Leeds Building Society

Pillar 3 Disclosures

at 31 December 2012

1. Overview

1.1. Background

The Basel II accord was implemented in the European Union via the Capital Requirement Directives (CRD). In turn, it was incorporated by the FSA into BIPRU, the FSA Prudential sourcebook for Banks, Building Societies and Investment Firms, and came into effect on the 1 January 2007. The Basel framework is made up of three ‘pillars’:

Pillar 1 – Sets out the minimum capital requirements for credit, market and operational risk.

Pillar 2 – The Internal Assessment and Supervisory Review and Evaluation Process (SREP), assesses whether additional capital should be held against risks not covered or fully covered in Pillar 1. No quantitative Pillar 2 disclosures are made in this document.

Pillar 3 – A firm is required to disclose key pieces of information on its capital, risk exposures and its risk management. Disclosures are designed to promote market discipline and complement Pillar 1 and Pillar 2.

Leeds Building Society (the Society) adopted the Pillar 1 Standardised Approach to Credit Risk and the Basic Indicator Approach to Operational Risk from 1 January 2008; it also became subject to Pillars 2 and 3 from that date. The disclosures in this document meet the Society’s obligation under Pillar 3 and covers credit risks (chapter 5), market risks (chapter 6), operational risks (chapter 7) the principles underlying the Society’s Remuneration Policy, and detailed information on the work and composition of the Remuneration Committee (chapter 8).

1.2. About Leeds Building Society

Leeds Building Society is the fifth largest building society in the UK with 65 branches throughout the country and offices in Gibraltar and Dublin, total assets of £10.3bn and 696,000 members.

During 2012 a strategy was developed to deliver the Society’s vision, “to be Britain’s most successful Building Society”. The strategy is built on four pillars:

- Security: to generate strong levels of profit, which are retained in the business to build a solid platform for growth and continued financial security.
- Customer focus: to support the aspirations of a wide range of borrowers and savers, in particular those who are not well served by the wider market.
- Service: to deliver outstanding personal service to all our members.
- Efficiency: to continue to reinvest in the business to improve efficiency whilst being intolerant of waste.

Leeds Building Society is a member-owned mutual, providing residential mortgage and savings products to its customers. This core activity delivers the significant majority of operating profit and is supplemented by the provision of financial advice, investments and insurance products, as well as other financial services products, such as cheque accounts and credit cards.

The Society seeks to attract customers on value (a mix of pricing and optionality) and aims to retain them through a combination of continuing value for money pricing, flexibility and consistently high levels of service. The Society seeks to generate sufficient profitability to support continuing growth and enable more & more people to benefit from our proposition. This is achieved through margin management in a low cost environment. A good level of profitability is seen as a key measure of sustainability and stability in terms of ongoing capital strength. This capital strength is augmented by the Society's mutual model, which allows us to retain earnings for investment in the business, rather than distribute them as dividends to shareholders.

1.3. Basis and Frequency of Disclosures

The Society has prepared this document in accordance with the requirements of Pillar 3, as set out in BIPRU. Unless otherwise stated, all figures are at the financial year-end, 31 December 2012. Future disclosures will be issued on an annual basis and are published as soon as practicable following the publication of the Annual Report and Accounts. This document should be read in conjunction with the Society's Annual Report and Accounts.

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

1.4. Scope

Leeds Building Society is regulated by the Financial Services Authority (FSA). From April 2013, the FSA will split into the Financial Conduct Authority and the Prudential Regulation Authority and the Society will be regulated by both. The Basel II Framework, therefore, applies to the Society and its subsidiary undertakings (together 'the Group' or 'the Society').

There is a requirement to calculate and maintain regulatory capital ratios on both a Group basis and on 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 set out overleaf:

Name	Major Activities
Leeds Financial Services Ltd	Provision of Financial Services
Leeds Mortgage Funding Ltd	Provision of Mortgage Finance
Leeds Overseas (Isle of Man) Ltd	Provision of Mortgage Finance
Headrow Commercial Property Services Ltd	Rental Income from Commercial Properties
Leeds Building Society Covered Bonds LLP	Provision of Mortgage Assets and guarantor of covered bonds
Albion Holdings Plc	Holding company for Albion 1 Plc
Albion 1 Plc	Provision of residential mortgage backed securities
Mercantile Asset Management Ltd	Non-trading
Countrywide Rentals 1 Ltd	Non-trading
Countrywide Rentals 2 Ltd	Non-trading
Countrywide Rentals 3 Ltd	Non-trading
Countrywide Rentals 4 Ltd	Non-trading
Countrywide Rentals 5 Ltd	Non-trading

All of the Group's subsidiaries are included in the Pillar 3 disclosures. The Group does not foresee any practical or legal impediments to the transfer of capital resources or the repayment of liabilities within the Group. Full details of the principal subsidiary undertakings are included at Note 16 to the Annual Report and Accounts.

1.5. Location and verification

The Pillar 3 disclosures are not subject to external audit, however, they have been approved by the Board Audit Committee and Risk Division on behalf of the Board. Some of the information within the disclosure also appears in the Society's audited 2012 Annual Report and Accounts.

The disclosures are published on the Society website www.leedsbuildingsociety.co.uk

1.6. Regulatory Developments

The expected implementation of BASEL III in 2014 introduces stricter definitions of the components of capital. Current instruments which do not meet the stricter definitions, principally the society's £25m Permanent Interest Bearing Shares (4% of total available capital resources), will be gradually derecognised for capital purposes, over a ten year period, starting in 2014. BASEL III had no effect in 2012 and the Society has considered the impact of these rules on future levels of capitalisation, including under stress testing. The Directors consider that the Society will continue to remain well capitalised and there is no foreseeable requirement to issue additional capital instruments.

2. Risk Management

2.1. Risk Management Strategy

The Society has developed a Risk Management Strategy (RMS) which sets out the vision and principles for risk management within the organisation, in the context of the Society's corporate plan. The RMS, supported by the Risk Management Framework, is maintained by the Society's Chief Risk Officer and is subject to annual appraisal by the Group Risk Committee, on behalf of the Board.

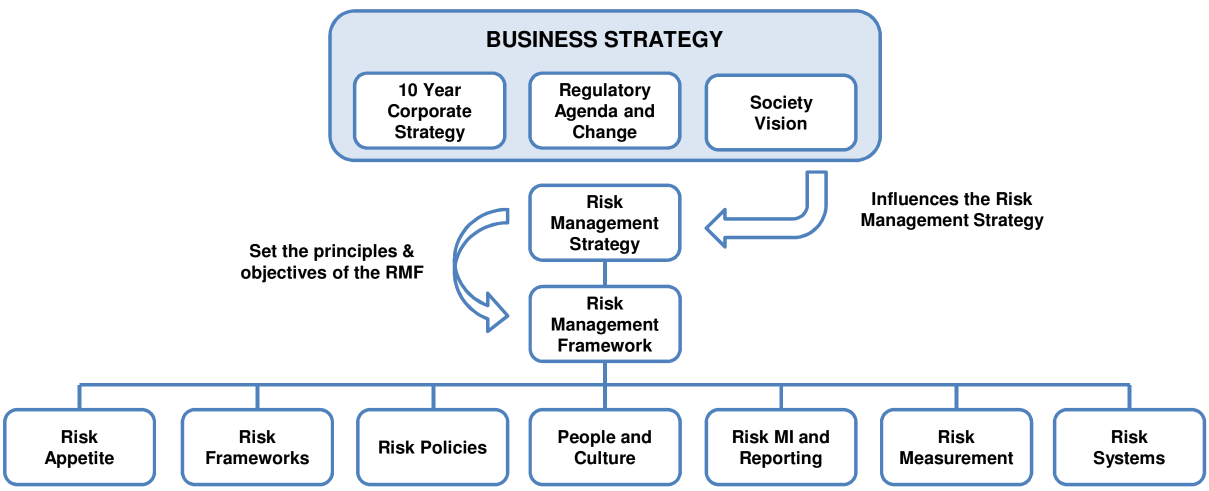
2.2. The Society's Risk Framework

The Risk Management Framework is designed to provide a structured approach to appropriately managing risks. This Framework identifies, assesses, manages and mitigates risks that may impair the delivery of the Society's strategic and business objectives.

The oversight and direction of the Board remains central to the Risk Management Framework. It ensures, through a series of Board sub-committees and Management fora that appropriate policies, procedures and processes are implemented across the business to control and monitor both the actual and potential risk exposures which arise from the Society's operations.

The Framework includes oversight bodies for the operational roles and responsibilities, both individual and collective, in the risk management process. This ensures exposed risks are aligned to the Risk Appetite of the Board and that any unacceptable risk exposures are identified and where possible mitigated, or the Society's appetite / tolerance amended, accordingly. The Risk Management Framework is represented diagrammatically as:

Diagram 1: Risk Management Framework

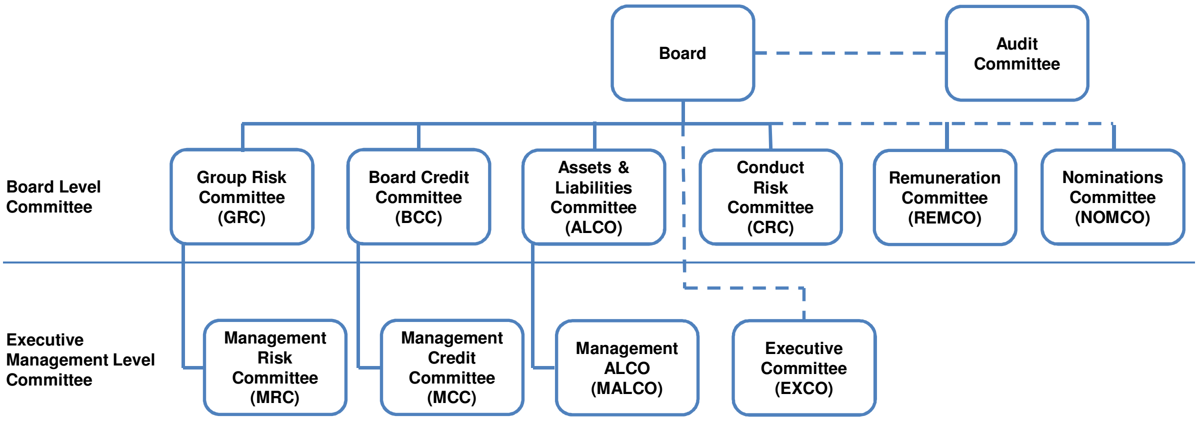


In addition to the ongoing assessment of known risk exposures, Management monitors external and emerging risks within its forward-looking Risk Appetite Dashboards. Management fosters an open communication culture that promotes the immediate escalation of actual or emerging risks.

2.3. Risk Governance

The Board is ultimately responsible for the Risk Management Framework and defines, through its Risk Appetite Statements, the acceptable levels and types of risk exposure that it considers likely to arise in the delivery of its strategic objectives. As noted above, the Board's risk governance is supported through a series of sub-committees, or by Management, operating under delegated mandates, outlined in diagram 2.

Diagram 2: Risk Control Structure



2.3.1. Board Sub-Committees

Board sub-committees operate under a Board delegated mandate, providing a forum for the direction and challenge of Management, whilst monitoring business performance and risk exposures.

Each of the Board level committees includes non-executive Directors, with other Committee members being drawn from the Executive and appropriate members of Senior Management.

The Group Risk Committee (GRC) is mandated to review the consolidated exposure to risk, and the appropriateness of the risk framework in place. On an annual basis, the Committee oversees the calculation and allocation of the Group's capital requirements, and recommends to the Board the conclusions of the Society's Internal Capital Adequacy Assessment Process (ICAAP). Throughout the year the Committee monitors the impact of changes in the profile of risk on the ICAAP requirements and the Board's stated Risk Appetite. Additionally, standing reports are received on the Society's Corporate Risk Register, external risk indicators, and updates on Management actions.

The Assets and Liabilities Committee (ALCO) is responsible for overseeing treasury policy, in line with the Board approved Financial Risk Management Policy (FRMP). In particular, the Committee oversees wholesale funding and liquidity investment strategies, hedging, interest rate risk management and counterparty credit criteria. It is also responsible for the ongoing development and maintenance of the Individual Liquidity Adequacy Assessment (ILAA) and its annual submission to the Board.

The Board Credit Committee (BCC) is responsible for formulating policy pertaining to asset quality and credit risk within the Society, controlling credit risk and monitoring its management, (including commercial and lifetime credit risks) for approval by the Board.

The Conduct Risk Committee (CRC) provides oversight of Conduct Risk across the Society and ensures fairness principles are promoted across all levels of the Society's operations. The Committee also approves new types of products before they are offered to members, to ensure they are suitable for the target audience, meet the Society's risk appetite and meet the required regulatory standards.

The Board Audit Committee (BAC) has overarching responsibility for the Society's systems and controls. It receives and considers reports from business areas including Internal Audit, IT Security, Financial Crime, and Compliance. It also oversees the financial reporting of the Society. Further details on the role of the Committee and the Society's internal controls is included on page 27 of the Annual Report and Accounts.

The Remuneration Committee (REMCO) is responsible for reviewing and advising on remuneration policies generally for the Society. It reviews the appropriateness and relevance of the Society's Remuneration Policy at least annually. The Committee also ensures the Society complies with the FSA Remuneration Code and the recommendations and guidance of the UK combined code. Further details on the work of the Committee are included in the Annual Report and Accounts on pages 30 to 34.

2.3.2. Executive Level Committees

A number of Executive management level committees operate under the delegated authority of the Board and its sub-committees These include an Executive Committee, which provides more general management oversight and direction to manage the day-to-day risks within the business, Management Assets and Liabilities Committee, Management Risk Committee and Management Credit Committee. These committees are supported by a number of more specifically focused fora.

2.4. Three lines of defence

Management has adopted and continues to develop a 'Three Lines of Defence' approach to its operational implementation of the Risk Management Framework. The Three Lines of Defence approach simplifies and clarifies the varying roles and responsibilities of staff as follows:

First line of defence – Operational Management

Operational Management is in the best position to assess risk exposures and is fully responsible for the risks its operations create. Ongoing oversight is provided through management fora. Management run the business and own the risks that arise through these operations.

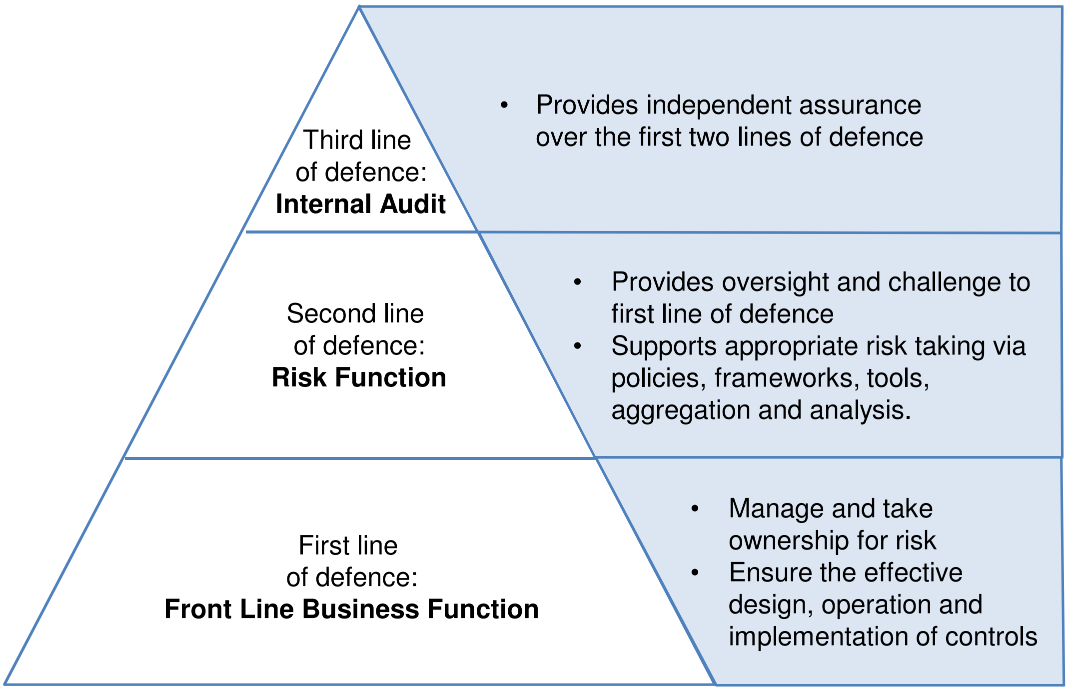
Second line of defence – Risk, Control and Compliance

The second line of defence, which is independent of operations, is responsible for the quantification, analysis and reporting of all risks. These functions create and uphold principles, policies and frameworks for risk management and facilitate risk assessment. The second line's role is the "four-eyes" oversight of the first line of defence to confirm adherence to Policies and the Board's appetite.

Third line of defence – Internal Audit

Internal Audit is independent of operations, reports directly to the Chief Executive and is accountable to the Chairman of the BAC. It's role is to independently confirm that Society activities are in line with the Board appetite or regulatory and legal requirements. The Board Audit Committee provides oversight of the Third line of defence.

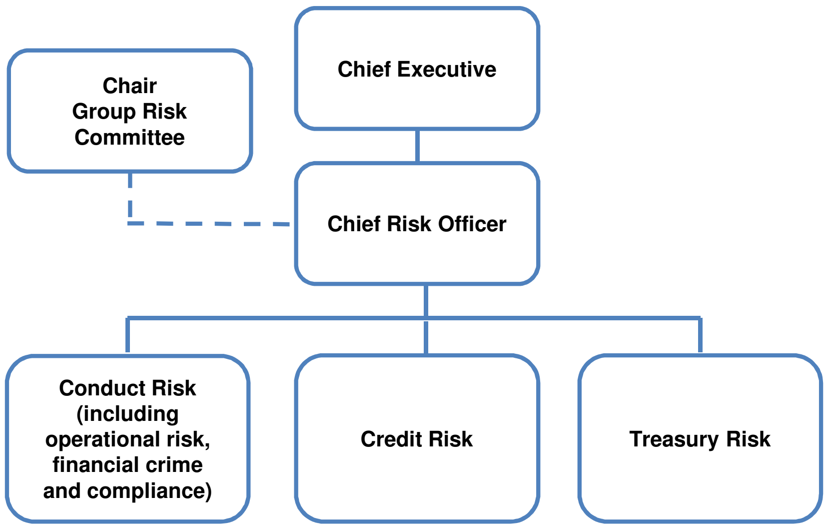
Diagram 3: The Society's three lines of defence



2.5. Risk Management Structure

To maximise effective risk management and to ensure independence, the Society has consolidated its second line of defence assurance activities under the remit of a Chief Risk Officer. The Chief Risk Officer reports to the Chief Executive but is also accountable to the Chairman of the Group Risk Committee, on behalf of the Board.

Diagram 4: Risk Management Structure



3. Capital resources

3.1. Total Available Capital

At 31 December 2012 and throughout 2012, the Society complied with the applicable capital requirements as set out by the FSA. The table below illustrates the Group's qualifying regulatory capital position as at 31 December, 2012:

	2012 £m	2011 £m
Tier 1		
Core Tier 1 reserves	575.1	537.0
PIBS	25.0	25.0
Total tier 1 capital	**600.1**	**562.0**
Tier 2		
Subordinated debt	0.5	0.7
Revaluation reserve	13.2	13.2
Collective provisions	24.3	34.7
Total tier 2 capital	**38.0**	**48.6**
Total capital resources	**638.1**	**610.6**

3.2. Tier 1 Capital

Tier 1 capital comprises the general reserve, other reserves and Permanent Interest Bearing Shares (PIBS). The general and other reserves represent the Group's accumulated accounting profits, as well as adjustments for pension obligations and property disposals. It excludes available for sale and cashflow reserves.

PIBS are unsecured deferred shares and rank behind the claims of all subordinated noteholders, depositors, creditors and investing members of the Society. Further details regarding the PIBS are set out in note 28 of the Annual Report & Accounts. The Group currently has no innovative Tier 1 instruments.

3.3. Tier 2 Capital

Tier 2 capital comprises the Group's property revaluation reserve, qualifying subordinated debt and collective impairment provisions. Under FSA 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 before holders of PIBS, of the Society. Further details regarding the subordinated debt are set out in note 27 of the Annual Report & Accounts.

In accordance with FSA rules, in the last five years to maturity, the subordinated debt will, for capital qualification purposes, be amortised on a straight-line basis. The subordinated debt has a fixed interest rate of 4.34% (2011: 4.34%) and a maturity date of 9 March 2015.

4. Capital Adequacy

4.1. Capital Management

The Society has adopted the Standardised Approach to Credit Risk and the Basic Indicator Approach to Operational Risk, since 1 January, 2008, in order to calculate the Basel II Pillar 1 minimum capital requirement.

The Society manages its capital supply and demand by balancing capital efficiency and prudence. The Board considers that this approach preserves the Society's competitive position in relation to capital requirements, and maintains and enhances the Society's reputation in the financial services industry.

Capital is measured and monitored against regulatory requirements. Regulatory capital covers all Pillar 1 risks (i.e., Credit Risk and Operational Risk) for all portfolios. The Society determines its Pillar 1 Capital Resource Requirement (CRR) using a regulatory capital calculator that is compliant with BIPRU.

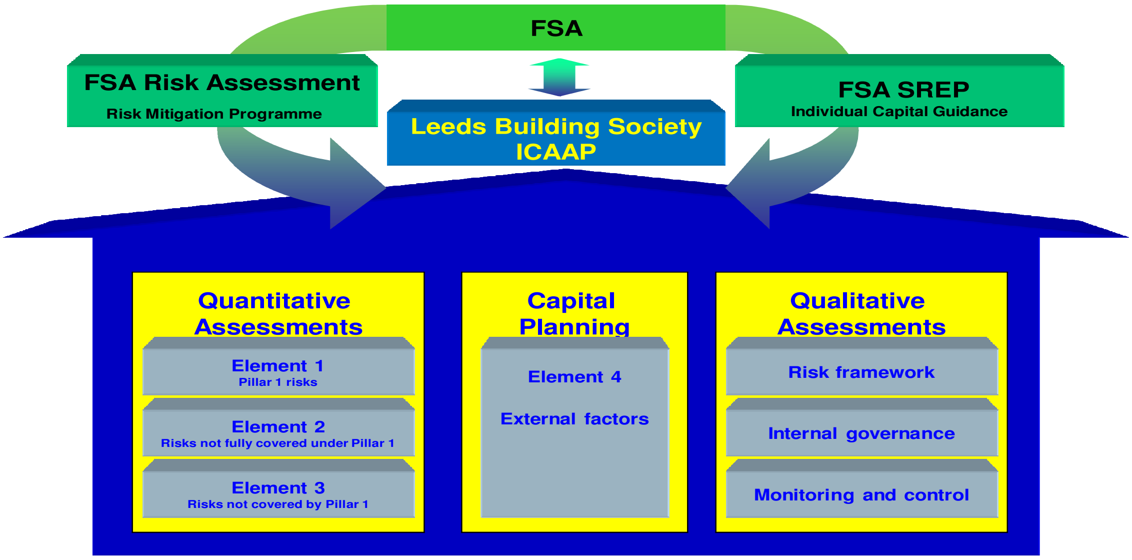
The Board receives monthly updates of the regulatory capital position, as well as quarterly forecasts.

4.2. Internal Capital Adequacy Assessment Process (ICAAP)

The ICAAP process and documentation is an articulation of the Society's approach to risk, its identification, quantification and management. On an annual basis, the Society fully updates the ICAAP document to reflect the changing nature of the risks facing the Society. In the intervening period, the oversight of business performance and any impact on risk exposures is dynamic, with the Risk Management Framework providing an escalation structure for any material changes. Notwithstanding real time oversight of risk exposures, on at least a quarterly basis, the Group Risk Committee will monitor the risks, using the Corporate Risk Register, Risk Appetite Dashboards and applicable stress testing, with their results used to confirm the continuing appropriateness of the annual ICAAP.

The ICAAP is prepared by the Risk Division, reviewed by the Finance Department and Internal Audit, and presented to the Group Risk Committee for recommendation to the Board for approval. The final ICAAP will be submitted to the FSA and reviewed as part of their Supervisory Review and Evaluation Process (SREP), see diagram 4.

Diagram 4: FSA Review Process



4.3. Minimum Capital Requirement (Pillar 1)

The table, below, shows the Society's overall minimum capital requirement for Credit Risk under the standardised approach (expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised Credit Risk exposure classes) at 31 December, 2012.

	2012 £m	2011 £m
Wholesale counterparties (inc. liquidity collateral deposits)	16.5	21.7
Unsecured lending	-	0.2
Secured on property (inc. lifetime mortgages)	260.3	242.5
Past due items	19.1	20.0
Other items	3.9	3.9
Sub total	**299.8**	**288.3**
Operational risk (basic indicator approach)	21.4	20.1
Total minimum capital requirement	**321.2**	**308.4**

There is no Pillar I requirement in respect of market risk as the Society and Group does not have a trading book.

At 31 December 2012 the Society held an excess of capital resources over pillar 1 minimum capital requirements of £316.9m (2011: £302.2m).

5. Credit Risk Measurement, Mitigation and Reporting

5.1. Introduction

Credit risk is the risk of financial loss where borrowers or counterparties are not able to meet their obligations as they fall due. The Society faces this risk through its lending to:

- Individuals through residential lending secured on real estate.
- Businesses through commercial lending secured on real estate; the Society has ceased new commercial lending.
- Wholesale counterparties through investments in liquid assets (treasury operations).

The Society employs appropriate underwriting and fraud detection techniques to support sound decision making, to minimise losses in its lending activities. In addition, a proactive approach to the control of bad and doubtful debts is maintained within the collections area.

Experienced risk functions operate within the Society, which are driven both by the recognised need to manage potential and actual risks, and also by the need to continually develop new processes, to ensure sound decisions are made in the future. In this way, any variations in risk from market, economic or competitive changes are identified and the appropriate controls developed and put in place.

Comprehensive management information on performance, within the various retail and wholesale portfolios, ensure that credit risk is effectively controlled and any adverse trends are identified before they impact on performance. Society performance is also measured against the industry, where appropriate, to inform and prompt action if appropriate. This management information is distributed across the Society, as appropriate, and monitored by the Board and its sub-committees. The Board Credit Committee is responsible for the formulation of policy pertaining to asset quality and credit risk for approval by the Board.

Policy statements covering, amongst other things, criteria to be used in considering limits on appropriate counterparties and countries are reviewed on a regular basis by the ALCO. Authorised limits on a counterparty are determined following rigorous analysis, giving due consideration to both internal and external credit ratings.

5.2. Exposures to Real Estate Property

The Society calculates Credit Risk for exposures secured by mortgages on residential real estate and commercial real estate using the Standardised Approach. The table below details the asset values for each key category of Pillar 1 exposure, and the risk weightings. These values form the basis of the capital requirements shown in section 4.3.

	2012		2011	
	%	£m	%	£m
Secured on residential real estate, of which	39%	7,615.0	40%	6,870.6
Prime	*38%*	*5,063.1*	*38%*	*4,588.7*
Shared ownership	*42%*	*1,007.2*	*44%*	*827.7*
Buy to let	*38%*	*1,089.1*	*39%*	*968.8*
Overseas (Euro)	*56%*	*265.2*	*56%*	*277.6*
Other closed portfolios	*44%*	*190.4*	*45%*	*207.7*
Commercial lending	100%	438.5	100%	504.9

Notes: The exposure value and average risk weight figures above include past due items.

The following table shows the residual maturity of the exposures:

Category	**Up to 12 months £m**	**1 to 5 years £m**	**More than 5 years £m**	**Total £m**
Secured on residential real estate	45.5	342.4	7,227.1	**7,615.0**
Secured on commercial real estate	140.8	222.0	75.7	**438.5**
Total at 31 December 2012	**186.3**	**564.4**	**7,302.8**	**8,053.5**

Category	**Up to 12 months £m**	**1 to 5 years £m**	**More than 5 years £m**	**Total £m**
Secured on residential real estate	44.1	372.9	6,453.6	**6,870.6**
Secured on commercial real estate	123.6	283.9	97.4	**504.9**
Total at 31 December 2011	**167.7**	**656.8**	**6,551.0**	**7,375.5**

5.3. Exposures to Wholesale Counterparties

The Society has exposures to banks, building societies, and sovereigns in its non-trading treasury book. The Society does not operate a trading book. Exposures to wholesale counterparties are maintained, principally, for liquidity purposes. This element of credit risk is managed by the first line Treasury function, within strict limits set by the ALCO.

The Society manages its Treasury Credit Risk in compliance with geographic, sector and counterparty limits, whose methodology is defined within the Society's Financial Risk Management Policy (FRMP) and which approved by the Board.

Limits are based on a combination of quantitative and qualitative risk assessments, using both internal and external data sources. These include the rating structures of Moody's, Standard and Poor's and Fitch. All limits are formally reviewed by ALCO on, at least, a quarterly basis. The Society uses external credit assessments provided by Moody's, Fitch and Standard & Poor's for the purposes of the Standardised Approach. All three rating agencies are recognised by the FSA as eligible external credit assessment institutions (ECAI) under the Capital Requirements Regulations 2006 (SI 2006/3221). A model developed internally is used to make credit assessments of unrated exposures, which is approved by the ALCO.

An ongoing assessment of investment quality is undertaken by the Treasury Credit Risk Team, which is part of the Society's Treasury Department. Oversight is provided by the Treasury Risk Team which reports to the Chief Risk Officer and therefore independent from the deal execution function that resides within the Treasury Department. ALCO receives a suite of regular reports, detailing any changes in perceived credit quality. If necessary, exception reporting also occurs following a breach of pre-defined triggers or changes in the external environment.

The Society's exposure to each of the credit quality steps for long and short-term investments to institutions is set out below:

Short-term investments (maturity 3 months or less)

Credit quality step	S&P rating	Fitch rating	Moody's rating	2012 %	2012 £m	2011 %	2011 £m
1	AAA to AA-	AAA to AA-	Aaa to Aa3	20%	826.4	20%	261.6
2	A+ to A-	A+ to A-	A1 to A3	20%	6.9	20%	313.2
3	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	20%	-	20%	25.0
4	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	50%	6.0	50%	14.5
5	B+ to B-	B+ to B-	B1 to B3	50%	-	50%	-
6	CCC+ and below	CCC+ and below	Caa1 and below	150%	-	150%	-
Unrated	Unrated	Unrated	Unrated	20%	12.7	20%	27.0
Total short term investments					**852.0**		**641.3**

Long-term investments (maturity greater than 3 months)

Credit quality step	S&P rating	Fitch rating	Moody's rating	2012 %	2012 £m	2011 %	2011 £m
1	AAA to AA-	AAA to AA-	Aaa to Aa3	20%	884.6	20%	1,243.1
2	A+ to A-	A+ to A-	A1 to A3	50%	183.3	50%	111.0
3	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	50%	37.9	50%	7.0
4	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	100%	3.2	100%	10.9
5	B+ to B-	B+ to B-	B1 to B3	100%	-	100%	-
6	CCC+ and below	CCC+ and below	Caa1 and below	150%	-	150%	11.7
Unrated	Unrated	Unrated	Unrated	50%	30.3	50%	19.8
Total long term investments					**1,139.3**		**1,403.5**

The Society's exposure to asset classes and the residual maturity is set out below:

	Up to 12 months £m	1 to 5 years £m	More than 5 years £m	Total £m
Financial institutions	359.5	108.5	10.6	**478.6**
Sovereigns	1,098.0	182.5	-	**1,280.5**
Asset backed secutities	-	70.6	161.6	**232.2**
Total at 31 December 2012	**1,457.5**	**361.6**	**172.2**	**1,991.3**

	Up to 12 months £m	1 to 5 years £m	More than 5 years £m	Total £m
Financial institutions	585.4	100.9	10.6	**696.9**
Sovereigns	987.5	136.6	-	**1,124.1**
Asset backed secutities	-	-	223.8	**223.8**
Total at 31 December 2011	**1,572.9**	**237.5**	**234.4**	**2,044.8**

5.4. Structured Funding

In 2012 the Society successfully launched its first securitisation programme, Albion No. 1 Plc. This is in addition to the Covered Bond issues in 2011 and 2012, by Leeds Building Society Covered Bonds LLP.

Both Leeds Building Society Covered Bonds LLP and Albion No. 1 plc are consolidated by the Group and loans secured on real estate include £1.6bn (2011: £1.1bn) and £0.4bn (2011: nil) which have been transferred from the Society to Leeds Building Society Covered Bonds LLP and Albion No. 1 plc respectively.

The loans secure £0.8bn (2011: £0.6bn) of covered bonds issued by the Society, and £0.4bn of residential mortgage backed securities issued by Albion No. 1 plc. The covered bonds have been used to secure long term funding from other counterparties.

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The residential mortgage backed securities have been entirely issued to Leeds Building Society to enable the Group to participate in the Bank of England's Funding for Lending Scheme. The loans are retained on the Society's balance sheet as the Society substantially retains the risk and reward relating to the loans. The Society accessed £200m through the Funding for Lending Scheme introduced by the Bank of England during 2012. This collateral swap transaction was entered into in contemplation of the Society's mortgage lending volumes and is held off balance sheet, as required by IFRS, and is not reflected in the Society's total assets.

5.5. Impairment Provisions

Individual assessments are made of all mortgage loans in possession and, based upon these assessments, an individual impairment reduction of these assets is made.

In addition, an impairment reduction is made against those loans and advances to customers where objective evidence indicates that a loss event has occurred and it is likely that losses may ultimately be realised; due to the amount that is expected to be irrecoverable from the sale of the property, taking into account other risk mitigants.

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 property price movements and adjustments, to allow for selling costs and forced sale values.

The following table shows the past due loans and provisions for impaired loans:

	Loans fully secured on residential property £m	Loans fully secured on land £m	Other loans £m	Total £m
At 1 January 2012				
Collective impairment	16.4	17.9	0.4	34.7
Individual impairment	28.9	21.5	2.7	53.1
	45.3	**39.4**	**3.1**	**87.8**
Income and expenditure account				
Charge for the year: collective impairment	(0.9)	(9.1)	(0.4)	(10.4)
Charge for the year: individual impairment	18.5	34.3	0.2	53.0
Adjustments to impairment losses for bad and doubtful debts resulting from recoveries during the year	(0.6)	(0.1)	-	(0.7)
	17.0	**25.1**	**(0.2)**	**41.9**
Amounts written off during the year				
Individual impairment	(17.9)	(28.5)	(2.6)	(49.0)
At 31 December 2012				
Collective impairment	15.5	8.8	-	24.3
Individual impairment	28.9	27.2	0.3	56.4
Total	**44.4**	**36.0**	**0.3**	**80.7**

	Loans fully secured on residential property £m	Loans fully secured on land £m	Other loans £m	Total £m
At 1 January 2011				
Collective impairment	9.0	10.0	0.9	19.9
Individual impairment	17.7	24.4	3.4	45.5
	26.7	**34.4**	**4.3**	**65.4**
Income and expenditure account				
Charge for the year: collective impairment	7.4	7.9	(0.5)	14.8
Charge for the year: individual impairment	23.1	11.7	-	34.8
Adjustments to impairment losses for bad and doubtful debts resulting from recoveries during the year	(0.6)	(0.5)	-	(1.1)
	29.9	**19.1**	**(0.5)**	**48.5**
Amounts written off during the year				
Individual impairment	(11.3)	(14.1)	(0.7)	(26.1)
At 31 December 2011				
Collective impairment	16.4	17.9	0.4	34.7
Individual impairment	28.9	21.5	2.7	53.1
Total	**45.3**	**39.4**	**3.1**	**87.8**

The table below shows further information on the payment status of loans:

	Residential		Other		Commercial	
	£m	%	£m	%	£m	%
Not impaired:						
Neither past due nor impaired	7,183.0	94.4	176.6	99.6	322.1	73.5
Past due up to 3 months but not impaired	213.7	2.8	-	-	-	-
Impaired:						
Not past due but impaired	-	-	-	-	60.0	13.6
Past due up to 3 months	-	-	-	-	20.8	4.7
Past due 3 to 6 months	78.2	1.0	-	-	-	-
Past due 6 to 12 months	59.2	0.8	-	-	-	-
Past due over 12 months	47.4	0.6	0.7	0.4	3.3	0.8
Possessions	33.5	0.4	-	-	32.3	7.4
Total at 31 December 2012	**7,615.0**	**100.0**	**177.3**	**100.0**	**438.5**	**100.0**

	Residential		Other		Commercial	
	£m	%	£m	%	£m	%
Not impaired:						
Neither past due nor impaired	6,375.8	92.7	176.4	99.7	460.2	91.1
Past due up to 3 months but not impaired	265.4	3.9	-	-	1.8	0.4
Impaired:						
Not past due but impaired	-	-	-	-	-	-
Past due up to 3 months	-	-	-	-	-	-
Past due 3 to 6 months	87.7	1.3	-	-	-	-
Past due 6 to 12 months	70.3	1.0	-	-	0.2	-
Past due over 12 months	46.6	0.7	0.6	0.3	7.0	1.4
Possessions	28.3	0.4	-	-	35.7	7.1
Total at 31 December 2011	**6,874.1**	**100.0**	**177.0**	**100.0**	**504.9**	**100.0**

Where appropriate for the customer's needs, the Society adopts a policy of forbearance and may grant certain changes to the terms of the mortgage. These changes include payment arrangements, concessions, capitalisation of arrears, transfers to interest only arrangements and term extensions. These strategies are undertaken in order to achieve reduced long term arrears and allow the best outcome for both the customer and the Society by dealing with arrears at an early stage. The table below provides further information on the residential loans existing at the 2012 reporting date by types of account renegotiations applied to our customers over the last 12 months. This includes renegotiations regardless of whether or not our customer has experienced financial difficulty in repaying their loan with the Group. For clarity, this table includes all balances which have had their terms renegotiated in the last 12 months, regardless of whether the renegotiation is still in place or whether the loan has reverted to its original terms. Further information on impairment is included within note 34 in the Annual Report & Accounts.

	Payment arrang-ements	Conce-ssions	Capitalis-ations	Transfer to interest only	Term extentsions	Other	Total
Neither past due nor impaired	70.6	18.8	46.7	66.2	60.6	9.3	272.2
Past due up to 3 months	61.0	10.6	18.3	1.2	0.7	0.1	91.9
Past due more than 3 months	58.8	9.3	6.1	0.5	-	-	74.7
Posessions	2.7	0.6	0.1	0.1	-	-	3.5
Total	**193.1**	**39.3**	**71.2**	**68.0**	**61.3**	**9.4**	**442.3**

5.6. Credit Risk Mitigation

The Society uses a wide range of techniques to reduce the credit risks of its lending. The basis of its underwriting uses a number of key controls, which are applied, as appropriate, to make decisions, from, including: The sourcing of external credit data; the use of credit scoring (both used to identify the ability of borrowers to maintain their repayment schedule); an assessment of the ability of a borrower to service the proposed level of borrowing without distress; and, an appropriate independent assessment of collateral put up to support the loan, in the event of default.

5.6.1. Residential Mortgages

Residential property is the Society's main source of collateral and means of mitigating credit risk, inherent in its residential mortgage portfolios. The Society takes a first charge on residential lending and all mortgage lending activities are supported by an appropriate form of valuation using an independent firm of valuers, indexed valuation (further advances) or, by exception, Automated Valuation Model, subject to business rules and confidence levels.

5.6.2. Commercial Lending

Collateral for commercial loans comprises a first legal charge over freehold or long leasehold property and additional security as appropriate, which might include:

- Guarantees;
- Debentures;
- Charged cash deposits.

In certain limited circumstances, the Society's charge is subject to other priority arrangements. The Society ensures that security is insured for full replacement cost and its interest is noted on the relevant policy.

5.6.3. Treasury use of Derivatives

Derivatives are contracts or arrangements whose value is 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. 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 description that affect the business. Accordingly, such instruments are not used in trading activity or for speculative purposes.

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).

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. The 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 setting the internal credit risk limits for derivative counterparties and the Society recognises the risk mitigating effect of these CSAs in its Pillar 1 capital requirement calculations. 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 such exposure.

Significant 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 investments	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
Equity linked investment products	Sensitivity to changes in equity indices	Equity linked interest rate swaps
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)

The table below shows the nominal value of derivative instruments used by the Group for hedging purposes:

	2012 £m	2011 £m
Derivatives held for hedging		
Derivatives designed as fair value hedges	4,515.9	3,127.7
Derivatives designated as cash flow hedges	143.5	-
Other derivatives held at fair value	1,664.9	1,707.5
Total derivatives asset / (liability) held for hedging	**6,324.3**	**4,835.2**

The table below shows the derivatives contracts held using the Mark to Market (MTM) method:

	Replacement cost £m	Credit exposure £m	Total exposure £m
Book at 31 December 2012	**36.8**	**40.1**	**76.9**

	Replacement cost £m	Credit exposure £m	Total exposure £m
Book at 31 December 2011	**54.2**	**43.8**	**98.0**

Note:

This methodology takes into consideration the Society's CSA agreements with swap counterparties and reduces the replacement cost of the swaps, when compared to Note 14 of the Society's Report and Accounts.

6. Market Risk

6.1. Market Risk Overview

Market Risk is the potential adverse change in Society income or the value of Group net worth arising from movements in interest rates, exchange rates or other market prices. Market Risk exists to some extent in all the Society's businesses. The Society recognises that the effective management of Market Risk is essential to the maintenance of stable earnings and the preservation of member value.

The Society's exposure to Market Risk is governed by the Board approved FRMP. This policy sets out the nature of the various risks that the Society is exposed to and how it seeks to manage and control those risks within approved risk appetite limits. Compliance with these limits is monitored by ALCO on a monthly basis, while day to day operational monitoring is performed by the Treasury Department.

Daily operational management

On a daily operational basis, the Society's exposure to market risk is managed by the Treasury Department so as to remain within the Board approved FRMP 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.

6.2. 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 annual 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 risk appetite or strategy for managing its interest rate risks. 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, does not have the type of higher risk exposure run by many banking institutions. Given the Society's policy of hedging fixed rate assets and liabilities back to a floating rate, outright interest rate risk arises mainly from the investment of the Society's reserves as per the Board approved investment strategy, which seeks to ensure a stable earnings profile over its medium term plan, by means of a targeted average duration. This affords Treasury a modest element of flexibility when determining the term for its investments of the Society's reserves.

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

	Annual earnings sensitivity (£m)				Market value sensitivity (£m)			
	2012		2011		**2012**		2011	
	+200bp	**-200bp**	+200bp	-200bp	**+200bp**	**-200bp**	+200bp	-200bp
Core portfolio	**17.8**	**(1.1)**	13.7	(4.3)	**11.4**	**(12.4)**	5.8	(5.4)
Capital & PIBS	**2.9**	**(6.2)**	4.9	(2.5)	**17.6**	**(48.8)**	24.8	(52.6)
Total	**20.7**	**(7.3)**	18.6	(6.8)	**29.0**	**(61.2)**	30.6	(58.0)

6.3. Foreign Currency Risk

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

The Society issues 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.

6.4. Other 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.

6.5. Pension Obligation Risk

The Society has funding obligations for a defined benefit pension scheme which was closed to new entrants on 31 December 1999. Pension risk is the risk that the value of the scheme's assets, supplemented by additional member 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 that was established in 2012. These committees 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.

7. Operational Risk

7.1. Overview

Operational Risk is defined by the Society as 'the potential risk of financial loss or impairment to reputation resulting from inadequate or failed internal processes and systems, from the actions of people or external events'. Within the Group, Operational Risk is sub-categorised by type: regulatory; theft or fraud; systems failure and people risk.

The Society calculates its Operational Risk Capital Requirement on the Basic Indicator Approach (BIA). This approach determines the capital charge for Operational Risk through the application of a flat (15%) charge on a single risk indicator (gross income) for the whole of the Society, including its subsidiaries.

7.2. Operational Risk Framework

Within the risk function an Operational risk team has the overall responsibility for establishing the framework within which operational risks are identified, monitored and managed across the Group. The framework is based on industry best practice and anticipated regulatory requirements. Day-to-day management of Operational Risk rests with Management.

Where the Board has established an appetite for risk, internal control processes and procedures are combined with risk mitigation techniques that include delegated mandates, operating limits, event monitoring and tolerance management. Where appropriate, risk transfer mechanisms are employed in the form of corporate insurance and outsourced relationships.

7.3. Operational Risk Oversight & Governance

Management oversight is maintained through a range of Management Committees that report through to the Management Risk Committee (Executive Management) and the Group Risk Committee (Board Sub-Committee).

7.4. Operational Risk Reporting

Risk reporting is incorporated into the monthly business performance scorecard. The scorecard, and an accompanying Operational Risk Dashboard report is presented to the Group Risk Committee and the Board, which includes an assessment of each risk.

7.5. Conduct Risk

Conduct Risk, which is a sub-set of operational risk, is considered by the Society to be the risk that actual or potential customer detriment arises, or may arise, from the way the Society conducts its business.

During 2012, the FSA published its final rules on its Mortgage Market Review, outlining the proposed approach to reforming the mortgage market, to ensure it is sustainable and works better for customers. The majority of the changes will come into effect in 2014, which will see, amongst other things, most interactive sales (e.g. face to face or telephone) being provided on an advised basis and a requirement, for all mortgage advisors to hold a relevant mortgage qualification. In addition, lenders will be fully responsible for assessing whether the customer can afford the loan and, whilst interest only loans can continue to be granted, there must be a credible strategy in place for repaying the capital. Although the Society will have to refine existing processes in preparation for implementation, it is not anticipated, at this stage, that this will have a significant effect on either lending policy or the current customer experience.

Overall, the Society has no tolerance for significant conduct risk events and a low tolerance for other conduct risk events. The Society restricts its activities to areas where appropriate expertise is in place. Any potential exposures are proportionate to the size and scale of the Society's operations and do not exceed those quantified within its operational risk appetite. The Society ensures independent assessment of conduct risk through a dedicated Conduct Oversight function. The Society has a product governance framework in place, which provides conduct risk oversight to new product developments and significant changes to existing products.

8. Remuneration

8.1. Remuneration Policy & Governance

The principles underlying the Remuneration Policy are that:

- Is it clearly linked to the business strategy, long term interests and security of the Society;
- The policies meet regulatory requirements and Corporate Governance best practice;
- A balance of fixed and variable remuneration will be used to create an acceptable relationship between risk and reward; and
- Basic pay and total remuneration will be set at a competitive level to attract and retain people of the required calibre.

8.2. Remuneration Governance

The Remuneration Committee, under delegated authority from the Board, is responsible for ensuring that the Society's Remuneration Policy follows best practice, complies with the FSA Remuneration Code, and the disclosure requirements arising under the third EU Capital Requirements Directive. The Directors' Remuneration Report is shown in the Annual Report and Accounts 2012 on pages 30 to 34. This report sets out the work and composition of the Remuneration Committee.

8.3. Code Staff

The Remuneration Policy also identifies management and staff who are considered ''Code Staff'', and "material risk takers", as defined by the Code. In addition to the Directors and General Managers, this includes senior managers in Mortgage Lending, Risk, Internal Audit, Conduct, HR, IT, Sales, Treasury, and Commercial Lending.

The table below sets out the aggregate quantitative remuneration for code staff in relation to their services for the year ended 31 December 2012:

	Number of beneficiaries No.	Fixed remuneration £000's	Variable remuneration £000's	Total remuneration £000's	Deferred variable remuneration £000's
Non Executive Directors	8	432	-	432	-
Executive Directors	4	1,047	455	1,502	187
Other Code Staff	19	2,015	400	2,415	57
Total	**31**	**3,494**	**855**	**4,349**	**244**

8.4. 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.	Delivery of corporate, personal and peer group performance objectives
Pension / benefits	Provides market competitive remuneration	Based on membership of either the Society's defined benefit or defined contribution scheme	Not applicable

9. Contacts

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

G Mitchell, General Manager Finance

At our Registered Offices:

Leeds Building Society
105 Albion Street
Leeds
LS1 5AS

Approved by the Board Audit Committee 22 April 2013

10. 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 FSA Handbook.
BIPRU	The Prudential Sourcebook for banks, building societies and investment firms which forms part of the FSA 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.

FSA	Financial Services Authority. The financial services industry regulator in the UK. In April 2013 the responsibilities of the FSA are to be split into the Prudential Regulatory Authority and the Financial Conduct Authority.
Individual Capital Adequacy Assessment Process (ICAAP)	The Group's own assessment, as part of Basel II 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.
Risk Appetite	The articulation of the level of risk that the Group is willing to take (or not take) in order to safeguard the interests of the Society's members whilst achieving business objectives.

RWA	Risk weighted assets. The value of an on or off balance sheet exposure adjusted under Pillar 1 rules to reflect the degree of risk it presents.
SREP	Supervisory Review and Evaluation Process, the FSA assessment of a firm's own capital assessment (ICA) under Basel II Pillar 2.
Subordinated Debt	A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing members but before holders of PIBS.
Tier 1 capital	A measure of financial strength as defined by the FSA. Tier 1 capital is divided into Core Tier 1 and other Tier 1 capital. Core Tier 1 capital comprises general reserves from retained profits. The book values of goodwill and intangible assets are deducted from Core Tier 1 capital and other regulatory adjustments may be made for the purposes of capital adequacy. Qualifying capital instruments such as PIBS are included in other Tier 1 capital (i.e. not Core Tier 1)