Pillar 3 Capital Disclosures

for the year ended 31 December 2014

Leeds Building Society

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SECTION 1 - OVERVIEW

Background

The introduction of consistent capital adequacy standards and an associated supervisory framework in the European Union, originally came into effect on the 1 January 2007 in the form of the Basel II Accord. With effect from 1 January 2014 it was replaced by both the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR), which are referred to as the CRD IV package. Together with local implementation rules and guidance, the updated regulation is enforced by the Prudential Regulation Authority (PRA).

The objectives of the reform package are to:

- Strengthen the regulation, supervision and risk management of the banking sector;
- Improve the banking sector's ability to absorb shocks arising from financial and economic stress;
- Improve risk management and governance; and
- Strengthen bank's transparency and disclosures.

This has been achieved through the introduction of enhanced requirements for:

- **Quality of eligible capital**, with eligible Common Equity Tier 1 (CET1), largely limited to paid-in share capital and retained earnings, with extended deductions;
- **Quantity of capital held** by setting significantly higher minimum capital ratios and reducing pro-cyclicality by introducing new capital buffers. Minimum CET1 of 4.5% supplemented by three additional capital buffers;
- **Capital requirements for Counterparty Credit Risk** including a new capital charge for potential mark-to-market losses on OTC derivatives known as a Credit Valuation Adjustment (CVA); and
- **A non-risk based leverage ratio** to safeguard against the build-up of leverage in the system.

Basis and frequency of disclosure

This document has been prepared under CRD IV in line with the current disclosure requirements as presented in Part Eight (Articles 431 to 455) of Regulation (EU) No 575/2013 of the European Parliament and of the European Council. The tables within this disclosure show the Society's regulatory measures on both a transitional basis per the PRA policy statement PS7/13 and an end point basis to reflect current expectations of where CRD IV will become binding. The Society has adopted the Standardised approach for all exposures and risk areas, and uses the capital risk weighting percentages set by the PRA. In 2014 the Society adopted The Standardised Approach (TSA) for the calculation of its Operational Risk Capital Requirement (ORCR). Previously, the Society calculated its ORCR under the Basic Indicator Approach.

As a minimum all disclosures will be issued on an annual basis, and more frequently if appropriate. The information presented is based on the Society's Annual Report and Accounts as at 31 December 2014 unless otherwise stated.

Location and verification

This disclosure has been reviewed by the independent Risk Division and reviewed by the Board Audit Committee (BAC) before approval by the Board. The disclosures are published on the Society's website (www.leedsbuildingsociety.co.uk).

There is no formal external audit requirement for these disclosures, however, some of the information also appears in the Society's' audited Annual Report and Accounts, which are subject to external audit verification. The Annual Report and Accounts have been prepared in accordance with International Financial Reporting Standards (IFRS) therefore the information in the Pillar 3 disclosures may not be directly comparable with that information.

SECTION 1 - OVERVIEW

Scope

For accounting purposes, the Society's consolidation group comprises the Society and all of its subsidiary entities. The Society is regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

For capital purposes the Society is required to calculate and maintain regulatory capital ratios on both a Group Basis and a 'solo consolidation' basis. However, as all the Society's activities are included in its solo consolidation, the requirement is met by a single, fully consolidated set of disclosures. The principal subsidiaries included under solo consolidation are:

Subsidiary Name
Leeds Mortgage Funding Ltd
Headrow Commercial Property Services Ltd
Leeds Building Society Covered Bonds LLP
Albion 2 PLC
Leeds Financial Services Ltd
Leeds Overseas (Isle of Man) Ltd
Mecantile Asset Management Ltd
Countrywide Rentals 1 Ltd
Countrywide Rentals 2 Ltd
Countrywide Rentals 3 Ltd
Countrywide Rentals 4 Ltd
Countrywide Rentals 5 Ltd

Further information on the Society's subsidiaries can be found in the December 2014 Annual Report and Accounts, note 13.

SECTION 2 - RISK MANAGEMENT OBJECTIVES AND POLICIES

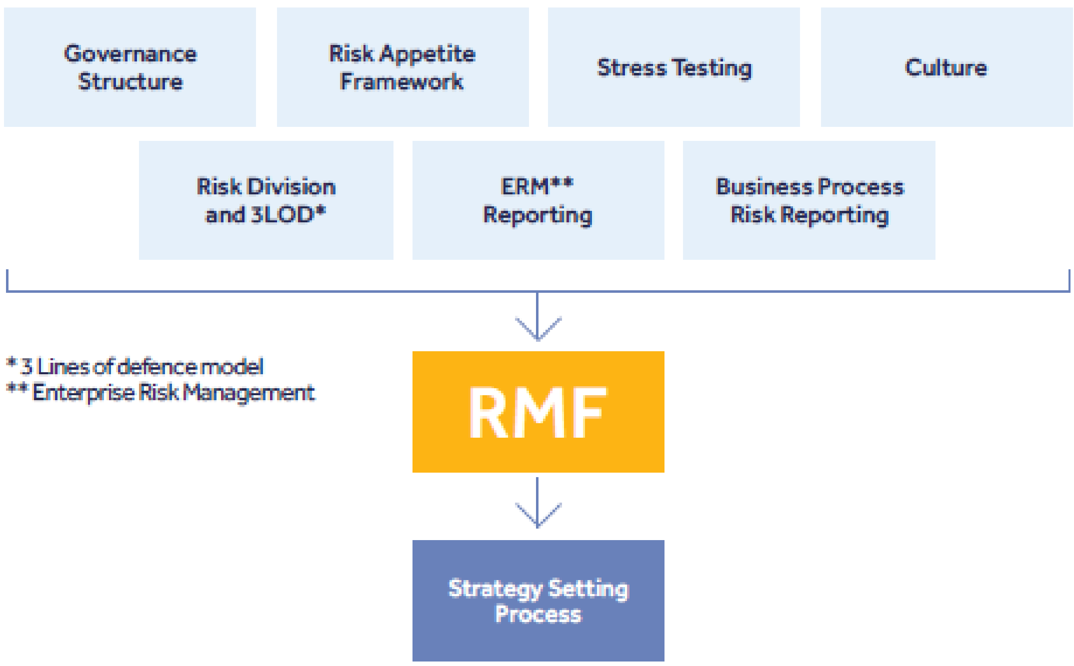
Overview

The Society recognises that effective management of the risks arising from its activities is fundamental to the long term success of the business. The Board aims to manage these risks through a formal structure for monitoring and managing risk. This comprises a range of Strategic Risk Appetite statements approved by the Board, detailed supporting frameworks and independent governance and oversight.

The Board considers that the risk management arrangements and systems are adequate in relation to the strategy, size and complexity of the Society.

Risk Management Framework (RMF)

The Risk Management Framework ("RMF") details how the Society takes a structured approach to risk management and an integrated and holistic view of the risks across the Society. This ensures a joined-up and consistent approach to aggregation and management of all risks, which are integrated into business management and decision making at both the strategic and operational levels. The RMF is owned by the Board, via the Group Risk Committee (GRC), and managed by an independent Risk Function. The diagram below summarises the seven main component parts of the RMF:



SECTION 2 - RISK MANAGEMENT OBJECTIVES AND POLICIES

The scope of the framework

The scope of the RMF extends to all risk types faced by the Society, which are captured within the Society's Risk Register. Although, the Society identifies, manages and reports against all Risk Register categories of risk, the Society has identified seven Principal Risks as summarised below;

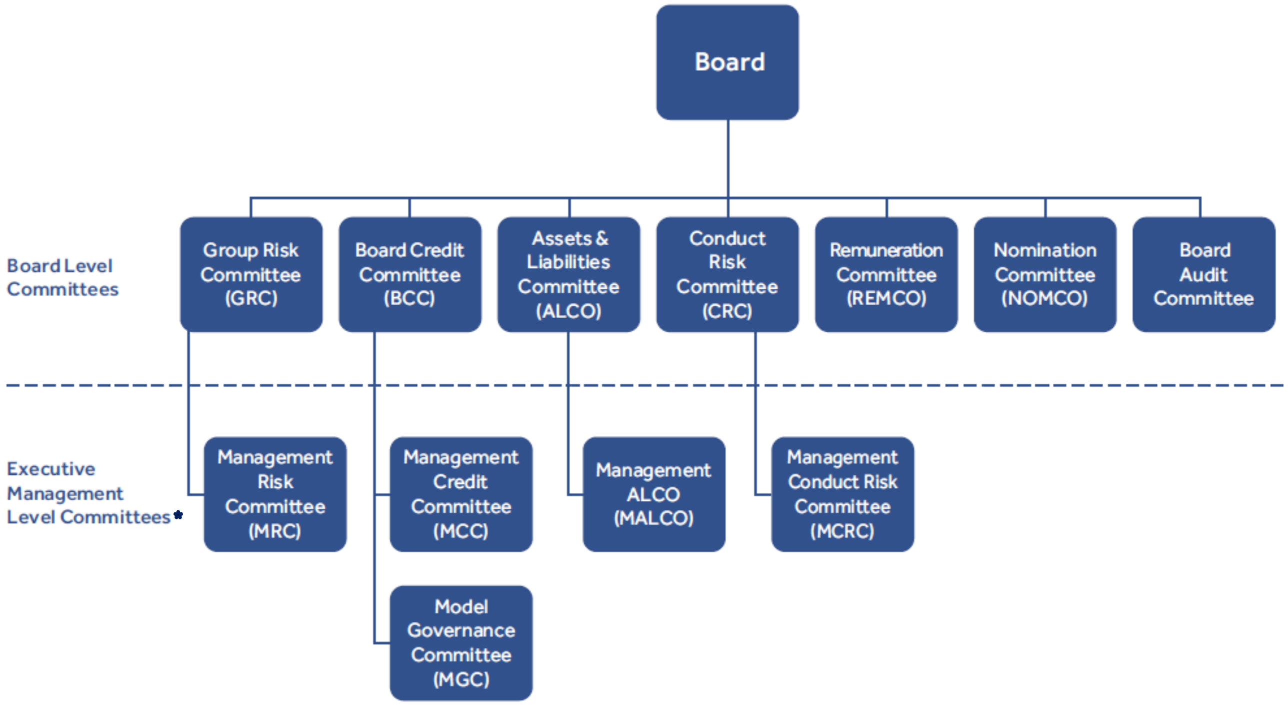
Principal Risk	Description	Section
Credit Risk	The risk that unexpected losses may arise as a result of mortgage customers (both residential and commercial), other borrowers or market counterparties failing to meet their financial obligations to repay the debt.	Section 5
Market Risk	The risk that changes in the level of interest rates, rates of exchange between currencies and prices of securities or other financial contracts, including derivatives, will have an adverse impact on the financial condition of the Society.	Section 6
Operational Risk	The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes conduct risk and actual or potential customer detriment that may arise from the way the Society conducts its business.	Section 7
Liquidity Risk	The risk that the Society is unable to meet its financial obligations as they fall due.	Section 8
Business & Strategic Risk	Risk to delivery of the Corporate Plan may arise through poor strategy or its improper implementation through inappropriate response to developments in the business environment.	Section 2
Conduct Risk	The risk that actual or potential customer detriment arises, or may arise, from the way the Society conducts its business.	Section 8
Pension Obligation Risk	The risk that the Society's obligations to its employee pension scheme may increase because of deterioration in the scheme position.	Section 8

SECTION 2 - RISK MANAGEMENT OBJECTIVES AND POLICIES

Risk governance

Committee structure

The committee structure for oversight of all aspects of the risk register universe is summarised under the diagram below:



*The Society also operates an Executive Committee and a Management Committee at this level.

The number of times the Board level committees met in 2014 and their constitution can be found on page 35 of the Corporate Governance Report in the Annual Report and Accounts 2014.

Infrastructure

The risk governance infrastructure of the Society is supported by three tiers with the following controls underpinning each level:

Tier	Controls
Tier 1: Board Governance Infrastructure	• Board Procedures Manual • Board level committee Terms of Reference (ToR) for: o Group Risk Committee; o Board Credit Committee; o Assets and Liabilities Committee; o Conduct Risk Committee; o Remuneration Committee; o Nomination Committee; and o Board Audit Committee.

SECTION 2 - RISK MANAGEMENT OBJECTIVES AND POLICIES

Tier	Controls
Tier 2: Executive Management Governance Infrastructure	• List of Board delegated authorities • Executive Management level committee ToR for: ○ Management Risk Committee; ○ Management Credit Committee; ○ Model Governance Committee; ○ Management Assets and Liabilities Committee; ○ Management Conduct Risk Committee; ○ Executive Committee (ExCo); and ○ Management Committee (ManCo);
Tier 3: Supporting Risk Management Infrastructure Documentation	• Risk Management Frameworks; • Risk Policies; • Risk Appetites; • Committee Reporting/MI; and • Individual Capital Adequacy Assessment Process, Individual Liquidity Assessment Process, Recovery Plan and Resolution Information Pack.

Strategic Risk Appetite (SRA) Framework

The Society deploys a SRA Framework to define the bounds of risk taking, in order for the Society to achieve its corporate objectives. This framework incorporates both qualitative statements and quantitative[1] metrics, across six SRA pillars. The Society's qualitative SRA statements are as follows:

Pillar	Strategic Risk Appetite Statement
Earnings Volatility	The Society will achieve a sufficient, stable and sustainable return on capital.
Capital Adequacy	The Society will maintain a capital buffer in excess of minimum regulatory requirements under normal conditions and a range of stress scenarios.
Balance Sheet Structure	The Society will maintain the balance sheet structure to manage against a range of stress scenarios.
Liquidity Management	The Society will hold sufficient liquidity to ensure that all liabilities are met as they fall due under normal circumstances and a range of stress scenarios.
Reputation and Conduct	The Society has no tolerance for significant conduct or compliance risk events and will maintain its reputation as a trusted provider.
Operational Effectiveness	The Society will maintain efficient operations and robust controls to reduce the probability of operational risks impacting performance.

[1] The Society has not disclosed the key ratios in respect of the SRA statements as they are considered to commercially sensitive

SECTION 2 - RISK MANAGEMENT OBJECTIVES AND POLICIES

The SRA is cascaded into relevant Society policies and limit structures and also informs relevant Society processes. The suite of SRA statements and metrics are reviewed on an annual basis by the Society's GRC. SRA exposures in relation to risk thresholds/triggers are reported to the Board each month. The Society has appropriate escalation procedures in place should risk exposures fall outside Board approved tolerances.

Stress testing framework

The Society's Stress Testing Framework (STF) is a key part of the Society's RMF and an integral risk management tool to support decision making at the strategic and operational levels. The Society's Board views stress and scenario testing as an intrinsic component of risk governance and takes ultimate responsibility for its application and embedding throughout the Society.

The STF seeks to formalise the approach to stress testing across the Society and ensure common principles are evident throughout stress testing activities across the Society. The STF provides the following benefits:

- Assists in strategic business planning;
- Enhances risk management and complements existing stress testing approaches with scenario analysis (including reverse stress testing);
- Better understanding of internal and external influences on the Society; and
- Better management of capital and liquidity resources against SRA and regulatory expectations.

The STF sets out clear stress testing principles, governance, roles & responsibilities and the frequency and application of stress testing for key activities (e.g. Corporate planning, ICAAP, ILAA, RRP and risk appetite).

Culture

The Society acknowledges that the effectiveness of embedding the RMF into the business is largely determined by the Society's culture. The Society's culture incentivises the embedding of risk management considerations into business as usual through various means:

- Ensuring that corporate objectives incentivise appropriate senior management and broader colleague behaviours;
- Embedding risk management considerations into the Society competency and values frameworks;
- Regular reviews of colleague performance against the competency and value frameworks;
- Incentive schemes that reward the right customer and colleague outcomes; and
- Robust talent recruitment and retention strategies.

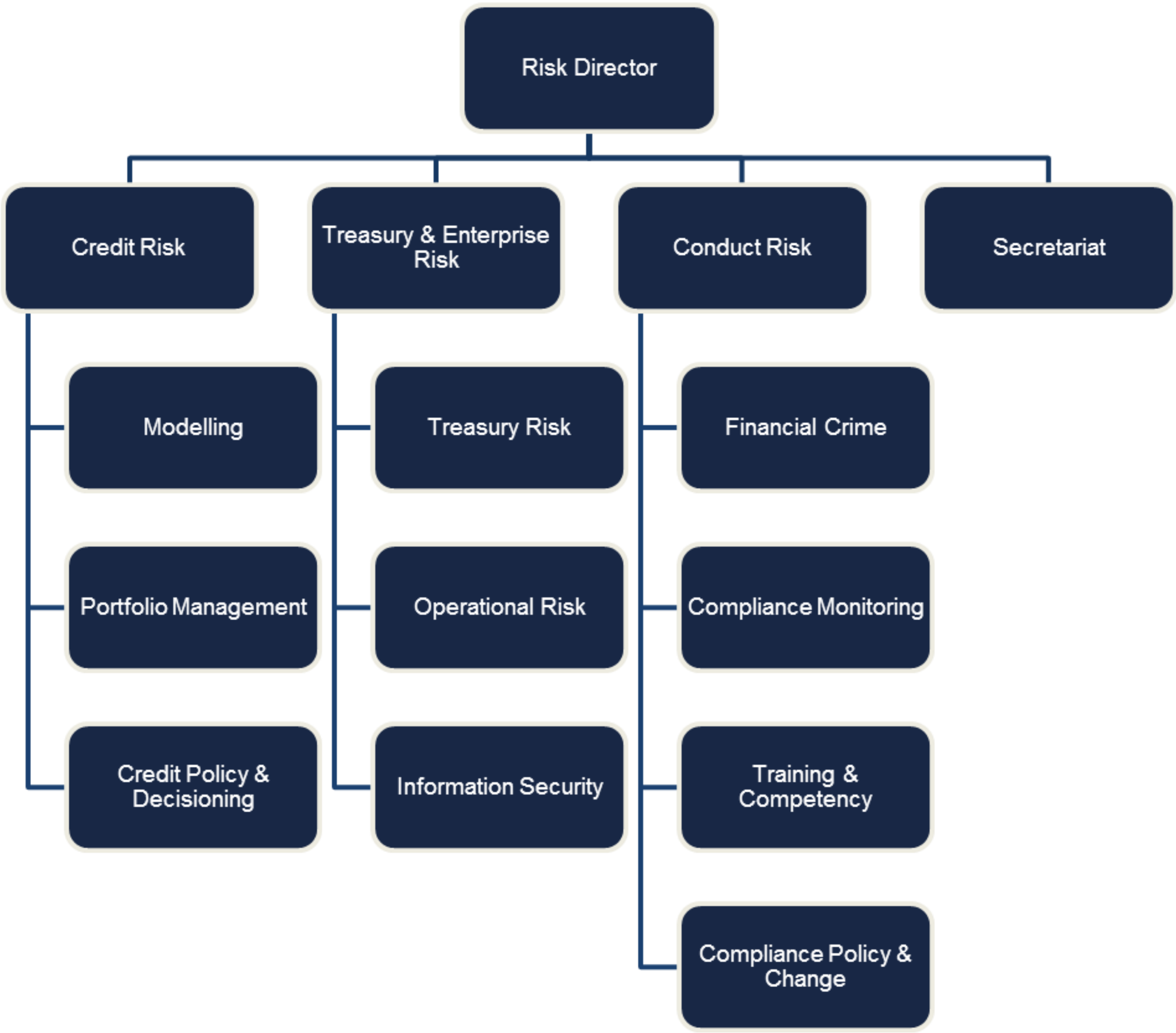
SECTION 2 - RISK MANAGEMENT OBJECTIVES AND POLICIES

Risk Division and three lines of defence approach

Risk Division

The Society's Risk Division is independent from the operational business divisions and is under the leadership of a Board level Risk Director. The Risk Director reports directly to the Chief Executive Officer and is also accountable to the Chairman of GRC.

The Risk Function structure is shown below, and has been designed to ensure the Society follows an integrated approach to risk management whilst maintaining specialist teams aligned with key risk categories to ensure the Society continues to drive good practice across the suite of Society risk exposures:



SECTION 2 - RISK MANAGEMENT OBJECTIVES AND POLICIES

Three lines of defence approach

For the RMF to operate effectively it is important that:

- Risk is owned by 1st line management and integrated within business processes;
- Appropriate supporting arrangements exist to ensure independent risk expertise and assurance is available; and
- Risk management is therefore a partnership between the Risk function and the business.

To apply these aspects the Society follows a 'three lines of defence' approach to Risk Management as shown in the following table:

1st Line	2nd Line	3rd Line
Day to day ownership of risk management. Line management within the business which, through the implementation of the Society's RMF, identifies, assesses and manages risk.	Oversight and challenge of 1st Line. Independent risk focused teams and risk based committees. These functions/committees challenge, monitor, guide and support the business in managing its risk exposure.	Independent Assurance. Internal Audit provide independent assurance to the Board (via the BAC) of the adequency and effectiveness of control systems operating within the 1st and 2nd Lines in terms of identifying and managing risk.

Enterprise Risk Management (ERM) reporting

The Society has adopted an ERM approach to risk reporting. More granular information on the Society's ERM risk reporting can be found in Section 7.

Business process risk reporting

To complement the Society's ERM approach the Society deploys business process risk reporting. More granular information in this regard can be found in Section 7.

SECTION 3 - CAPITAL RESOURCES

Total available capital

The Capital Requirements Regulations (CRR) and the Capital Requirements Directive (CRD), known together as the CRD IV package, came into effect on 1 January 2014. CRD IV is intended to increase the quality and quantity of capital financial institutions are required to hold. The requirements of CRD IV will be implemented over a five year period and there are a number of transitional rules which apply.

The strength of the Society's capital position, which is primarily made up of retained profits, together with the conservative nature of the Society's lending, means that the Society already meets the minimum capital resources and leverage ratio requirements based on both the transitional rules which applied from 1 January 2014 and the additional provisions which will be phased in between 2014-2019.

CRD IV requires the Society to hold a countercyclical buffer as determined by the PRA. The buffer is currently set at zero.

The Society does not foresee any practical or legal impediments to the transfer of capital resources or the repayment of liabilities between its Parent and Subsidiaries.

SECTION 3 - CAPITAL RESOURCES

The table below sets out the capital position based on the transitional rules of CRD IV:

	Transitional CRD IV rules 2014 £m	Full implementation CRD IV rules 2014 £m	Transitional CRD IV rules 2013 £m	Full implementation CRD IV rules 2013 £m
Common Equity Tier 1 (CET 1)				
General reserve	**689.0**	**689.0**	626.4	626.4
Revaluation reserve	**12.4**	**12.4**	12.4	12.4
Available for sale reserve	**3.9**	**3.9**	(4.1)	(4.1)
Cashflow hedge reserve	**-**	**-**	-	-
CET 1 prior to regulatory adjustments	**705.3**	**705.3**	634.7	634.7
Regulatory adjustments:				
Other deductions	**(1.3)**	**(1.3)**	(1.1)	(1.1)
CET 1 capital	**704.0**	**704.0**	633.6	633.6
Additional Tier 1 capital (AT 1)				
Permanent interest bearing shares (PIBS)	**25.0**	**25.0**	25.0	25.0
Regulatory adjustments:				
Amortisation of PIBS under transitional rules	**(5.0)**	**(25.0)**	(5.0)	(25.0)
Total Tier 1 capital	**724.0**	**704.0**	653.6	633.6
Tier 2 capital				
Collective provisions	**16.3**	**16.3**	22.1	22.1
Subordinated debt	**0.9**	**0.9**	0.9	0.9
Regulatory adjustments:				
Amortisation of subordinated debt under transitional rules	**(0.9)**	**(0.9)**	(0.7)	(0.9)
Total Tier 2 capital	**16.3**	**16.3**	22.3	22.1
Regulatory capital	**740.3**	**720.3**	675.9	655.7

Tier 1 capital

Tier 1 capital comprises general reserve (including other reserve), revaluation reserve, available for sale reserve and Permanent Interest Bearing Shares (PIBS). The general reserve represents the Society's accumulated profits, as well as adjustments for pension obligations.

PIBS are unsecured deferred shares issued for an indeterminate period and rank behind the claims of all subordinated noteholders, depositors, creditors and investing members of the Society. The Society's PIBS are denominated in sterling, pay a fixed coupon of 13.375% per annum and are only repayable in the event of resolution of the Society. The Society currently has no other qualifying Tier 1 instruments.

SECTION 3 - CAPITAL RESOURCES

As defined in the CRD IV requirements the Society's PIBS will cease to qualify as a Tier 1 capital instrument by 2018 with 20% of the instrument being derecognised each year from 1st January 2014.

Tier 2 capital

Tier 2 capital comprises the Society's qualifying subordinated debt and collective impairment provisions. Under regulatory rules, qualifying subordinated notes cannot exceed 50% of the total of tier 1 capital, and tier 2 capital cannot exceed tier 1 capital.

Subordinated notes are unsecured and rank behind the claims of all depositors, creditors and investing members, but ahead of the Society's PIBS holders. The subordinated debt has a fixed annual interest rate of 4.34% and matures on 9th March 2015.

Capital reconciliation statement

	Transitional CRD IV rules 2014 £m	Full implementation CRD IV rules 2014 £m
Total CET 1 attributable to members per the Statement of Financial Position	705.3	705.3
Adjustments to CET 1 capital:		
Defined benefit pension surplus	(1.3)	(1.3)
Total adjustments to CET1 capital	(1.3)	(1.3)
Adjustments to AT 1 capital:		
Permanent Interest Bearing Shares (PIBS)	25.0	25.0
Amortisation of PIBS	(5.0)	(25.0)
AT 1 capital	20.0	-
Adjustments to Tier 2 capital:		
Collective impairment allowance	16.3	16.3
Tier 2 capital	16.3	16.3
Regulatory capital	740.3	720.3

SECTION 3 - CAPITAL RESOURCES

Capital flow

	Transitional CRD IV rules 2014 £m
Regulatory capital 31 December 2013	**675.9**
Adjustments to CET 1 capital:	
Profit for the period	**69.4**
Pension actuarial movement	**(6.8)**
Available for sale reserve	**8.0**
Other deductions	**(0.2)**
Total adjustments to CET1 capital	**70.4**
Adjustments to additional Tier 1 capital: amortisation of PIBS	**-**
Adjustments to Tier 2 capital:	
Add back: Collective impairment allowance	**(5.8)**
Other deductions	**(0.2)**
Total adjustments to Tier 2 capital	**(6.0)**
Regulatory capital 31 December 2014	**740.3**

SECTION 4 - CAPITAL ADEQUACY

Capital Management Framework and Policy

The Society manages capital in accordance with the principles, approach and accountability documented within the Capital Management Framework (CMF) and Capital Management Policy. The capital management principles of the Society have been designed to meet the capital and leverage expectations of our key stakeholders.

Capital adequacy is monitored on a monthly basis against a number of key metrics to ensure that it stays within the Board's risk appetite.

Internal Capital Adequacy Assessment Process (ICAAP)

The Society assesses its capital adequacy through an ICAAP, at least annually. This process is used to determine the level of capital required to support the Society's current and future business activities. The ICAAP ensures that the Society meets regulatory capital requirements under normal and stressed environments, over a five year time horizon.

The Society's current ICAAP and capital management activities complied with CRD IV at the date of its implementation. The Society will update its ICAAP and capital management activities as CRD IV rules are updated through the transitional period.

Following Board approval, the ICAAP is considered by the PRA as part of its Supervisory Review and Evaluation Process (SREP). This SREP is used to determine Individual Capital Guidance (ICG) including a capital planning buffer for the Society. During 2014, the Society remained strongly capitalised with capital resources significantly above the PRA prescribed ICG.

SECTION 4 - CAPITAL ADEQUACY

Minimum capital requirement – Pillar 1

The Society's minimum capital requirement under Pillar 1 is calculated by adding the credit risk requirement to the requirements for operational risk, CVA and other commitments. The following tables show the capital requirement and excess capital resources surplus under Pillar 1 as at 31 December 2014 (on a fully implemented CRD IV basis).

	Average RWA 2014 %	Average Capital Requirement 2014 £m	**Risk weight 2014 %**	**Capital requirement 2014 £m**	Risk weight 2013 %	Capital requirement 2013 £m
Credit risk						
Residential mortgage loans	38.4%	281.6	**37.1%**	**289.4**	39.7%	273.8
Equity release	35.0%	5.1	**35.0%**	**5.1**	35.0%	5.1
Commercial mortgage loans	100.0%	25.2	**100.0%**	**21.5**	100.0%	28.8
Other loans	75.0%	0.2	**75.0%**	**0.2**	75.0%	0.2
Liquidity	5.7%	7.9	**5.2%**	**6.6**	6.3%	9.1
Other items	100.0%	5.9	**100.0%**	**5.8**	100.0%	5.9
Counterparty risk (derivatives including CVA)		5.9		**5.4**		6.3
Total credit risk requirement		331.6		**334.0**		329.2
Operational risk		21.8		**19.7**		23.9
Other commitments		3.1		**2.8**		3.4
Pillar 1 capital requirement		356.5		**356.5**		356.5
Total available capital		688.0		**720.3**		655.7
Excess capital over minimum Pillar 1 requirement		331.5		**363.8**		299.2

CRD IV requires the inclusion of an additional pillar 1 capital charge for potential market value losses on OTC derivatives, known as CVA. The CVA charge has been calculated based on the net contractual collateral derivative position of the Society.

	Transitional CRD IV rules 2014 Minimum %	**Full implem-entation CRD IV rules 2014 Actual %**	Transitional CRD IV rules 2013 Minimum %	Full implem-entation CRD IV rules 2013 Actual %
Capital ratios				
Common equity tier 1 ratio	**4.5%**	**15.6%**	4.5%	14.6%
Tier 1 ratio	**6.0%**	**15.6%**	6.0%	14.6%
Total capital ratio	**8.0%**	**16.0%**	8.0%	15.1%

SECTION 4 - CAPITAL ADEQUACY

The table below shows the movements in risk weighted assets between 31 December 2013 and 31 December 2014.

	Residential mortgages £m	Equity release mortgages £m	Commercial mortgages £m	Other loans £m	Liquidity £m	Other items £m	Total £m
Risk Weighted Assets 31 Dec 2013	3,422.5	63.8	359.9	2.5	113.8	73.8	4,036.2
Change in RWA %	(88.3)	-	-	-	(1.2)	-	**(89.5)**
Change in portfolio size	283.3	-	(91.2)	-	(30.1)	(1.3)	**160.8**
Risk weighted assets 31 Dec 2014	3,617.5	63.8	268.8	2.5	82.5	72.5	4,107.5

The residential mortgage risk weighted asset (RWA) movement reflects the growth in mortgage balances in the year with net residential lending of £1.1bn in 2014. The change in the RWA percentage reflects the improving quality of assets, which resulted in a reduction in the RWA percentage to 39.7% from 37.1%.

The reduction in the commercial mortgage total RWA has been driven by the overall reduction in the portfolio as the Society continues to implement actions to wind down the portfolio.

Leverage Ratio

One of the additional requirements of the CRD IV package requires firms to calculate a non-risk based Leverage Ratio which supplements the risk based capital requirements. The ratio compares the tier 1 capital resources of the firm against a measure of total assets of the Society.

The table below shows the Society's fully implemented Leverage Ratio based on the rules published by the PRA in June 2014, against a regulatory minimum of 3% (effective from 2018).

	2014 £m	2013 £m
Tier 1 capital (CRD IV fully implemented)	704.0	633.6
Exposures		
Balance sheet assets (excluding derivatives)	12,010.8	11,094.7
Mortgage pipeline	90.2	417.0
Other committed facilities	270.0	250.0
Repurchase agreements	70.0	14.0
Derivative exposures	88.0	171.5
Leverage exposure	12,529.0	11,947.2
Leverage Ratio	5.62%	5.3%

The basis of calculating the 2014 leverage ratio has been updated to reflect the latest interpretation of the guidance and other changes as follows:

- **Mortgage pipeline** – the reduction in the value of the pipeline reflects application of a 50% (2014: 100%) credit conversion factor as defined with the CRR guidelines; and
- **Derivative netting** – the reduction in derivative exposures reflects the Society gaining membership to the International Swaps and Derivatives Association (ISDA) and obtaining the appropriate legal opinions to enable the netting of derivative exposures, as permitted in the CRR guidelines.

SECTION 5 – CREDIT RISK

Overview

Credit risk represents the risk that customers or counterparties may not meet their financial obligations as they fall due. The Society faces this risk from its mortgage customers and wholesale counterparties.

Market background and uncertainties

The key driver of credit risk within the Society is the performance of the UK economy. Specifically, a deterioration of the UK economy could result in increased levels of unemployment, an erosion of real household income and reductions in the value of residential property. The combination of these factors may lead to increased levels of mortgage arrears and in some cases losses. Whilst the UK economy is expected to improve further in 2015, with lower levels of unemployment and more stable house prices, the Society retains a prudent stance with regard to new residential mortgage lending. The UK economic environment also affects the performance of the Society's legacy commercial loan portfolio. In recent years, reduced demand for UK goods and services has resulted in lower levels of rental demand and, as a consequence, lower commercial property prices.

The Society ceased new commercial lending in 2008 and since this time has deployed a strategy to reduce its exposure to this asset class. In 2014, the portfolio reduced by a further £91m to £269m.

Credit risk within the Society is also influenced by the performance of the Irish and Spanish economies, through its legacy Irish and Spanish residential lending portfolios (2.3% of total loan balances). Whilst both economies have started to demonstrate elements of stability, economic outlooks within these jurisdictions remain fragile. Although wholesale markets have recently been less volatile than during the financial crisis, the Society has retained a low appetite for counterparty credit risk. The Society has no direct wholesale credit exposure to sovereign or financial institutions in Ireland, Portugal, Spain, Greece, Italy or Cyprus.

Retail & Commercial credit risk

The Society's exposure to retail & commercial credit risk is summarised as follows:

	Average £m	**2014 £m**	2013 £m
Mortgages			
Retail mortgages	9,193.0	**9,756.6**	8,629.3
Commercial mortgages	314.4	**268.8**	359.9
Other items	183.8	**184.8**	182.8
Total gross exposure (contractual amounts)	9,691.1	**10,210.2**	9,172.0
Impairment, fair value, EIR and Hedging adjustments	15.3	**50.7**	(20.1)
Total net exposures	9,706.4	**10,260.9**	9,151.9

SECTION 5 – CREDIT RISK

Residential credit risk

This risk is overseen by a specialist retail credit risk function, reporting to the Risk Director, with oversight from BCC. The Society's credit policy is approved annually by the Board and is reviewed on an ongoing basis by the BCC. It details the current limit structures in respect of mortgage lending and reflects the Society's current risk appetite. The BCC also receives management information, highlighting the performance of the Society's mortgage portfolio.

With regard to new lending, residential credit risk is managed using the following tools:

- Credit scorecard assessment;
- Affordability assessment based on income and expenditure;
- Stressed interest rates;
- Access to credit data, which reviews the credit history of an individual;
- Independent expert appraisal of the suitability and value of a property; and
- Underwriting systems, which are a hybrid of computer systems and suitably qualified underwriters.

The Society's retail credit risk function monitors the performance of the portfolio, including stress testing, on an ongoing basis. This identifies trends and facilitates understanding of the portfolio, which is used to assess whether the current risk appetite remains appropriate. If a borrower's financial situation starts to deteriorate, the Society has established procedures to respond appropriately.

The Society has a dedicated Collections function, which seeks to engage with customers, at an early stage, to discuss potential financial difficulties. Forbearance options are determined on a case by case basis, with the aim of working with borrowers to clear arrears. The Society is able to offer customers an appropriate range of options, including an extension of the mortgage term, a temporary change to interest only, deferral of interest, reduced monthly repayments, transfer to an alternative product or a special interest rate (subject to meeting criteria). After all other options have been exhausted, the Society may take possession of the mortgaged property. Analysis of the Society's residential portfolio and forbearance activity is used to inform the provisioning policy. This ensures that the Society properly recognises losses, in accordance with its accounting policies.

SECTION 5 – CREDIT RISK

Exposures by geographic region

As shown in the table below the largest regional concentrations are in the South East, London, Midlands and Yorkshire and Humberside.

	2014 £m	2014 %	2013 £m	2013 %
Residential regional analysis				
East of England	353.8	3.6%	276.1	3.2%
Greater London	1,106.9	11.3%	1,001.0	11.6%
Midlands	1,209.8	12.4%	1,009.6	11.7%
North East	447.7	4.6%	414.2	4.8%
North West	748.2	7.7%	673.1	7.8%
Northern Ireland	346.4	3.6%	345.2	4.0%
Other	39.0	0.4%	34.5	0.4%
Scotland	639.1	6.6%	578.2	6.7%
South East	2,263.7	23.2%	1,881.2	21.8%
South West	849.8	8.7%	699.0	8.1%
Southern Ireland	159.8	1.6%	172.6	2.0%
Spain	85.7	0.9%	94.9	1.1%
Wales	335.9	3.4%	302.0	3.5%
Yorkshire & Humberside	1,170.8	12.0%	1,147.7	13.3%
Total	9,756.6	100.0%	8,629.3	100.0%

Residual maturity profile

	2014				2013			
	Up to 12 months £m	1 - 5 years £m	>5 years £m	Total £m	Up to 12 months £m	1 - 5 years £m	>5 years £m	Total £m
Asset classes								
Secured on residential property	56.3	328.6	9,371.7	9,756.6	51.2	337.8	8,240.3	8,629.3

Commercial mortgage risk

Although the Society closed its commercial lending operations to new business in 2008, Management has retained a team of appropriately skilled colleagues, to implement the exit strategy from this asset class. This function has also been supported by the Risk Function, which provides 2nd line oversight of the performance and management of the portfolio. Portfolio performance is monitored closely and overseen by BCC, with monthly reporting to the Board. All loans continue to be assessed on a case by case basis, using a broad range of potential impairment indicators. If a loan is deemed impaired the Society uses a combination of formal recovery action and appropriate forbearance, through loan extensions, restructures or property sales, to reduce the risk and minimise losses. Similar to residential credit exposures, analysis of the commercial portfolio and forbearance measures informs the Society’s provisioning policy. Over recent years, the Society has made significant provisions against its commercial portfolio, which has ensured that impairment and losses have been recognised in accordance with its accounting policies.

SECTION 5 – CREDIT RISK

Exposures by sector

The table below provides an overview of the sectoral split of the Society's commercial loan portfolio;

	2014 £m	**2014 %**	2013 £m	2013 %
Sector				
Retail	**95.2**	**35.4%**	129.1	35.9%
Offices	**99.2**	**36.9%**	141.0	39.2%
Commercial investment and industrial units	**55.2**	**20.5%**	66.1	18.4%
Leisure and hotel	**3.0**	**1.1%**	4.9	1.4%
Other, including mixed use	**16.2**	**6.1%**	18.8	5.1%
Total	**268.8**	**100.0%**	359.9	100.0%

Exposures by geographic region

The table below shows a regionally diverse commercial loan portfolio with the largest concentration being in London and the South East;

	2014 £m	**2014 %**	2013 £m	2013 %
Commercial regional analysis				
East of England	**22.0**	**8.2%**	31.0	8.6%
Gibraltar	**1.3**	**0.5%**	1.8	0.5%
Greater London	**41.4**	**15.4%**	56.6	15.7%
Midlands	**14.5**	**5.4%**	28.8	8.0%
North East	**25.0**	**9.3%**	28.1	7.8%
North West	**23.7**	**8.8%**	28.4	7.9%
Scotland	**14.2**	**5.3%**	16.9	4.7%
South East	**83.3**	**31.0%**	102.9	28.6%
South West	**8.9**	**3.3%**	17.6	4.9%
Wales	**4.7**	**1.7%**	6.8	1.9%
Yorkshire & Humberside	**29.8**	**11.1%**	41.0	11.4%
Total	**268.8**	**100.0%**	359.9	100.0%

SECTION 5 – CREDIT RISK

Residual Maturity Profile

The table below provides an overview of the maturity profile of the Society's commercial loan portfolio;

	2014				2013			
	Up to 12 months	1 - 5 years	>5 years	Total	Up to 12 months	1 - 5 years	>5 years	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Asset classes								
Secured on commercial property	**78.7**	**144.2**	**45.9**	**268.8**	128.6	165.0	66.3	359.9

Treasury credit risk

As a consequence of the financial crisis, the Society significantly tightened its wholesale counterparty credit criteria. This has resulted in limits and exposures being UK centric, with some limits extended to highly rated counterparties based outside the UK.

The Society's UK exposure is diversified, through holdings of UK Government securities, holdings in financial institutions and asset backed securities, along with deposits at the Bank of England. All credit limits are subject to review on at least an annual basis. This ensures that counterparty exposures remain compliant with Board approved wholesale credit limits and Financial Risk Management Policy (FRMP). Established credit lines are based on a combination of internal assessment, external credit ratings, credit default swap spreads, the jurisdiction in which the counterparty is domiciled and other market intelligence.

Operationally, a dedicated resource within the 1st line Treasury Function monitors the Society's exposures on a daily basis in line with the Society's FRMP and reports market developments, as appropriate. Oversight is also provided by the Risk Function and the Treasury Credit Risk Committee, which convenes monthly to review wholesale credit exposures. ALCO also receives management information regarding wholesale credit exposures, at each meeting.

Repurchase agreements (Repo) between counterparties and the Society are all transacted through Global Master Repurchase Agreements (GMRA). As at December 2014 the Society had outstanding repo's totalling £70m.

Short term Investments

			2014		2013	
			Exposure £m	Risk weight %	Exposure £m	Risk weight %
Credit quality step	**Fitch rating**	**Moody's rating**				
1	AAA to AA-	Aaa to Aa3	**650.3**	**20.0%**	908.7	20.0%
2	A+ to A-	A1 to A3	**129.2**	**20.0%**	65.5	20.0%
3	BBB+ to BBB-	Baa1 to Baa3	**72.2**	**20.0%**	-	20.0%
4	BB+ to BB-	Ba1 to Ba3	**-**	**50.0%**	-	50.0%
5	B+ to B-	B1 to B3	**-**	**50.0%**	-	50.0%
6	CCC+ and below	Caa1 and below	**-**	**150.0%**	-	150.0%
Unrated	Unrated	Unrated	**-**	**20.0%**	4.0	20.0%
Total short term investments			**851.7**		978.2	

SECTION 5 – CREDIT RISK

Long term investments

			2014		2013	
			Exposure £m	Risk weight %	Exposure £m	Risk weight %
Credit quality step	**Fitch rating**	**Moody's rating**				
1	AAA to AA-	Aaa to Aa3	**981.5**	**20.0%**	903.0	20.0%
2	A+ to A-	A1 to A3	**30.5**	**50.0%**	138.8	50.0%
3	BBB+ to BBB-	Baa1 to Baa3	**-**	**50.0%**	19.0	50.0%
4	BB+ to BB-	Ba1 to Ba3	**1.7**	**100.0%**	1.7	100.0%
5	B+ to B-	B1 to B3	**-**	**100.0%**	-	100.0%
6	CCC+ and below	Caa1 and below	**-**	**150.0%**	-	150.0%
Unrated	Unrated	Unrated	**6.7**	**50.0%**	9.9	50.0%
Total Long term investments			**1,020.4**		1,072.4	

We have nominated two ECAIs for this purpose Moody's Investors Service ('Moody's') and Fitch Group ('Fitch').

Exposures by asset class

	2014		2014		
	Average Exposure £m	Average RWA %	Year end £m	RWA £m	Weighted average RWA %
Asset class					
Financial institutions	**239.7**	**28%**	**281.5**	**66.3**	**23.6%**
Central banks	**1,390.3**	**-**	**1,334.4**	**-**	**-**
Multilateral development banks	**148.7**	**-**	**156.0**	**-**	**-**
Government agency debt	**35.4**	**-**	**22.8**	**-**	**-**
Asset backed securities	**143.0**	**20%**	**70.7**	**12.8**	**18.2%**
Revolving credit	**4.4**	**50%**	**6.7**	**3.4**	**50.0%**
Total	**1,961.5**		**1,872.1**	**82.5**	

SECTION 5 – CREDIT RISK

Exposures by geographic region

2014	UK £m	Europe £m	Europe Supra-national £m	North America £m	Global Supra-national £m	Australia £m	Far East £m	Total £m
Asset class								
Financial institutions	163.8	81.2	-	36.5	-	-	-	281.5
Central banks	1,334.4	-	-	-	-	-	-	1,334.4
Multilateral development banks	-	-	58.5	10.0	52.5	-	35.0	156.0
Government agency debt	-	22.8	-	-	-	-	-	22.8
Asset backed securities	70.7	-	-	-	-	-	-	70.7
Revolving credit	6.7	-	-	-	-	-	-	6.7
Total	1,575.6	104.0	58.5	46.4	52.5	-	35.0	1,872.1

2013	UK £m	Europe £m	Europe supra-national £m	North america £m	Global supra-national £m	Australia £m	Far east £m	Total £m
Asset class								
Financial institutions	182.4	5.4	-	4.0	-	6.0	-	197.8
Central banks	1,428.8	17.3	-	-	-	-	-	1,446.1
Multilateral development banks	-	-	63.8	-	47.6	-	30.0	141.4
Government agency debt	-	47.9	-	-	-	-	-	47.9
Asset backed securities	215.3	-	-	-	-	-	-	215.3
Revolving credit	2.1	-	-	-	-	-	-	2.1
Total	1,828.6	70.6	63.8	4.0	47.6	6.0	30.0	2,050.6

SECTION 5 – CREDIT RISK

Residual maturity profile

	2014			
	Up to 12 months £m	1 - 5 years £m	5 > years £m	Total £m
Asset class				
Financial institutions	**279.8**	**1.7**	**-**	**281.5**
Central banks	**877.3**	**457.1**	**-**	**1,334.4**
Multilateral development banks	**42.5**	**113.5**	**-**	**156.0**
Government agency debt	**7.9**	**14.9**	**-**	**22.8**
Asset backed securities	**5.1**	**12.0**	**53.6**	**70.7**
Revolving credit	**6.7**	**-**	**-**	**6.7**
Total	**1,219.3**	**599.2**	**53.6**	**1,872.1**

	2013			
	Up to 12 months £m	1 - 5 years £m	5 > years £m	Total £m
Asset class				
Financial institutions	179.1	11.1	7.6	197.8
Central banks	1,152.3	293.8	-	1,446.1
Multilateral development banks	51.6	89.8	-	141.4
Government agency debt	-	47.9	-	47.9
Asset backed securities	3.8	69.3	142.2	215.3
Revolving credit	-	2.1	-	2.1
Total	**1,386.8**	**514.0**	**149.8**	**2,050.6**

Counterparty credit risk

Counterparty credit risk in relation to derivatives is the risk that a counterparty could default and the Society has to replace positively valued swaps at current market prices. This risk is mitigated by offsetting the amounts due to the same counterparties ('netting benefits') and by cash deposited by some counterparties ('collateral held'), under a Credit Support Annex (CSA).

Derivatives are contracts or arrangements that are valued in accordance with the mark to market method as outlined within CRR Article 274. Valuations are derived from one or more underlying price, rate or index inherent in the contract or arrangement, such as interest rates, exchange rates or stock market indices. As a member of ISDA, the Society benefit from netting of counterparty credit expsoures, including collateral when calculating its counterparty exposure. Derivatives are only used by the Society in accordance with Section 9A of the Building Societies Act 1986, to reduce the risk of loss arising from changes in interest rates or other factors of a prescribed nature that affect the business. Accordingly, such instruments are not used in trading activity or for speculative purposes.

CSAs exist for collateralising derivative transactions with counterparties to which the Society has derivative exposures in order to mitigate the risk of loss on default. CSAs allow margin calls to be made on the net mark to market value of derivative exposures with a particular counterparty. CSAs are taken into consideration when calculating credit risk exposure for derivative counterparties, and the Society recognises the risk mitigating effect of these in its pillar 1 capital requirement calculations.

Through 2014 the Society monitored its collateral positions on a daily basis with all collateral being transacted in line with the agreed terms of our CSA's, with all collateral taking the form of cash. If the Society were to be 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 has no 'wrong way' risk exposure and no appetite for such exposures.

The following tables show the Society's exposure to counterparty credit risk for derivative contracts as at 31 December 2014:

	2014 Notional £m	2014 Exposure £m
Centrally Cleared Derivative Contracts		
Interest rate contracts	4,135.6	18.8
Non Cleared Derivatives		
Interest rate contracts	4,806.5	67.4
Quanto swaps	14.5	-
Equity swaps	262.8	25.6
Cross currency swaps	376.5	7.7
Floating swaps	791.7	0.9
Bank base rate swaps	1,025.9	-
Gross positive fair of contracts	11,413.5	120.4
Netting benefits		(96.3)
Netted current credit exposure	11,413.5	24.1
Derivative Exposure including PFE		110.3
Collateral		(22.3)
Net derivative credit exposure		88.0

Whilst exchange traded derivatives have been cleared through central counterparties (CCP's) for many years, recent regulatory initiatives designed to reduce systemic risk in the banking system are directing increasing volumes of OTC derivatives to be cleared through CCPs. The Society now transacts all new qualifying swaps through Central Counterparties.

Impairment of financial assets

Impairment provision

Individual assessments are made of all mortgage loans in arrears or possession and investment securities where there is objective evidence that all cashflows may not be received. Based upon these assessments, individual impairment reductions to these assets are made. In addition, a collective impairment reduction is made against those loans and advances to customers where objective evidence, including forbearance measures indicates that it is likely that losses may ultimately be realised and thus a loss event has occurred. The impairment value is calculated by applying various factors to each loan. These factors take into account the Society's experience of default and delinquency rates, loss emergence periods, regional house price movements and adjustments to allow for forced sale values.

Past due and impaired loans

Impaired loans are where there is objective evidence that an impairment event has occurred, meaning that the Society does not expect to collect all the contractual cash flows when they are contractually due.

Loans past due are when a borrower has failed to make a payment when it is contractually due.

The following table shows the movement in the year in impairment provisions.

	2014			
	Loans fully secured on residential property £m	Loans fully secured on land £m	Other loans £m	Total £m
At 1 January 2014				
Collective impairment	12.3	9.8	-	22.1
Individual impairment	25.8	26.6	-	52.4
	38.1	**36.4**	**-**	**74.5**
Income and expenditure account				
Charge for the year				
Collective impairment	(2.5)	(3.3)	-	(5.8)
Individual impairment	9.1	34.4	2.5	46.0
Adjustments to impairment losses for bad and doubtful debts resulting from recoveries during the year	(0.7)	-	-	(0.7)
	5.9	**31.1**	**2.5**	**39.5**
Amount written off during the year				
Individual impairment	(14.4)	(42.5)	-	(56.9)
At 31 December 2014				
Collective impairment	9.8	6.5	-	16.3
Individual impairment	19.8	18.5	2.5	40.8
	29.6	**25.0**	**2.5**	**57.1**

SECTION 5 – CREDIT RISK

	2013			
	Loans fully secured on residential property £m	Loans fully secured on land £m	Other loans £m	Total £m
At 1 January 2013				
Collective impairment	15.5	8.8	-	24.3
Individual impairment	28.9	27.2	0.3	56.4
	44.4	**36.0**	**0.3**	**80.7**
Income and expenditure account				
Charge for the year				
Collective impairment	(3.3)	1.0	-	(2.3)
Individual impairment	16.0	34.9	0.3	51.2
Adjustments to impairment losses for bad and doubtful debts resulting from recoveries during the year	(0.8)	(0.2)	-	(1.0)
	11.9	**35.7**	**0.3**	**47.9**
Amount written off during the year				
Individual impairment	(18.2)	(35.3)	(0.6)	(54.1)
At 31 December 2013				
Collective impairment	12.3	9.8	-	22.1
Individual impairment	25.8	26.6	-	52.4
	38.1	**36.4**	**0.0**	**74.5**

The table below shows the payment status of loans:

SECTION 5 – CREDIT RISK

	Group & Society Residential		Group & Society Other	
	2014 £m	2014 %	2014 £m	2014 %
Not impaired:				
Neither past due nor impaired	9,256.5	94.9%	181.3	98.6%
Past due up to 3 months not impaired	330.4	3.4%	-	-
Impaired:				
Not past due impaired	-	-	2.5	1.4%
Past due 3 to 6 months	72.5	0.7%	-	-
Past due 6 to 12 months	40.4	0.4%	-	-
Past due over 12 months	39.8	0.4%	-	-
Possessions	17.0	0.2%	-	-
Total	9,756.6	100.0%	183.8	100.0%

	Group & Society Residential		Group & Society Other	
	2013 £m	2013 %	2013 £m	2013 %
Not impaired:				
Neither past due nor impaired	8,110.0	93.9%	182.9	100.0%
Past due up to 3 months not impaired	332.4	3.9%	-	-
Impaired:				
Not past due impaired	-	-	-	-
Past due 3 to 6 months	73.6	0.9%	-	-
Past due 6 to 12 months	41.8	0.5%	-	-
Past due over 12 months	47.3	0.5%	-	-
Possessions	24.2	0.3%	-	-
Total	8,629.3	100.0%	182.9	100.0%

SECTION 5 – CREDIT RISK

	Group & Society Commercial		Group & Society Commercial	
	2014	**2014**	2013	2013
	£m	**%**	£m	%
Not impaired:				
Neither past due nor impaired	**197.7**	**73.5%**	256.9	71.4%
Past due up to 3 months not impaired	**-**	**-**	-	-
Impaired:				
Not past due impaired	**43.5**	**16.2%**	79.6	22.1%
Past due up to 3 months	**3.5**	**1.3%**	2.0	0.6%
Past due 3 to 6 months	**-**	**-**	-	-
Past due 6 to 12 months	**-**	**-**	-	-
Past due over 12 months	**-**	**-**	-	-
Possessions	**24.1**	**9.0%**	21.4	5.9%
Total	**268.8**	**100.0%**	359.9	100.0%

The impairment provisions for the Society's Spanish and Irish portfolios included in the above tables are £3.0m and £13.3m respectively. The value of impaired loans in Spain and Ireland shown in the above tables, are £6.4m and £31.8m respectively.

The Society does not have any impaired wholesale counterparty exposures (2013: nil).

SECTION 6 – MARKET RISK

Market risk overview

Market risk is the risk that the value of, or income emanating from, the Society's assets and liabilities changes adversely, as a consequence of movements in interest rates or foreign currency rates.

These risks are managed through the use of Board limits, offsetting assets and liabilities and the use of financial derivative instruments, such as interest rate and basis swaps. Board limits are reviewed annually and ALCO receives management information on interest rate and basis risk exposures. Operationally, Treasury is responsible for managing the Society's interest rate and basis risk exposures and this is overseen by the Treasury Risk Function and ALCO.

Market background and uncertainties

During 2014 market interest rates fluctuated due to uncertainty surrounding the timing of bank base rate rises, as a consequence of an emerging deflationary economic environment, changes in central bank rhetoric and heightened levels of geopolitical risk. It is expected that these uncertainties will remain during 2015.

Daily operational management

On a daily operational basis, the Society's exposure to market risk is managed through the Treasury Function, in line with the Board approved limits. Market risk is measured and reported using a variety of techniques, including interest rate re-pricing, gap analysis, duration, market value and earnings sensitivity analysis under a series of different rate scenarios.

Risk Type	Reporting Measure
Interest rate Risk	Sensitivity
Basis Risk	Earnings at Risk
Foreign exchange Risk	Sensitivity
Price Risk	N/A

Interest rate risk

The primary market risk faced by the Society relates to changes in interest rates. The Society measures its potential interest rate risk exposure using both earnings sensitivity measures (Earnings at Risk or EAR) as well as market value (MV) sensitivity measures. The Society has a low tolerance to interest rate risk and has set conservative risk limits to ensure its exposures remain within its capacity to absorb any potential adverse impact on profitability.

There has been no significant change in the year to the Society's strategy for managing its interest rate risk. The Society's exposures continue to be managed through the use of appropriate hedging instruments, as well as by taking advantage of natural hedges within the Society's balance sheet.

The Society does not run a trading book and, therefore, all derivatives are transacted to reduce risk. The Society has a policy for investing its Reserves which is approved by ALCO. This seeks to ensure a stable earnings profile over the medium term, by means of a targeted average duration.

Under the PRA's handbook for CRR firms (Interest Risk arising from non-trading book activities), the Society carriers out evaluations of sudden and unexpected 200bps interest rate shocks in both directions and immediately reports to the PRA if the results of the analysis show that the economic value of the Society would decline by more than 20% of Own Funds.

SECTION 6 – MARKET RISK

The table below details the Society's sensitivity to a 200 basis point change in interest rates, at 31 December 2014, with all other variables held constant. A positive number indicates an increase in earnings or market value.

	Annual earnings sensitivity				Market value sensitivity			
	2014		2013		2014		2013	
	+200 bp £m	-200 bp £m	+200 bp £m	-200 bp £m	+200 bp £m	-200 bp £m	+200 bp £m	-200 bp £m
Portfolio								
Core	24.5	(6.7)	19.4	(13.2)	(4.4)	(1.6)	(3.6)	3.7
Capital	3.1	(1.0)	8.5	(2.8)	(0.7)	0.4	13.0	(34.6)
Total	27.6	(7.7)	27.9	(16.0)	(5.1)	(1.2)	9.4	(30.9)

The above sensitivities include a zero floor assumption.

The Society also runs a stochastic Earnings at Risk (EaR) model to measure interest rate risk. The 12 month EaR exposure as at 31 December 2014 is £3.0m down on its prior year equivalent of £3.1m. The interest rate risk position of the Society is reviewed three times a week and the key assumptions are:

- Mortgage pipeline business is assumed as a % of applications and % of offers;
- Variable rate non-maturity savings balances are assumed to reprice in one month & one day; and
- No prepayments are assumed

The Society has set optionality limits to minimise the potential impact from fixed rate mortgage and savings balances which have penalty free access. Additional reporting is also undertaken on a quarterly basis to monitor historic utilisation of optionality to assess potential future exposure.

Foreign currency risk

The Society's policy is not to run material, speculative foreign exchange positions.

The Society is exposed to Euro denominated mortgages as well as receiving funding in foreign currencies; hence exposures to exchange rate fluctuations arise. Cross-currency interest rate swaps are utilised to reduce both the interest rate and exchange rate risk exposures that come from funding in foreign currency. Redenomination risk is the risk that on conversion to a new currency there is devaluation. The Society has Euro denominated residential mortgage assets in Spain and Ireland and actively manages the risk of redenomination.

Price risk

The Society's policy is to have no material exposure to equity markets. Any exposures arising from the Society's products are eliminated, as far as it is practicable, by appropriate hedging contracts.

SECTION 6 – MARKET RISK

Derivative activities

The table below describes the significant activities undertaken by the Society, the related risks associated with such activities and the types of derivatives which are typically used in managing such risks. These risks may also be managed using on balance sheet instruments or natural hedges that exist within the Society's own balance sheet.

Activity	Risk	Type of Derivative
Fixed rate savings products	Sensitivity to falls in interest rates	Receive fixed interest rate swaps (fair value hedge)
Fixed rate mortgage lending	Sensitivity to increases in interest rates	Pay fixed interest rate swaps (fair value hedge)
Fixed rate funding	Sensitivity to falls in interest rates	Receive fixed interest rate swaps (fair value hedge)
Fixed rate asset investment swaps	Sensitivity to increases in interest rates	Pay fixed interest rate swaps (fair value hedge)
Mortgages and savings linked to different rate indices	Sensitivity to changes in the underlying cost of funding / investment return	Basis Swaps e.g., for tracker mortgages, the Society would seek to pay the average monthly Bank Base Rate plus a margin in return for receiving LIBOR (fair value hedge)
Equity linked investment products	Sensitivity to changes in equity indices	Equity linked interest rate swaps (fair value hedge)
Investment and funding in foreign currencies	Sensitivity to changes in foreign exchange rates	Cross currency interest rate swaps and foreign exchange contracts (fair value hedge)

Derivatives for use in hedge relationships are traded only when the underlying position being hedged contains the same risk features. The derivatives used will match the risks of the underlying asset or liability and therefore hedge the associated market risk.

All derivatives entered into by the Society are used for hedging purposes, however, not all are designated as such. Some derivatives are held as economic hedges. In these cases natural offsets can be achieved, these hedges are only entered into where a high degree of effectiveness can be achieved.

SECTION 7 – OPERATIONAL RISK

Overview

Operational risk is the risk of financial or reputational loss as a result of inadequate or failed processes, people and systems or from external events. The Society acknowledges that operation risks are inherent to, or in, its business activities. The Board has agreed an overarching risk appetite for operational risk, which is monitored by management and reported to the GRC and Board.

The Society has implemented a bottom up/top down approach to support the adoption of an enterprise wide risk management approach which encourages first line ownership of risk management and reporting, with the second line performing more of a coordination, aggregation and oversight role.

The Operational Risk Function engages with each area of the business to maintain departmental risk registers, which include an assessment of the effectiveness of key controls as well as relevant mitigation actions to further enhance the control environment.

Risk reporting is linked to strategic and corporate objective risks as well as operational and business resilience risks and informs debate at the Risk Committees.

Annual risk monitoring plans are in place covering internal activities and external developments. This enables management to maintain a focus on managing current and future key risks which could result in the failure of the business to delivering against corporate objectives.

Capital requirements and stress testing

In 2014 the Society adopted The Standardised Approach (TSA) for the calculation of its Operational Risk Capital Requirement (ORCR). Previously, the Society calculated its ORCR under the Basic Indicator Approach.

Under TSA, the Society considers the underlying source of income with reference to business lines prescribed in CRR, each of which has a specified percentage multiplier. The relevant multiplier is applied to the three year average net interest income and net other income for each business line and the sum of this calculation provides the Society with its ORCR.

In 2014, Senior Management mapped the Society's income to two business lines, Retail Banking and Commercial Banking. The mapping process was included in the TSA use test which was subject to independent Internal Audit review.

As part of the 2014 ICAAP stress testing of operational risk requirements, the Society recognised the impact of extreme events on its capital requirements. As a result of these stress testing activities, additional Pillar 2 capital was allocated for Operational Risk. The calculated ORCR is significantly in excess of the actual loss experience of the Society.

Risk Management Framework (RMF) - Operational risk

The scope of the RMF extends to all risk types faced by the Society.

The RMF details how the Society follows a structured approach to identifying, monitoring and managing all organisational risks. It is an integral part of the Society's strategy, ensuring that there is a supporting infrastructure to monitor and manage against corporate objectives and broader strategic risks, including operational risk. The Society has identified seven principal risks summarised below:

- Credit risk;
- Market risk;
- Operational risk;
- Liquidity risk;

SECTION 7 – OPERATIONAL RISK

- Business & strategic risk;
- Conduct risk; and
- Pension obligation risk.

Refer to Section 2 for a more detailed summary of the Society's RMF

Operational risk is embedded into all elements of the RMF however, the key components are:

- Enterprise Risk Management Reporting; and
- Business Process Reporting.

The diagram below summarises the ERM Framework and how operational risk reporting supports the Society enterprise-wide risk management approach.

The framework is designed to integrate top down and bottom up reporting, providing a holistic view of risk exposure and profile reporting against the Society strategy and agreed corporate objectives.

The Operational Risk Function aggregates and co-ordinates various operational risk information submitted from across the business on a monthly basis for reporting in line with the governance structure. In addition, it operates independently, providing risk challenge, views and reports of the Society operational and strategic risk profile and exposures to the Board and relevant committees.

Business process reporting complements top down strategic reporting to ensure the consistency of business resilience and standards across all Society divisions. This also creates a focus on managing current and future key risks which could impair the success of the Society.

Business process reporting includes frequent risk and control self assessment reviews across the business and facilitates the aggregation of control environment reporting, identifying potential issues in one area which could impact other areas.

SECTION 7 – OPERATIONAL RISK

Operational risk appetite

The operational risk appetite is defined in line with the overarching SRA Framework, which is designed to ensure that appetite is appropriately cascaded across the various frameworks and that it is consistent and linked directly to Board appetite. The Board proactively monitors a full suite of indicators and metrics that identify operational performance against the approved appetite position.

Operational risk Oversight & Governance

Specialist management fora provide oversight in respect of operational risk exposures in areas such as information security, business change, conduct risk and business continuity. In addition, senior management and Board sub Committees receive risk reports, registers and dashboards that track operational risk exposures in the operating environment, with the Board receiving minutes / updates from each of its sub - Committees. The three lines of defence model ensures appropriate escalation of actual / near miss events to the Risk Function and senior management. This is balanced with the strategic oversight of the overall impact of operations considered by the Board and its sub-Committees, which measures exposures against the approved Risk Appetite positions documented in the RMF.

Internal and external loss data reporting

Operational risk events can generate a range of impacts ranging from minor processing errors through to significant financial loss and/or severe disruption to Society operations. The Society maintains an actual loss and near miss breach log in order to ensure that actual and potential incidents and their associated losses are identified, captured, managed, reported and escalated.

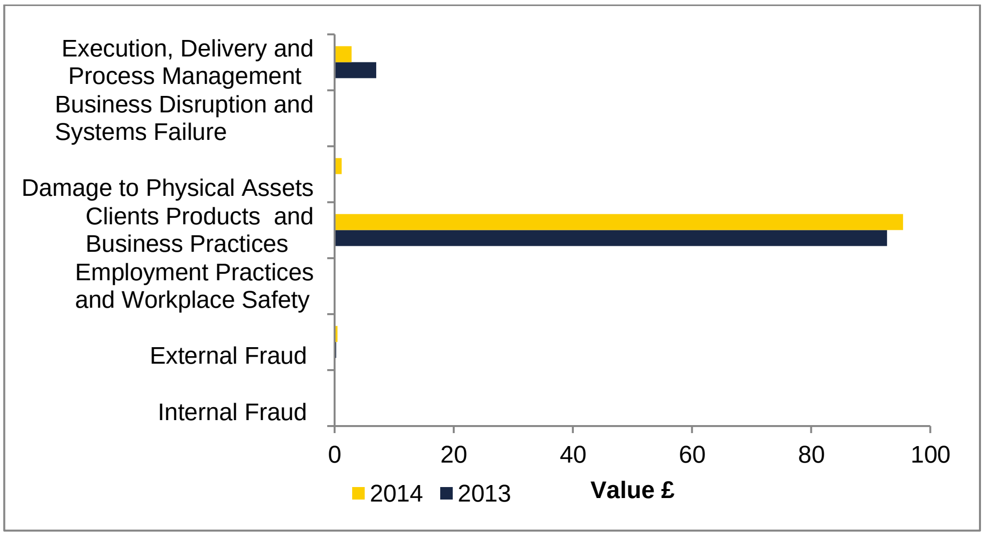
The Risk Function captures this information at a departmental level and aggregates it for management, Risk Committees and Board reports that are aligned to TSA Business Lines and, to the seven Basel categories used for regulatory reporting purposes.

In line with industry experience, Society losses are concentrated in the 'Clients, Products & Business Practices' category which in 2014, accounted for in excess of 95% of operational risk loss by value, the remaining losses being attributable to external fraud, damage to physical assets, employment practices and workplace safety.

The analysis below presents the Society's operational risk events by Basel II category, by count and by value.

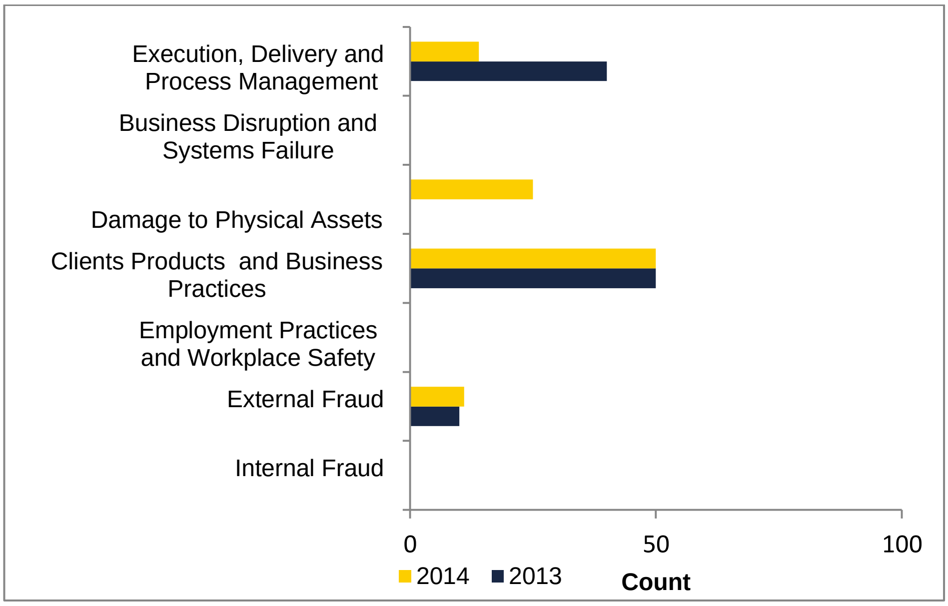
Operational risk events by risk type

% of total risk events by value



SECTION 7 – OPERATIONAL RISK

% of total risk events by count



SECTION 8 – OTHER RISKS

Pension obligation risk

The Society has funding obligations for a defined benefit pension scheme which was closed to new entrants in January 2000 and future accruals from 31 December 2014. Pension risk is the risk that the value of the scheme's assets, supplemented by additional contributions, will be insufficient to cover obligations over the remaining life of the scheme. The return on the scheme's assets will vary, depending on the movement in equity markets and interest rates, whilst the projection of the scheme's liabilities is based on estimates of mortality, inflation and future salary increases. In practice, the actual outcome may differ to the estimates and any shortfall will be borne by the Society.

This risk is managed through regular meetings of the Pension Trustee Board and an Investment sub-Committee. These forums receive quarterly investment monitoring updates, prepared by the scheme's independent advisors and annual actuarial updates, which may lead to a course of appropriate action, such as altering asset allocations. The Pension Trustee Board liaises with Society management as appropriate.

Business risk

Business risk means any risk arising from changes in its business, including the risk that the firm may not be able to carry out its business plan and its desired strategy, internal or external factors which create a restrictive impact on the Society's business or ability to deliver its planned strategy which results in financial loss, impacts on efficiency or impairment to reputation, or which inhibits the delivery of the strategic objectives. These risks are monitored through the Society's three lines of defence approach set out in section 2.

Liquidity risk

This is the risk that the Society is unable to meet its financial obligations as they fall due, or is only able to do so at an excessive cost. The risk arises from timing mismatches of cash inflows and outflows. The risk is managed through Board approved limits and policy, which determine the overall minimum level, appropriate composition and maturity of liquidity and funding balances. Operationally, the Society's Treasury Function is responsible for the day to day management of liquidity and wholesale funding. The Society determines the adequacy of its liquidity through daily reporting and the annual ILAA. This process determines a minimum level of liquid assets required under stressed environments to ensure sufficient liquidity is held at all times and is subject to review by the PRA with oversight from the Society's 2nd Line.

Conduct risk

Overall, the Society has extremely limited tolerance 'for' and 'to' conduct risk events, and in line with its stated appetite, restricts its activities to areas where appropriate expertise is in place. Customer facing and operational areas provide 1st line management of conduct risk, monitoring standards and customer outcomes against agreed standards. In 2014, a revision to the Society's structure saw the introduction of a new Business Support function. This department has assumed 1st line responsibility for quality assurance over the key operational areas. It is envisaged that the new structure will allow all 1st line quality assurance monitoring to be aligned and to better enable good practice to be shared across the Society. Monthly management information is provided to a dedicated 2nd line Conduct Oversight function, which undertakes independent assurance over the 1st line activity. Detailed conduct risk management information, from both the 1st and 2nd line, is prepared for review by the CRC at each meeting, with actions and outcomes being appropriately monitored. Key aspects of this report are subsequently incorporated into monthly Board reporting.

SECTION 9 – SECURITISATION

Overview

The Society has securitised a number of mortgage loans by pooling them together and transferring the loans to a Special Purpose Entity (SPE), Albion 2.

Originated securitisations

Debt securities in issue (funding) are secured against the Society's assets as part of the Society's structured funding programme. The programme has enabled the Society to obtain both secured funding and created additional collateral which can be used to source additional funding.

As there is not considered to be a transfer of significant credit risk, the Society does not calculate risk weighted exposure amounts for any positions it holds in the securitisation and these continue to be calculated in line with capital requirements consistent with other mortgage assets. The risk relating to the underlying mortgage pool therefore remains with the Society and is included in the residential mortgage tables detailed throughout this document.

The Society takes the role of servicer, seller, cash manager and Floating Rate Note registrar in relation to the securitisation. The provision of liquidity for the securitisation is borne by the Society, who bears the risk of cashflow mismatches between bond holders and borrowers.

The securitisation has issued senior tranche instruments with the Society retaining the first loss element.

Treatment of the securitisations

Residential mortgages have been pledged by the Society in order to raise wholesale funding. The pledged mortgages remain on the balance sheet of the Society, as the Society has retained substantially all the risks and rewards of ownership. These assets are held at amortised cost. The transfers of the mortgage loans to the securitisation companies are not treated as sales by the Originator, and therefore no gains are recognised.

The Society use Moody's and Fitch for the credit rating agencies for the securitisations.

As at the 31st December 2014 there were no assets awaiting securitisations. On the 13 February 2015 a new retained securitisation vehicle was established (Guildford No.1), issuing notes totalling £880m.

Securitisation – Albion No. 2 plc

Albion No.2 plc (Albion No. 2) was incorporated in July 2013 and issued £0.3bn of debt securities to external investors. The Notes issued are rated by both Fitch and Moody's as AAA. At the 31 December 2014, £0.2bn of mortgages were pledged to Albion No. 2 and outstanding debt securities in issue were £0.2bn.

		2014				2013			
		Gross assets securitised	Notes issued	Retained notes	Underlying assets past due and impaired	Gross assets securitised	Notes issued	Retained notes	Underlying assets past due and impaired
Securitisation company	Type of securitisation	£m	£m	£m	£m	£m	£m	£m	£m
Albion 2	Residential mortgage securitisation	202.2	185.4	35.9	3.9	296.0	274.8	35.9	2.1

SECTION 9 – SECURITISATION

Purchased securitisation positions

The Society invests in securitised assets as part of its overall investment strategy to maintain a diverse and liquid portfolio. The Society's holdings of RMBS and their associating risk weightings for capital purposes are included in the table in section 5.

Prior to investing in a new RMBS transaction the Risk Function conducts the appropriate due diligence credit analysis on securities in accordance with Article 406 of the CRR. In addition to the above the Society operates both issuer and individual securitisation limits to guard against concentration risk.

Daily checks are carried out within the Society using the Bloomberg rates for the purchased RMBS. Limits are in place to mitigate the risk of over investing. The Society also carries out quarterly stress testing for RMBS as part of the ongoing due diligence requirements set out in the CRR.

The Society's exposure to purchased securitisation positions amounted to £53.7m at 31 December 2014 and comprises senior tranches of residential mortgage-backed securities (RMBS). As at 31 December 2014, £52.2m had a credit rating of AAA to AA and £1.5m had a credit rating of A. Purchases and retention of RMBS are undertaken within a clearly defined credit risk policy. RMBS are held as 'Available-for-sale' at fair value on the Society's balance sheet. If the assets are sold before maturity a gain or loss would be recognised in the Income Statement.

As at 31 December 2014, no purchased securitisation positions were past due or impaired. The Society uses the Standardised approach defined under CRR to calculate risk weights for its purchased securitised positions.

	>3mths Investment £m	Risk Weight %	Long Term RWA £m
RMBS			
Aaa	37.7	20.0%	7.5
Aa-1	-	20.0%	-
Aa-2	10.0	20.0%	2.0
Aa-3	4.5	20.0%	0.9
A1	-	50.0%	-
A2	1.5	50.0%	0.8
A3	-	50.0%	-
Baa-1	-	100.0%	-
Total RMBS	**53.7**		**11.2**

In line with the CRR the Society monitor and stress both the asset and underlying pool of asset backed securities, which are reported to ALCO on a quarterly basis.

SECTION 10 – REMUNERATION

Remuneration Policy

The Remuneration policy is designed to provide competitive remuneration packages which support the long term interests of the Society and which attract, reward and retain talented colleagues, to enable the delivery of business objectives to support the Society's strategy, whilst providing value for members. The Policy focuses on ensuring effective and sound risk management through:

- A robust governance structure for setting goals and considering outcomes in the context of a defined risk assessment process;
- Alignment with the Society's strategy, values, long term goals and priorities;
- Ensuring that fixed salary is the main component of total remuneration, to create an acceptable relationship between risk and reward; and
- Ensuring that variable remuneration does not breach risk, capital and liquidity limits.

The Society will ensure that an advisory vote on the Remuneration Policy takes place annually, unless the approved policy remains unchanged, in which case it intends to propose a similar resolution at least every three years. This vote is in addition to the annual advisory vote on the Directors' Remuneration Report. Further details on the remuneration policy are set out in the Remuneration Report on page 46 in the Annual Report and Accounts.

Remuneration governance

The Remuneration Committee, under delegated authority from the Board, is responsible for setting the Society's Remuneration Policy and ensuring it is implemented and adhered to. The Remuneration Committee reviews compliance of the Remuneration Policy against the requirements of the FCA Remuneration Code. The Directors' Remuneration Report is shown in the Annual Report and Accounts 2014 on pages 44 to 55. This report sets out the work and composition of the Remuneration Committee.

Code Staff

The Remuneration Policy also identifies management and staff who are considered ''Code Staff'' and/or "material risk takers", as defined by the FCA Remuneration Code. In addition to the Directors and General Managers, this includes Senior Managers in the Risk and Legal functions.

The table below sets out the aggregate quantitative remuneration for code staff in relation to their services for the year ended 31 December 2014:

	Number of beneficiaries	Fixed remuneration	Variable remuneration	Total remuneration	Deferred remuneration
	No.	£000's	£000's	£000's	£000's
Type of staff					
Non-Executive Director	9	468	-	468	-
Executive Director	4	1,151	589	1,740	462
Other Code Staff	17	2,178	566	2,744	93
Total	**30**	**3,797**	**1,155**	**4,952**	**555**

Remuneration takes the form of cash, with deferred remuneration being unvested and subject to risk assessment and adjustment prior to the scheduled date of payment. No adjustments were made as a result of the 2014 review.

SECTION 10 – REMUNERATION

There were no sign on payments or severance payments made within the year.

No individual received remuneration exceeding the value of EUR 1 million.

Remuneration structures for Code Staff

The main components of remuneration for code staff are:

	Purpose	Operation	Performance metrics
Basic pay	Reflects level of accountability	Once set, any future increases are linked to personal performance and market benchmarking	Execution of the role, as defined in the role profile
Performance related pay	Rewards performance against a range of financial and business objectives	Maximum of 75% of basic pay, with 40% of the award deferred over three years for Executive Directors Maximum of 50% with 20% deferred over one year for General Managers. Non-Executive Directors do not receive variable remuneration.	Delivery of corporate, personal and peer group performance objectives
Operation of clawback	Deferral element has been introduced to ensure annual performance creates value sustained over the longer term.	Independent assessment takes place prior to the payment of each deferred award.	Not applicable
Pension	Provides market competitive remuneration	Based on the membership of the Society's defined contribution scheme. In appropriate circumstances e.g. where contributions exceed the annual or lifetime allowance, there is an option to receive a cash allowance in lieu of pension contributions.	Not applicable
Benefits	To align total remuneration broadly with the market	The principal benefits are life assurance, private medical insurance and long term health insurance. Other benefits may be provided based on individual circumstances e.g. relocation	Not applicable

Other directorships

A list of directorships held by Directors and Senior Management team are included on page 111 and 112 of the Annual Report and Accounts.

SECTION 11 - CONTACTS

Should you have any queries regarding this document, please contact:

R Litten, Finance Director

At our Registered Offices:

Leeds Building Society

105 Albion Street

Leeds

LS1 5AS

Approved by the Board 24 February 2015

SECTION 11 – GLOSSARY OF TERMS

Basel II Framework	Basel II is the second framework 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 regulatory Handbook.
Basel III Framework	The Basel III framework replaced Basel II from 1 January 2013. The regulatory framework was implemented in Europe through the Capital Requirements Directive IV (CRD IV) package of regulation and was effective from 1 January 2014.
BIPRU	The Prudential Sourcebook for banks, building societies and investment firms which forms part of the regulatory Handbook for Basel II.
Counterparty Credit Risk	Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.
Credit Quality Steps	A credit quality assessment scale as set out in BIPRU 3.4 (Risk weights under the Standardised Approach to credit risk).
Credit risk	The potential to incur losses from the failure of a borrower or counterparty to meet its obligation to pay interest or repay capital on an outstanding loan.
Credit risk mitigation	Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meets its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.
ECAI	External Credit Assessment Institution. An ECAI (e.g., Moody's, Standard and Poor's, Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.

SECTION 11 – GLOSSARY OF TERMS

Individual Capital Adequacy Assessment Process (ICAAP)	The Group's own assessment, as part of Basel III requirements, of the levels of capital that it needs to hold in respect of regulatory capital requirements for risks it faces under a business-as-usual scenario and a variety of stress scenarios.
Interest rate risk	Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates.
LTV	Loan to Value. The ratio of current exposure value as a proportion of the value of the asset held as security (usually residential property) expressed as a percentage.
Maturity	The remaining time the borrower is permitted to take to fully discharge their contractual obligation (principle, interest and fees) under the terms of a loan agreement.
Minimum capital requirement	The minimum amount of regulatory capital that a financial institution must hold to meet the Basel II Pillar 1 requirements for credit and operational risk.
PIBS	Permanent Interest Bearing Shares. Unsecured, deferred shares that are a form of Tier 1 capital.
Provisions	Amounts set aside to cover incurred losses associated with credit risks.