Skipton Building Society

Pillar 3 Year-end disclosures

30 March 2009

Contents

1.0 Introduction

1.1 Background

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

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

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

Pillar 3 requires building societies and banks operating under the Basel II framework to disclose quantitative and qualitative information regarding their risk assessment process and capital resources, and hence their capital adequacy.

1.2 Basis and frequency of disclosure

This Pillar 3 report is based upon the Group's Annual Report and Accounts for the year ended 31 December 2008, unless otherwise stated. Subsequent disclosures will be issued on an annual basis as soon as practicable after the publication of the Group's Annual Report and Accounts.

1.3 Media and location of publication

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

1.4 Verification of disclosure

These disclosures have been reviewed by the Group's Board Audit Committee. There is no requirement for the disclosures to be audited; however, some of the information within the disclosures also appears in the Group's audited Annual Report & Accounts.

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

Solo consolidation group

As at 31 December 2008 the Solo consolidation group consists of Skipton Building Society, Amber Homeloans Limited and Skipton Building Society Covered Bonds LLP.

UK consolidation group

As at 31 December 2008 the UK consolidation group (UKCG) consists of the entire Group with the exception of the following entities in accordance with BIPRU 8.5.1:

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

3.0 Risk management objectives and policies

3.1 Introduction

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

3.2 Group Risk management framework

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

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

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

3.3 Board

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

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

3.4 Asset and Liability Committee (ALCO)

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

3.5 Group Retail Credit Committee (GRCC)

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

3.6 Operational Risk Committee (ORC)

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

3.7 Board Audit Committee (BAC)

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

4.0 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 2008.

	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Tier 1			
Reserves	703.6	651.0	614.3
Permanent Interest Bearing Shares (PIBS)	25.0	25.0	25.0
Pension fund deficit adjustment	16.7	1.3	1.3
Unrealised losses on available-for-sale debt securities	13.2	13.2	13.2
Unrealised losses on cash flow hedges	21.2	21.2	21.2
Total tier 1 capital	**779.7**	**711.7**	**675.0**
Deductions from tier 1 capital:			
Goodwill	(210.9)	(96.2)	-
Intangible assets	(31.6)	(23.1)	(2.8)
Material holdings[1] (50%)	-	-	(22.5)
Total tier 1 capital after deductions	**537.2**	**592.4**	**649.7**
Tier 2			
Subordinated debt	180.0	180.0	180.0
Collective impairment allowance	14.0	14.0	14.0
Total tier 2 capital	**194.0**	**194.0**	**194.0**
Deductions from tier 2 capital:			
Investment in subsidiary companies	-	(79.3)	(161.2)
Material holdings (50%)	-	-	(22.5)
Total tier 2 capital after deductions	**194.0**	**114.7**	**10.3**
Total capital resources	**731.2**	**707.1**	**660.0**

[1] A material holding represents an investment in a financial institution or credit institution which exceeds 10% of the share capital of the issuer, eg the Society's investment in Skipton Guernsey Limited.

4.2 Tier 1 capital

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

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

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

Intangible assets are deducted from capital for regulatory purposes.

4.3 Tier 2 capital

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

The subordinated note holders' rights are subordinated to those of the depositors and other creditors and also to PIBS shareholders in respect of share principal and accrued interest. Further details regarding subordinated debt are set out in note 29 to the Group's 2008 Annual Report and Accounts. Under FSA rules subordinated debt is included in the Group's capital resources in accordance with UK GAAP rather than IFRS.

5.0 Capital adequacy

5.1 Summary of approach to capital adequacy planning

Capital is held by the Group to absorb losses which may occur during the economic cycle. The Internal Capital Adequacy Assessment Process (ICAAP) is the means by which the Group ensures that:

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

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

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

The following table sets out the minimum capital resources requirements (Pillar 1) for the Solo, UK and full consolidation groups, together with their respective capital adequacy positions as at 31 December 2008.

	Full consolidation group[2] £m	UK consolidation group £m	Solo consolidation group £m
Credit Risk (Standardised)	407.8	402.9	394.5
Operational Risk (Standardised)	67.7	33.2	5.5
Market Risk (Foreign Exchange PRR[3])	0.7	0.2	-
Total minimum capital requirement	**476.2**	**436.3**	**400.0**
Total capital resources (section 4.1)	**731.2**	**707.1**	**660.0**
Excess of own funds over minimum capital requirement under Pillar 1	**255.0**	**270.8**	**260.0**
Capital ratio (%)	**153.5%**	**162.1%**	**165.0%**

5.2 Capital reporting

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

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

5.3 Transferability of capital

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

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

6.0 Minimum capital requirement – Pillar 1

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

6.1 Credit risk overview

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

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

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

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

The following table details the minimum capital requirement for credit risk for the full consolidation group as at 31 December 2008 broken down by exposure value.

	Exposure value £m	Capital requirement £m
Corporates – unsecured lending to corporates	28.0	2.2
Retail – debt factoring loans	30.3	1.8
Secured on real estate property	9,100.3	301.2
Past due items	259.3	21.6
Other items	6.6	-
Total loans and advances to customers	**9,424.5**	**326.8**
Central governments or central banks	477.9	-
Regional governments or local authorities	3.7	0.1
Financial institutions	1,703.0	29.0
Securitisation positions – see section 6.1.8	236.8	3.8
Short-term claims on institutions and corporates	756.9	12.1
Total wholesale lending	**3,178.3**	**45.0**
Other items – eg fixed assets, derivatives, and sundry debtors	845.8	35.6
Secured on real estate property – commercial off-balance sheet loans	5.7	0.4
Total other	**851.5**	**36.0**
Total	**13,454.3**	**407.8**

The following table details the minimum capital requirement for credit risk for the UK consolidation group as at 31 December 2008 broken down by exposure value.

	Exposure value £m	Capital requirement £m
Corporates – unsecured lending to corporates	28.0	2.2
Retail – debt factoring loans	30.3	1.8
Secured on real estate property	9,105.7	301.4
Past due items	259.3	21.6
Other items – deeds accounts	0.5	-
Total loans and advances to customers	**9,423.8**	**327.0**
Central governments or central banks	477.9	-
Regional governments or local authorities	3.7	0.1
Financial institutions	1,682.7	28.6
Securitisation positions – see section 6.1.8	236.8	3.8
Short term claims on institutions and corporates	756.9	12.1
Total wholesale lending	**3,158.0**	**44.6**
Other items – eg fixed assets, derivatives, and sundry debtors.	567.9	30.9
Secured on real estate property – commercial off-balance sheet loans	5.7	0.4
Total other	**573.6**	**31.3**
Total	**13,155.4**	**402.9**

The following table details the minimum capital requirement for credit risk for the Solo consolidation group as at 31 December 2008 broken down by exposure value.

	Exposure value £m	Capital requirement £m
Corporates – unsecured lending to corporates	24.4	2.0
Retail – other unsecured lending	3.8	0.2
Secured on real estate property	8,749.0	290.1
Past due items	258.6	21.6
Other items – deeds accounts	0.5	-
Total loans and advances to customers	**9,036.3**	**313.9**
Central governments or central banks	477.9	-
Regional governments or local authorities	3.7	0.1
Financial institutions	1,665.2	28.2
Securitisation positions – see section 6.1.8	236.8	3.8
Short term claims on institutions and corporates	756.9	12.1
Total wholesale lending	**3,140.5**	**44.2**
Other items – eg fixed assets, derivatives, and sundry debtors	784.0	36.0
Secured on real estate property – commercial off-balance sheet loans	5.7	0.4
Total other	**789.7**	**36.4**
Total	**12,966.5**	**394.5**

6.1.1 Credit risk: loans and advances to customers

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

- the evaluation of the credit risk associated with potential borrowers through a combination of lending policy criteria which is regularly reviewed and updated to reflect changing macroeconomic environments, credit scoring, policy rules and underwriting. The primary factors considered are affordability using appropriate stressing, residential status, residential history, credit history, employment history, nature of income and loan-to-value (LTV). In addition, confirmation of borrower identity is obtained. When considering applications the primary focus is placed on the strength of the covenants which will determine the willingness and ability to repay;
- the geographic and product segments are monitored to ensure nature limits are adhered to on a monthly basis;
- the maximum loan available is determined by its percentage of the lower of the vacant possession price or open market value, with nature limits for LTV bandings and business distribution reviewed monthly;
- the taking of security against the loan. All mortgages are secured by way of a first legal charge against the property; and
- ongoing monitoring of account performance, including arrears and default emergence by portfolio sectors. Loans which show signs of adverse performance are managed by specialist teams who manage the collections and recovery processes.

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

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

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

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

			2008	
	Full group 07 / 08 average £m	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Total residential mortgages	8,757.0	8,815.7[4]	8,820.9	8,479.8
Commercial loans	496.6	527.8	527.8	527.8
Other lending:				
Debt factoring loans	32.6	30.8	30.8	-
Premium finance loans	31.7	-	-	-
Other loans	44.7	50.2	44.3	28.7
Gross balances	**9,362.6**	**9,424.5**	**9,423.8**	**9,036.3**
Impairment provisions	(30.6)	(44.1)	(44.1)	(43.7)
Fair value adjustment	97.9	187.3	187.3	180.0
Total	**9,429.9**	**9,567.7**	**9,567.0**	**9,172.6**

The maturity of loans and advances to customers from 31 December 2008 is as follows:

		2008	
	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
On call and at short notice	42.4	36.3	5.7
In not more than three months	3.4	3.4	3.4
In more than three months but not more than one year	19.8	19.8	20.4
In more than one year but not more than five years	251.0	251.0	257.5
In more than five years	9,107.9	9,113.3	8,749.3
	9,424.5	**9,423.8**	**9,036.3**
Fair value adjustment	187.3	187.3	180.0
Less: Impairment	(44.1)	(44.1)	(43.7)
Total	**9,567.7**	**9,567.0**	**9,172.6**

6.1.2 Credit risk: commercial lending

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

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

Commercial portfolio asset quality monitoring is based on a number of measures, including financial covenant monitoring and updated assessments of the value of the primary security. In the event

[4] The total residential mortgages balance for the full group is lower than the UK consolidation group balance due to consolidation adjustments that are required at a full group level.

that particular exposures begin to show adverse features such as payment arrears, covenant breaches or business trading losses, a full risk re-appraisal is undertaken with cases being managed individually by specialist teams who oversee the collections and recovery processes. The Board and GRCC review reports on credit risk exposures and performance of the commercial portfolio monthly.

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

	2008 £m
Leisure and hotel	53.5
Retail	19.8
Nursing / residential homes	42.3
Offices	17.4
Commercial investment and industrial units	313.4
Residential investment	58.6
Miscellaneous	22.8
Total	**527.8**

Having considered the risks inherent in this class of lending, the Society ceased commercial lending to new customers in November 2008.

6.1.3 Credit risk: wholesale lending

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

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

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

			2008	
	Full group 07/08 average £m	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Cash in hand and balances with the Bank of England	247.7	359.4	359.4	359.4
Cash with banks and building societies	717.4	1,064.4	1,044.1	1,026.6
Gilts	93.0	111.0	111.0	111.0
Certificates of deposit	1,080.2	946.5	946.5	946.5
Local authority investments	30.2	3.7	3.7	3.7
Fixed rate bonds	13.4	1.7	1.7	1.7
Floating rate notes	395.4	390.0	390.0	390.0
Residential mortgage backed securities	286.0	243.0	243.0	243.0
Commercial mortgage backed securities	61.2	58.6	58.6	58.6
Total	**2,924.5**	**3,178.3**	**3,158.0**	**3,140.5**

The table below sets out the maturity of the wholesale lending book.

	2008 Full consolidation group £m	 UK consolidation group £m	 Solo consolidation group £m
Loans and advances to credit institutions			
Repayable on demand	40.3	23.8	5.2
In not more than three months	1,044.0	1,040.2	1,041.3
	1,084.3	**1,064.0**	**1,046.5**
Debt securities			
In not more than one year	1,209.5	1,209.5	1,209.5
In more than one year	525.1	525.1	525.1
	1,734.6	**1,734.6**	**1,734.6**
Cash in hand and balances with the Bank of England			
Repayable on demand	359.4	359.4	359.4
	359.4	**359.4**	**359.4**
Total	**3,178.3**	**3,158.0**	**3,140.5**

The table below sets out the capital held for the wholesale lending book by credit rating and exposure value:

	Full consolidation group		**UK consolidation group**		**Solo consolidation group**	
Rating	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**
Aaa	843.8	5.2	843.7	5.2	843.6	5.2
Aa1	766.3	12.5	746.2	12.9	730.9	12.5
Aa2	461.0	7.2	461.0	7.2	459.8	7.2
Aa3	453.3	7.3	453.3	7.3	452.4	7.3
A1	180.0	3.6	180.0	3.6	180.0	3.6
A2	270.0	4.4	270.0	4.4	270.0	4.4
A3	102.7	1.7	102.7	1.7	102.7	1.7
Baa1	19.0	0.7	19.0	0.7	19.0	0.7
Baa2	25.5	0.7	25.5	0.7	25.5	0.7
Unrated:						
Building societies	53.0	0.8	52.9	0.8	52.9	0.8
Local authorities	3.7	0.1	3.7	0.1	3.7	0.1
Total	**3,178.3**	**45.0**	**3,158.0**	**44.6**	**3,140.5**	**44.2**

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

	Full consolidation group		**UK consolidation group**		**Solo consolidation group**	
Geographical region	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**
UK	1,724.5	20.1	1,710.3	19.8	1,704.2	19.6
Rest of Europe	1,043.6	19.7	1,043.4	19.7	1,042.5	19.7
North America	106.1	0.9	106.1	0.9	106.1	0.9
Australasia	214.1	1.7	208.2	1.6	197.7	1.4
Far East	90.0	2.6	90.0	2.6	90.0	2.6
Total	**3,178.3**	**45.0**	**3,158.0**	**44.6**	**3,140.5**	**44.2**

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

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

Central Governments and Central Banks			
Credit quality step	**Risk weight**	**Moody's ratings[5]**	**Exposure values £m**
1	0%	Aaa	**471.9**

Regional Governments and Local Authorities			
Credit quality step	**Risk weight**	**Moody's ratings**	**Exposure values £m**
Unrated	20%	Unrated	**3.7**

Financial Institutions			
Credit quality step	**Risk weight**	**Moody's ratings**	**Exposure values £m**
1	20%	Aaa to A2	1,957.0
2 (residual / original maturity < 3 months)	20%	A1 to A3	374.0
2 (original maturity > 3 months)	50%	A1 to A3	37.4
3 (residual / original maturity < 3 months)	20%	Baa2	14.5
3 (original maturity > 3 months)	50%	Baa1 to Baa2	30.0
Unrated	20%	Unrated	53.0
			2,465.9

Covered Bonds			
Credit quality step	**Risk weight**	**Moody's ratings**	**Exposure values £m**
1	20%	Aaa	-

Mortgage Backed Securities			
Credit quality step	**Risk weight**	**Moody's ratings**	**Exposure values £m**
1	20%	Aaa	**236.8**

Full group total			**3178.3**

6.1.4 Concentration risk

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

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

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

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

6.1.5 Impairment

Impairment of loans and advances to customers

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

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

Loans that are subject to individual impairment provisions which have satisfactorily entered into arrangements for predetermined periods may be individually assessed as being no longer considered to be past due or impaired provided they are subject to ongoing future review to determine whether they remain impaired or are considered to be past due.

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

		2008	
	Full consolidation group £m	**UK consolidation group £m**	**Solo consolidation group £m**
Neither past due nor individually impaired	8,342.5	8,347.8	8,012.0
Past due but not individually impaired:			
Up to 3 months	156.8	156.8	152.0
3 to 6 months	22.1	22.1	21.6
6 to 9 months	8.9	8.9	8.9
9 to 12 months	2.4	2.4	2.4
Over 12 months	2.2	2.2	2.2
Total	**8,534.9**	**8,540.2**	**8,199.1**
Individually impaired	242.7	242.7	242.7
Possessions	38.1	38.1	38.1
Total	**8,815.7**	**8,821.0**	**8,479.9**

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

Full consolidation group, UK consolidation and solo group

	2008 **£m**
Neither past due nor individually impaired	511.5
Past due but not individually impaired:	
Up to 3 months	10.6
3 to 6 months	1.8
6 to 9 months	0.1
9 to 12 months	0.1
Over 12 months	-
Total	**524.1**
Individually impaired	3.7
Total	**527.8**

The table below sets out the impairment losses on loans and advances for the full consolidation group for the year ended 31 December 2008.

	Loans fully secured on residential property	**Loans fully secured on land**	**Other loans**	**Total**
	£m	**£m**	**£m**	**£m**
Group				
At 1 January 2008				
Individual impairment	3.1	0.5	2.5	6.1
Collective impairment	10.1	0.8	-	10.9
	13.2	**1.3**	**2.5**	**17.0**
Amounts written off during the year				
Individual impairment	(5.5)	(0.4)	(0.6)	(6.5)
	(5.5)	**(0.4)**	**(0.6)**	**(6.5)**
Income Statement				
Impairment losses on loans and advances				
Individual impairment	30.5	0.6	0.8	31.9
Collective impairment	3.1	-	-	3.1
	33.6	**0.6**	**0.8**	**35.0**
Adjustment to impairment losses on loans and advances resulting from recoveries during the year				
Individual impairment	(0.4)	-	-	(0.4)
Charge for the year	**33.2**	**0.6**	**0.8**	**34.6**
Disposal of subsidiaries	**-**	**-**	**(1.0)**	**(1.0)**
At 31 December 2008				
Individual impairment	**27.7**	**0.7**	**1.7**	**30.1**
Collective impairment	**13.2**	**0.8**	**-**	**14.0**
	40.9	**1.5**	**1.7**	**44.1**

Impairment of treasury assets

During the year, an impairment loss of £11.0m has been recognised in relation to a senior unsecured exposure to Kaupthing Singer & Friedlander Limited, which went into receivership in October 2008. We prudently provided the full amount of our investment, but remain hopeful that at least some of this amount will be recovered in the future. In addition, an impairment charge of £0.5m in relation to a Commercial Mortgage Backed Security was also made.

The table below sets out the impairment losses on Treasury assets for the Skipton Group for the year ended 31 December 2008 which is the same for all levels of consolidation.

	£m
At 1 January 2008	
Individual impairment	-
	-
Amounts written off during the year	
Individual impairment	-
	-
Income Statement	
Impairment losses on treasury assets	
Individual impairment	11.5
	11.5
Adjustment to impairment losses on loans and advances resulting from recoveries during the year	
Individual impairment	-
Charge for the year	**11.5**
At 31 December 2008	
Individual impairment	11.5
	11.5

6.1.6 Credit risk mitigation

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

Residential mortgages

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

Commercial mortgages

The commercial property is the primary source of collateral utilised for credit risk mitigation and in all instances will be secured by way of first legal charge over the freehold or long leasehold property. The primary security may be supplemented, depending on the nature and amount of the loan and the security offered, by other forms of security deemed appropriate and considered on a case by case basis. The forms of additional security could comprise legal undertakings, mortgage debentures, equitable charges and personal guarantees or as sanctioned by the Commercial

Underwriting team who are suitably experienced to make these determinations. The Group ceased originations of new commercial lending during 2008 but will consider alterations to present commercial borrowings on a case by case basis.

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

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

6.1.7 Credit derivatives

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

6.1.8 Securitisation

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

6.1.9 Derivative counterparty credit risk mitigation

The Group uses derivative instruments (interest rate, foreign currency and equity) to hedge its exposure to market risk. Credit Support Annexes (CSA), that are collateralised with cash, exist for collateralising derivative transactions with counterparties to which the Group has its largest derivatives exposures. The CSA counterparties are banks that satisfy the credit assessment process specified in the Society's Wholesale Credit Policy.

The Group measures exposure value on counterparty credit exposures under the CCR[6] mark to market method. This exposure value is derived by adding the net market value of the contract (replacement cost) to the contract's potential credit exposure, which is derived by applying a multiple based on the contract's residual maturity to the notional value of the contract.

The total exposure value on counterparty credit risk exposures at 31 December 2008 was:

Derivative exposures	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Total exposure excluding CSA deposits	322.1	322.1	322.1
Exclude intra-group exposures	(36.4)	(36.4)	(27.6)
Exclude collateral deposited with the Group	(80.7)	(80.7)	(80.7)
Total exposure	**205.0**	**205.0**	**213.8**

6.2 Operational risk

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

Operational risk within the Group is overseen by an executive Operational Risk Committee that reviews the Group's operational risk management policy, monitors the Group's exposure to operational risks and reviews the framework for measuring and controlling operational risks. ORC

[6] Counterparty Credit Risk

reviews the Group's risk appetite and recommends changes to the Group Operational Risk Policy for formal review and approval by the Board.

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

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

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

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

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

The Skipton Group has adopted the standardised approach for calculating the Pillar 1 capital requirements for operational risk, which is based upon the sum of the average of 3 years' net income, segmented by business line and multiplied by the published Regulatory 'beta factors'.

As at 31 December 2008 this approach resulted in the Pillar 1 minimum capital requirements as follows:

	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Operational risk capital requirement	**67.7**	**33.2**	**5.5**

6.3 Market risk

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

6.3.1 Interest rate risk

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

The Group manages interest rate risk through the use of appropriate financial instruments, including derivative instruments and cash instruments such as loans, deposits and bonds. The Group uses a number of metrics to monitor interest rate risk: interest rate gap; earnings-at-risk;

market value; and value-at-risk. The latter three measures calculate interest rate risk exposure positions based on historical data going back over approximately the last seven years and using 95% confidence intervals. The Board and Operational limits around all these metrics have been set to reflect the Group's low risk appetite.

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

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

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

The interest rate exposures during 2008 were as follows:

			2008		
	As at 31 December £m	**Average £m**	**High £m**	**Low £m**	**Board Limit at 31 December £m**
Earnings-at-Risk	1.5	3.7	5.2	1.5	11.5
Market Value	0.4	2.1	3.6	0.4	5.8
USD LIBOR Value-at-Risk	0.8	0.6	0.8	0.5	2.0
3% Parallel Interest Rate Gap	n / a	14.7	25.4	1.2	n / a
2% Parallel Interest Rate Gap	6.6	6.9	8.6	6.0	38.3

6.3.2 Currency risk

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

- Foreign exchange risk on its Euro MTN funding scheme
- Equity investments in Jade Software Corporation Limited and Northwest Investments NZ Limited which are denominated in New Zealand dollars
- Skipton Guernsey's International Account savings products

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

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

The Group's exposure to foreign exchange risk is calculated in accordance with BIPRU 7.5, representing 8% of the net sterling equivalent of the foreign currency assets and liabilities. As at 31 December 2008, the foreign currency risk capital requirement was as follows:

	Full consolidation group £m	**UK consolidation group £m**	**Solo consolidation group £m**
Foreign exchange risk capital requirement	**0.7**	**0.2**	**-**

6.3.3 Equity risk

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

At 31 December 2008, the Group had £86.4m of equity related savings balances all of which were fully hedged. Therefore, the Group's exposure to equity risk, net of hedging, is immaterial (in accordance with BIPRU 11.3.5).

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 Liquidity risk

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

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

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

7.2 Pension obligation risk

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

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

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

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

7.3 Reputational risk

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

7.4 Insurance risk

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

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

7.5 Investment risk

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

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

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

7.6 Credit rating downgrade

A further decline could result in it becoming more difficult to secure wholesale funding and when obtained at a higher cost. As a result of this, in the short term the Group would have to increase its level of retail funding. Whilst the Group's strong retail franchise would enable this, such funding would be expected to come at a higher cost to the Group. This scenario is included in the weekly stress testing carried out by Group Risk and is reported to ALCO on a monthly basis.

8.0 Post balance sheet events

The Skipton Building Society merged with the Scarborough Building Society on 30 March 2009. The risks associated with this type of transaction were carefully controlled and managed by the Project Steering Committee. Over the next few months management will be focused on ensuring that any post integration issues, which are not expected to be significant, are expediently resolved as they arise. This Pillar 3 report is based upon the Group's Annual Report and Accounts for the year ended 31 December 2008 and therefore the capital impact of the merger has not been included in this document.