratio (%)	**15.43**	**14.23**
Total capital ratio (%)	**17.14**	**15.67**

As at 31 December 2013 the Full Group Core Tier 1 ratio, under Basel II, was 12.32%, as disclosed in the 2013 Annual Report and Accounts. On the same date the UK consolidation group Core Tier 1 ratio, under Basel II, was 14.44%, as noted in the table overleaf. The main reason the UK consolidation group Core Tier 1 ratio is higher is because this regulatory consolidation group does not include a number of subsidiaries which attract operational risk and credit risk capital requirements, and goodwill capital resources deductions, principally in relation to Connells.

The table overleaf also shows the comparison between the capital adequacy of the UK consolidation group under Basel II and that of the prudential consolidation group under CRD IV. The Core Tier 1 ratio under Basel II has been replaced by the CET1 ratio under CRD IV. These ratios both analyse core capital strength so can be used for comparison purposes.

	Basel II UK consolidation group	CRD IV Prudential consolidation group	
		Transitional	*Fully Loaded*
	31/12/13 (£m)	**01/01/14 (£m)**	**01/01/14 £(m)**
General Reserve	828.0	828.0	832.9
Regulatory adjustments:			
Available for sale reserve	-	(5.5)	(5.5)
Defined pension fund adjustment	12.9	-	-
CET1 deductions:			
Intangible assets and goodwill	(30.5)	(30.5)	(30.5)
Total Tier 1 capital after deductions	**810.4**	**792.0**	**796.9**
Additional Tier (AT1)			
Permanent Interest Bearing Shares (PIBS)	90.0	72.0	-
Total Tier 1 Capital	**900.4**	**864.0**	**796.9**
Tier 2			
Subordinated liabilities	82.7	54.1	16.4
Collective impairment allowance	24.0	23.9	23.9
Permanent Interest Bearing Shares (PIBS)	-	18.0	40.0
Total Tier 2 Capital	**106.7**	**96.0**	**80.3**
Deductions From Totals of Tier One and Tier Two Capital			
Investments that are not material holdings or qualifying holdings	(97.5)	-	-
Total Capital	**909.6**	**960.0**	**877.2**
Current RWAs	5,611.0	5,611.0	5,611.0
Adjustment to CRD IV RWAs	-	(12.2)	(12.2)
Total RWAs under CRD IV	**5,611.0**	**5,598.8**	**5,598.8**
Core Tier 1 (2013) / CET1 (2014) Ratio	**14.44%**	**14.14%**	**14.23%**

Key changes impacting the CET1 ratio are set out below:

- Removal of 100% deduction for investments that are material or non-material qualifying holdings.
- The Available for sale reserve is to be fully recognised reflecting any unrealised gains and losses.
- Basel II regulations allow for defined pensions liabilities to be added back to core Tier 1 capital with 5 years of pension contributions being deducted instead. This adjustment is no longer allowable under CRDIV.

The RWA balance changes under CRD IV due to a change in approach for Equity Release mortgages, deferred tax assets and investments in subsidiary holdings outside the financial sector.

In addition to the changes above the Tier 1 position will reduce due to the transfer of PIBS from Tier 1 to Tier 2 capital. The CRD IV rules state that these instruments will be phased out of CET1 between 1 January 2013 and 31 December 2021. In addition, following the implementation of CRD IV some of Skipton's subordinated debt is no longer eligible as capital resources.

8.2 Leverage Ratio

The CRD IV regulations also include the introduction of a new capital leverage ratio defined as the ratio of Tier 1 capital to total exposure. The leverage ratio is subject to an observation period by the European Banking Authority (EBA) from the 1 January 2013 until 1 January 2017. Following this a binding requirement will be finalised for implementation on 1 January 2018. A limit of 3% under the fully loaded definition is currently being applied to eight major UK banks and building societies. Although this does not apply to Skipton Building Society we will ensure we satisfy this as a minimum until the final rules are agreed.

In January 2014 the Basel Committee set out a revised definition of the leverage ratio. We have applied this definition to calculate a leverage ratio at a prudential group level, being the key consolidation level at which we are regulated under CRD IV. The leverage ratio calculated on this basis is 5.6% as at 1 January 2014.

	Basel II UK consolidation group	**CRD IV Prudential consolidation group**	
		Transitional	*Fully Loaded*
	31/12/13 (£m)	**01/01/14 (£m)**	**01/01/14 (£m)**
Leverage Ratio	6.33%	6.07%	5.60%

Glossary

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

Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan commitment is overdue.
Asset Backed Securities (ABS)	An asset backed security is a security whose value and income payments are derived from and collateralised (or 'backed') by a specified pool of underlying assets. Typically these assets are pools of residential or commercial mortgages.
Basel II	Basel II is the second of the Basel Accords, issued by the Basel Committee on Banking Supervision, which defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive, and was implemented in the UK via the PRA Handbook.
Basel III	Basel III became effective in the UK on 1 January 2014 and sets out details of strengthened global regulatory standards on bank capital adequacy and liquidity.
BIPRU	The Prudential sourcebook for banks, building societies and investment firms which sets out the PRA's capital requirements.
Business Risk	The risk that the external environment has the potential to affect the Society's business model.
Capital Requirement	The minimum amount of capital resources that a financial institution must hold to cover the risk of losses.
Capital Resources	Capital held, less all required regulatory adjustments and deductions. Capital comprises general reserve, Permanent Interest Bearing Shares, subordinated debt and collective provisions.
Commercial Loan	Loan secured on commercial property, loans to Registered Social Landlords and loans relating to project finance.
Commercial mortgage backed securities (CMBS)	Securities that represent interests in a pool of commercial mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and / or principal).
Conduct Risk	The risk of delivering poor or inappropriate outcomes for customers.
Common Equity Tier 1 Capital	Common Equity Tier 1 (CET1) capital primarily comprises internally generated capital from retained profits. An adjustment is made to deduct intangible assets and goodwill. CET1 capital is fully loss absorbing.
Core Tier 1 Capital	Defined by the PRA as Tier 1 capital less hybrid capital instruments (innovative Tier 1 securities and Permanent Interest Bearing Shares for building societies) and certain regulatory adjustments.
Core Tier 1 Ratio	Core Tier 1 Capital as a percentage of risk-weighted assets.
Counterparty Credit Risk	Counterparty credit risk is the risk that the counterparty to a transaction defaults before the final settlement of the transaction's cash flows.
CRD IV	CRD IV is made up of the Capital Requirements Regulation (CRR), which is directly applicable to firms across the EU, and the Capital Requirements Directive (CRD), which must be implemented through national law. CRD IV has implemented the Basel III agreement in the EU.
Credit Risk	The risk that a borrower or counterparty fails to pay the interest or capital on a loan or other financial instrument resulting in a loss to the Society.
Credit Risk Mitigation	Techniques utilised to reduce the potential loss in the case that either a borrower or counterparty becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit issuance, set off or netting.
Debt Securities	Assets representing certificates of indebtedness of credit institutions, public bodies or other undertakings excluding those issued by central banks.
Debt Securities in Issue	Transferable certificates of indebtedness of the Group to the bearer of the certificates. These are liabilities of the Group and include certificates of deposit.
Delinquency	A debt or financial obligation is considered to be in a state of delinquency when payments are overdue.
Derivative Financial Instruments	A derivative financial instrument is a type of financial instrument (or

	an agreement between two parties) that has a value based on the underlying asset, index or reference rate it is linked to. The Group uses derivative financial instruments to hedge its exposures to market risks such as interest rate, equity and currency risk.
Effective Interest Rate Method (EIR)	The method used to measure the carrying value of a financial asset or a liability and to allocate associated interest income or expense over the relevant period.
Fair Value	Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction.
Financial Conduct Authority (FCA)	The statutory body responsible for conduct of business regulation and supervision of UK authorised firms from the 1 April 2013.
Financial Services Compensation Scheme (FSCS)	The UK's compensation fund of last resort for customers of authorised financial services firms. The FSCS may pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it, usually because it has stopped trading or has been declared in default. The FSCS is funded by the financial services industry. Every firm authorised by the FCA is obliged to pay an annual levy, which goes towards its running costs and compensation payments.
Forbearance Strategies	Strategies to assist borrowers in financial difficulty, such as arrears capitalisation, a reduction in the monthly payment, a conversion to interest only or a mortgage term extension. Forbearance strategies aim, if possible, to avoid foreclosure or repossession.
Free Capital	The aggregate of gross capital and provisions for collective impairment losses on loans and advances to customers less property, plant and equipment, investment properties and intangible assets.
Funding for Lending Scheme	A scheme launched by the Bank of England and HM Treasury in August 2012 which provides funding to banks and building societies with the aim of stimulating lending within the economy.
Funding Limit	Measures the proportion of shares and borrowings (excluding the fair value adjustment for hedged risk) not in the form of shares held by individuals. The calculation of the funding limit is explained in the Annual Business Statement.
GENPRU	General Prudential Sourcebook for banks, building societies, insurers and investment firms which forms part of the PRA Handbook for Basel II.
Goodwill	Goodwill arises on the acquisition of subsidiary undertakings, joint ventures, associates or businesses and represents the excess of the fair value of consideration over the fair value of identifiable net assets and contingent liabilities acquired at the date of acquisition.
Impaired Loans	Loans where the Group does not expect to collect all the contractual cash flows or expects to collect them later than they are contractually due.
Individually / Collectively Assessed	Individual assessments are made of all mortgage loans where objective evidence indicates losses are likely or the property is in possession. A collective impairment provision is made against the remaining group of loans and advances where objective evidence indicates that it is likely that losses may be realised.
Individual Capital Adequacy Assessment Process (ICAAP)	The Group's own assessment, as part of regulatory requirements, of the levels of capital that it needs to hold in respect of the risks it faces under a business as usual scenario and a variety of stress scenarios.
Individual Liquidity Adequacy Assessment (ILAA)	The Group's own assessment that current and projected levels of liquidity are sufficient and appropriate for the Group's plans, under a variety of stress scenarios. It also details the Group's compliance with the PRA's regulatory BIPRU 12 requirements.
Internal Ratings-Based Approach (IRB)	An advanced approach to measuring capital requirements in respect of credit risk under Basel II and, from 1 January 2014, CRD IV. The IRB approach may only be used with permission from the PRA.
International Swaps and Derivatives Association (ISDA) Master Agreement	A standardised contract developed by ISDA and used to enter into bilateral derivatives transactions.
Investment Grade	The highest range of credit ratings, from Aaa to Baa3, as measured by external credit rating agencies.
Lending Limit	Measures the proportion of business assets not in the form of loans fully secured on residential property. The calculation of the lending limit is explained in the Annual Business Statement.
Leverage Ratio	The ratio of Tier 1 capital divided by total exposure, which includes on and off balance sheet assets, after netting derivatives.
Liquid Assets	The total of cash in hand and balances with the Bank of England, loans and advances to credit institutions and debt securities.
Liquidity Ratio	Liquid assets as a percentage of shares and borrowings.
Loan-To-Value Ratio (LTV)	A ratio which expresses the amount of a mortgage as a percentage of

	the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a quarterly basis to reflect changes in a house price index (HPI)).
Loans Past Due / Past Due Loans	Loans on which payments are overdue including those on which partial payments are being made.
London Interbank Offered Rate (LIBOR)	A benchmark interest rate at which banks can borrow funds from other banks in the London interbank market.
Market Risk	The risk that the value of, or net income arising from, the Group's assets and liabilities changes as a result of changes to interest rates or exchange rates.
Medium Term Notes (MTN)	Corporate notes continuously offered by an entity to investors through a dealer.
Member	A person who has a share investment or a mortgage loan with the Society.
Mortgage Backed Securities (MBS)	Assets which are backed by underlying mortgage collateral.
Net Interest Income	The difference between interest received on assets and interest paid on liabilities.
Net Interest Margin	Net interest income as a percentage of mean total assets.
Operational Risk	The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.
Permanent Interest Bearing Shares (PIBS) or Subscribed Capital	Unsecured, deferred shares that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, payables and investing members of Skipton Building Society.
Pillar 1 - Minimum Capital Requirements	The part of the Basel II Framework which sets out the regulatory minimum capital requirements for credit, market and operational risk.
Pillar 2 - The Supervisory Review Process	The part of the Basel II Framework which sets out the processes by which financial institutions review their overall capital adequacy. Supervisors then evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments.
Pillar 3 - Market Discipline	The part of the Basel II Framework which sets out the disclosure requirements for firms to publish details of their risks, capital and risk management. The aims are greater transparency and strengthening market discipline.
Prime	Prime mortgages are those granted to the most credit worthy category of borrower.
Provisions	Amounts set aside to cover incurred losses associated with credit risks.
Prudential Regulation Authority (PRA)	The statutory body responsible for the prudential supervision of banks, building societies, insurers and a small number of significant investment firms in the UK from 1 April 2013.
Renegotiated Loans	Loans are classed as renegotiated, with the customer's consent, when their terms have changed during the year. Loans and advances may be renegotiated whether or not our customer is experiencing financial difficulty in repaying their loan with the Group.
Repurchase Agreement (Repo) / Reverse Repurchase Agreement (Reverse Repo)	Short to medium term funding agreements which allow a borrower to sell a financial asset, such as an ABS or Government bonds as security for cash. As part of the agreement the borrower agrees to repurchase the security at some later date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the party on the other end of the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or reverse repo, which can typically be resold or repledged if desired.
Residential Loans	Money loaned to individuals rather than institutions. Residential mortgage lending is secured against residential property.
Residential Mortgage Backed Securities (RMBS)	A category of ABS that represent interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and / or principal).
Risk Appetite	The articulation of the level of risk that the Group is willing to take (or not take) in order to safeguard the interests of the Society's members whilst achieving business objectives.
Risk Weighted Asset (RWA)	The value of assets, after adjustment, under Basel II rules to reflect the degree of risk they represent.
Securitisation	A process by which a group of assets, usually loans, are aggregated into a pool which is used to back the issuance of new securities. A firm transfers these assets to a special purpose vehicle which then issues securities backed by the assets. The Group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.
Shares	Money deposited by non-corporate depositors in a retail savings

	account with the Society. Such funds are recorded as liabilities for the Society.
Shares and Borrowings	The total of shares, amounts owed to credit institutions, amounts owed to other customers and debt securities in issue, including accrued interest and fair value adjustments for hedged risk.
Special Purpose Entity (SPE)	A legal entity whose operations are limited to the acquisition and financing of specific assets. The Group uses SPEs to facilitate securitisation programmes.
SREP	Supervisory Review and Evaluation Process, the PRA assessment of a firm's own capital assessment under Basel II Pillar 2.
Standardised Approach	The basic method used to calculate capital requirements for credit risk under Basel II. The risk weights used in the capital calculation are determined by PRA supervisory parameters.
Stress Testing	Risk management exercise used to improve a firm's understanding of its business model vulnerabilities.
Subordinated Debt / Liabilities	A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing members (other than holders of PIBS).
Sub-prime	Loans to borrowers typically having weakened credit histories that include payment delinquencies and in some cases potentially more severe problems such as court judgements and discharged bankruptcies.
Tier 1 Capital	A measure of financial strength. Tier 1 capital is divided into Core Tier 1 and other Tier 1 capital. Core Tier 1 capital comprises general reserves from retained profits. The book values of goodwill and other intangible assets are deducted from Core Tier 1 capital and other regulatory adjustments may be made for the purposes of capital adequacy. Qualifying capital instruments such as PIBS are included in other Tier 1 capital (i.e. not Core Tier 1).
Tier 2 Capital	Comprises the Group's qualifying subordinated debt and collective impairment allowance (for exposures treated on a Basel II standardised basis). Certain regulatory deductions may be made for the purposes of assessing capital adequacy.
Wholesale Funding	Amounts owed to credit institutions, amounts owed to other customers and debt securities in issue excluding balances deposited by offshore customers.