PRINCIPALITY

Pillar 3 Disclosures

Principality Group
31 December 2010

Contents

1. Overview

1.1 Background

The European Union Capital Requirements Directive came into effect on 1 January 2007. It introduced consistent capital adequacy standards and an associated supervisory framework in the European Union based on the BASEL II rules agreed by the G-10.

Implementation of the Directive in the UK was by way of rules introduced by the Financial Services Authority ("the FSA"). Among them are disclosure requirements applicable to banks and building societies which are known as Pillar 3. These are designed to promote market discipline by providing market participants with key information on a firm's risk exposures and risk management processes. Pillar 3 also aims to complement the minimum capital requirements described under Pillar 1 of BASEL II, as well as the supervisory review processes of Pillar 2.

Principality Building Society ("the Society") adopted the Pillar 1 standardised approach to credit risk and operational risk from 1 January 2008; it also became subject to Pillars 2 and 3 from that date. The disclosures in this document are on a standardised basis and in accordance with the rules laid out in the FSA Handbook BIPRU Chapter 11.

The Society has applied to the FSA for permission to use an Internal Ratings Based ("IRB") approach to retail credit risk and capital management. This will allow the Society to use its own estimates of risk, rather than values prescribed by the FSA, after certain conditions have been satisfied. The IRB approach would further enhance the Society's risk management processes.

1.2 Basis and Frequency of Disclosures

Disclosures will be issued at least annually based on the most recent published Annual Report and Accounts. Unless otherwise stated, all figures are as at 31 December 2010, the Society's financial year end.

1.3 Scope of Application

The Society is regulated by the FSA and the BASEL II Framework therefore applies to the Society and its subsidiary undertakings ("the Group"). The Group is made up of the following main trading entities:

Principality Building Society
Nemo Personal Finance Limited
Peter Alan Limited

Full details of the principal subsidiary undertakings are included in Note 22 to the Annual Report and Accounts for the year ended 31 December 2010.

There are no differences in the basis of consolidation for accounting and regulatory capital purposes. Full details of the basis of consolidation can be found in Note 1 to the Annual Report and Accounts for the year ended 31 December 2010.

1.4 External Audit

These disclosures are not subject to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Group's audited Annual Report and Financial Statements.

2. Risk Management Objectives and Policies

2.1 Principal Risk Categories

The Group is primarily a producer and retailer of financial products, mainly in the form of mortgages, secured loans and savings. These products give rise to a financial asset or liability and are termed financial instruments. As well as mortgages, secured loans and savings, the Group also uses wholesale financial instruments to invest liquid asset balances, raise wholesale funding and to manage the interest rate risk arising from its operations.

The Group's principal business objective is to provide members with the benefits of a mutual organisation through the design, manufacture and delivery of attractive savings and mortgage products. The Group aims to manage all the risks that arise from its operations, with the main risks within its business operations being credit risk, market risk (including interest rate risk), liquidity risk, operational risk, reputational risk and pension obligation risk.

The ways in which the Group manages these risks include:

- Using models and output from those models to help guide business strategies;
- Producing key risk information and indicators to measure and monitor performance;
- Using Management and Board Committees to monitor and control specific risks; and
- Using limits, and triggers to control portfolio composition.

Credit risk

Credit risk is the potential risk that a customer or counterparty will fail to meet their financial obligations to the Group as they become due.

Credit risk arises primarily from loans to residential customers, loans to commercial customers and from the liquid and investment assets held by Group Treasury in order to meet liquidity requirements and for general business purposes.

The controlled management of credit risk is critical to the success of the Group's lending and investment portfolios. The quality of individual lending decisions, the subsequent management and control, together with the application of a credit policy that reflects the "risk appetite" of the business, will all have a direct impact on the achievement of the financial objectives of the Group.

Each business area, residential first and second charge lending, commercial lending and treasury has its own individual Credit Risk Policy Statement (CRPS) setting out its risk appetite and is approved by the Group Risk Committee. The CRPS include such matters as policy scope, structures and responsibilities, definitions of risk and risk measurement and monitoring. In addition, each business area has its own detailed Procedure Manual setting out operating rules and standards.

Day-to-day management of credit risk is undertaken by specialist teams working in each business area in compliance with policies approved by the Group Risk Committee – such functions undertaken include credit sanctioning, portfolio management and management of high risk and defaulted accounts.

Market risk

Market risk is the risk that the value of income arising from the Group's assets and liabilities varies as a result of changes in interest rates or exchange rates and typically arises from imperfect matching and different interest rate features, repricing dates and maturities of mortgages, savings, and wholesale products.

Group Treasury is responsible for managing Group exposure to all aspects of market risk within the operational limits set out in the Group's Treasury Policies. Oversight is provided by the Asset and Liability Committee (ALCO). ALCO approves the market risk policy and receives regular reports on all aspects of market risk including interest rate risk and foreign currency risk. Reporting lines and terms of reference are set out clearly by the Board which also receives monthly reports from the Group Finance Director covering significant issues dealt with by ALCO.

Liquidity risk

Liquidity risk is the risk that the Group is not able to meet its financial obligations as they fall due, or can do so only at excessive cost. The objective of the Group's liquidity policy is to maintain sufficient liquid assets at all times to cover cash flow imbalances and fluctuations in funding, to maintain full public confidence in the business and to enable the Group to meet all financial obligations.

The day-to-day management of liquidity is the responsibility of Group Treasury, which manages the Group's portfolio of liquid assets and wholesale funding facilities. ALCO exercises control over the Group's liquidity through the operation of strict liquidity policies and close monitoring. The Board applies prudent policies to ensure the interests of members and depositors are protected and that public confidence in the Group is maintained.

An Individual Liquidity Adequacy Assessment (ILAA) was conducted by the Board during the year in accordance with the FSA's new liquidity guidelines. The Board is satisfied that the Group has sufficient liquid assets at its disposal, even under stressed scenarios, to meet obligations as they fall due.

Operational risk

Operational risk is the risk of a loss arising from inadequate or failed internal processes or systems, human error or external events. It also includes IT and Legal and Compliance risk.

The Group's operational risk management framework sets out the strategy for identifying, assessing and managing operational risk with senior management having responsibility for understanding how it impacts on their business areas and for putting in place the appropriate controls, for example, business continuity management, disaster recovery and insurance.

The framework is regularly reviewed and updated to confirm that the risks being managed remain relevant and appropriate to the business.

During the year, the FSA published a Consultation Paper (CP10/06) on The Assessment and Redress of PPI Complaints which provides feedback on the earlier Consultation Paper of the same name (CP09/23). The proposals apply to all types of PPI policies, which, in the Group's case, relate to secured personal lending PPI products.

Nemo Personal Finance, the secured personal lending subsidiary, joined with the British Bankers Association in a judicial review of the Financial Services Authority's proposed approach to the assessment and redress of complaints in respect of sales of Payment Protection Insurance. The outcome is important to ensure clarity over the approach being taken by the FSA in relation to PPI complaints and assess the outcome of the judicial review to ensure that Members' interests are best served. Provisions of £19.8m are held pending the outcome of the review which is already reflected in the general reserve and capital calculations in sections 3 and 4.

Reputational Risk

This is the risk of loss through damage to the Group's reputation caused by the crystallisation of other risk factors such as regulatory censure, brand contamination, market pricing etc

The Group's comprehensive risk management framework provides for the management of the key risks which may lead to damage to the Group's reputation.

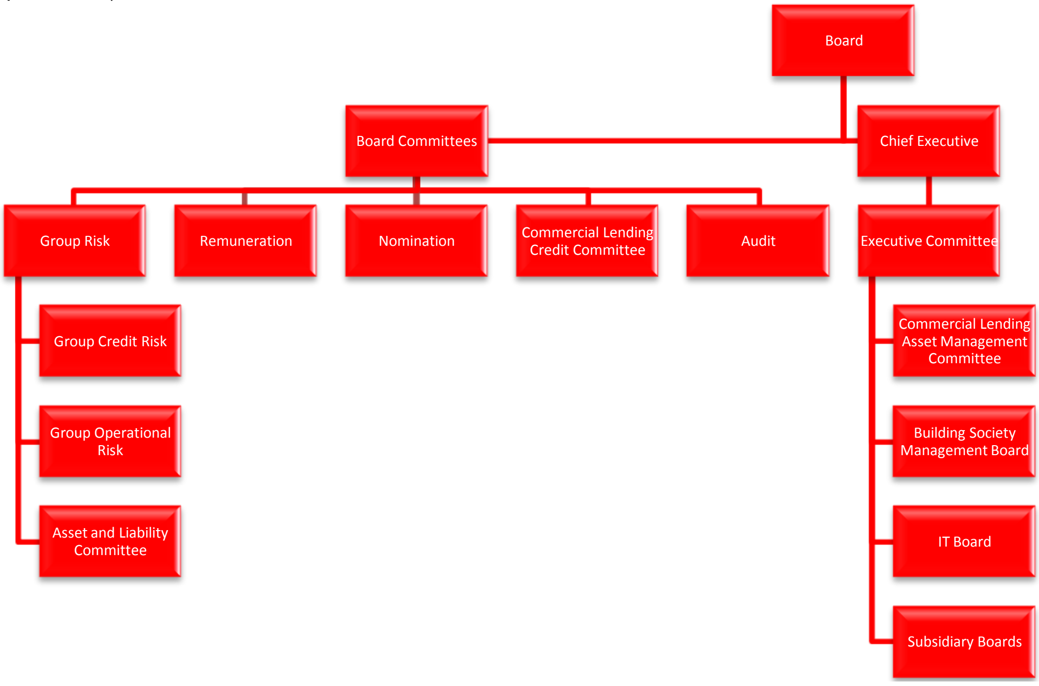
Pension obligation risk

This is the risk that the pension scheme will not have enough assets to fund employee pensions as and when they fall due. The Group has a defined benefit scheme which is closed to new members and was closed to future accruals on 31 July 2010. This was replaced with an enhanced defined contribution scheme, the Group Flexible Retirement Plan (GFRP). The Group injected £1.0m into the defined benefit scheme on closure and has committed to a further injection of £1.0m on the first anniversary of the closure to help reduce the current deficit.

The possibility exists of an impact on Group profitability from increased longevity, increasing scheme liabilities, a fall in asset values or returns, changes to discount factors used to value future pension liabilities or from changes in accounting rules or policy leading to the requirement for extra contributions.

2.2 Risk Governance

The responsibility for the overall framework of risk governance and management lies with the Board of Directors. The Board is responsible for determining risk strategy, setting the Group's risk appetite and ensuring that risk is monitored and controlled effectively. It is also responsible for establishing a clearly defined risk management structure with distinct roles and responsibilities. Within that structure, line managers are responsible for the identification, measurement and management of the risks within their areas of responsibility.



The current terms of reference of the Group's Board committees are published on the Society's website. The following summaries have been extracted from committee terms of reference as at December 2010.

Board of Directors

The Board focuses on strategic issues, control of the business, review of operational and management performance and maintaining a system of effective corporate governance. The Board operates through its regular meetings and five committees – Group Risk, Remuneration, Nomination and Commercial Lending Credit Committee and Audit.

Group Risk Committee

The Group Risk Committee (GRC) is a Board Committee, chaired by the Board's Deputy Chairman, a non-executive director. Membership includes the executive directors of the Society, the Director of Group Risk, the Managing Director of Nemo Personal Finance Limited, the Managing Director of Peter Alan Limited, the Director of Human Resources, the Head of Commercial Lending, the Director of Finance and a further non-executive director.

The GRC is responsible for assisting the Board in the development and approval of the Group Risk Appetite, risk monitoring and capital management. The functions of the committee include advising the Board of the impact of strategic developments on the risk profile of the Group, monitoring the effectiveness of the Group's risk assessment framework, ensuring adequate assessment and quantification of all material prudential risks to support current and future estimation of regulatory capital requirements.

Remuneration Committee

The principal responsibilities of the Remuneration Committee include the approval of the terms of the annual pay review for Group management and staff, the approval of the level of remuneration for the executive directors of the Society and managing directors of subsidiary companies together with determining and agreeing with the Board the framework and policy for the remuneration of those individuals. The Committee is appointed by the Board from amongst the non-executive directors, and comprises not less than three members.

Nomination Committee

The Nomination Committee assists the Board in the appointment of non-executive directors, and is responsible for making recommendations for the appointment of the Chief Executive and other executive directors. The Committee is appointed by the Board from amongst the non-executive directors and comprises not less than three members.

Commercial Lending Credit Committee

The principal function of the Committee is to sanction commercial loan applications which fall within the criteria defined by the Board. The Committee is chaired by the Chief Executive. Other members include the Group Finance Director, Director of Group Risk, Senior Managers from the Commercial Lending Division, together with the Society Chairman and three other non-executive directors. The minutes of Committee meetings are reviewed by the Board.

As part of the review of overall Committee structures that was undertaken by the Board during 2010, the Board concluded that given the level of activity in the commercial lending market currently, it was appropriate that the sanctioning of any new significant commercial lending be moved to the Group Credit Risk Committee during 2011.

Audit Committee

The Audit Committee assists the Board in ensuring the accounting and reporting systems provide accurate information, there are systems of controls to reflect the risk profile of the Group and that these are reviewed regularly and also that there is compliance with the requirements of regulatory authorities throughout the Group. The Committee is appointed by the Board from amongst the non-executive directors and comprises not less than three members.

Group Credit Risk Committee

The Group Credit Risk Committee (GCRC) is a management committee, chaired by the Group Finance Director. Membership includes the Chief Operating Officer, the Director of Group Risk, the Group Credit Risk Manager, the Head of Commercial Underwriting, the Director of Risk Commercial Lending, the Managing Director (Business Development) Nemo Personal Finance Limited, and the Head of Risk Nemo Personal Finance Limited.

The Committee is responsible for the management of the Group's Retail and Commercial credit risk in line with the Risk Appetite as set out by the Group Risk Committee and the Board. The functions of the committee include review and approval of the Retail and Commercial credit risk policies together with the development of detailed limits and triggers for credit risks within the overall Risk Appetite and the monitoring of the performance of credit risk exposures.

Group Operational Risk Committee

The Group Operational Risk Committee (GORC) is chaired by the Director of Group Risk and membership includes, amongst others, the Group Finance Director, the Chief Operating Officer, the Group Operational Risk Manager, the Director of Human Resources, the Director of IT, the Director of Risk Commercial Lending, the Operations Director Nemo Personal Finance Limited, the Head of Risk Nemo Personal Finance Limited and the Managing Director of Peter Alan Limited.

The Committee is responsible for the ownership of the Operational Risk Framework and its implementation. The duties of the committee include the development and implementation of a robust operational risk framework and operational risk policies together with oversight of the key operational risk exposures facing the Group.

Asset and Liability Committee

The Asset and Liability Committee (ALCO) is chaired by the Group Finance Director and membership includes the Executive Directors of the Society, the Director of Finance and the Treasurer. Its functions include monitoring the interest rate characteristics of retail, commercial and wholesale assets and liabilities, ensuring that the Society's liquidity meets the statutory obligations and remains within limits approved by the Board, monitoring the credit risk of assets held for liquid purpose and monitoring the performance of the funding and liquid asset portfolios. The minutes and actions are reviewed by the Board and EXCO.

Executive Director Committee

The Executive Director Committee (EXCO) is the principal management committee of the Group and membership includes all the Executive Directors, the Human Resources Director, Director of Group Risk and the Company Secretary. The functions of EXCO are to agree strategy and policies for recommendation to the Board and agree new business initiatives and associated investment appraisal for submission to the Board for approval. They also oversee strategy implementation, monitor performance of the Society and its subsidiaries, and approve changes to interest rates for Society savings and mortgage accounts, and the introduction of new products.

Commercial Lending Asset Management Committee

The Commercial Lending Asset Management Committee (CLAMCO) is chaired by the Chief Executive and membership includes the Group Finance Director, Director of Group Risk and senior management from the Commercial Lending Division. Its functions include review of commercial lending products, monitoring the performance of Society's commercial lending portfolio, review of new lending, high-risk and non-performing assets and provisioning requirements, review and approval of the commercial lending base rate and to review and approve any material amendments to procedures, policy, and documentation. The minutes and actions are also reviewed by EXCO and the Board.

Building Society Management Board

The Building Society Management Board (BSMB) is chaired by the Chief Executive and membership includes, amongst others, the Chief Operating Officer, the Head of Business Change, the Sales Director, the Head of Member Services, the Marketing Director and the IT Director. One of its principal functions is to act in an advisory capacity for the Group Risk Committee and establish a framework to formally review the performance of the scorecards, the quality of the retail lending portfolios, credit acquisition and approval, credit control and recoveries performance, bad debt provisions and credit policy within the context of the evolving business objectives.

The BSMB monitors all aspects of the Building Society performance, determines retail policies and procedures for the Building Society and approves proposals for new product design and pricing making recommendations to the Group Credit Risk Committee and Group Risk Committee in respect of changes to lending policy. BSMB also identifies and monitors all risks inherent in the Building Society operations and ensures appropriate controls are in place to manage those risks. The minutes and actions are also reviewed by EXCO.

2.3 Remuneration

In compliance with the requirements set out in the FSA's Policy Statement PS10/21 'Implementing CRD3 requirements on the disclosure of remuneration' issued in December 2010, the following tables display the 2010 remuneration for the Group's managers and members of staff whose actions have a material impact on the risk profile of the Society (Code Staff). This includes executive and non-executive directors.

Tier 2 disclosure requirements, under the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU), can be sourced as follows:

- BIPRU 11.5.18R(1, 2 & 3): The information required on remuneration decision making used for determining the remuneration policy, the link between pay and performance and the most important remuneration design characteristics are contained within the Report of the Remuneration Committee on pages 26 and 27 of the 2010 Annual Report and Accounts.

- BIPRU 11.5.18R(6 & 7): The required aggregate quantitative information on Code Staff remuneration is shown in the tables below.

Aggregate Group Remuneration, broken down by business area

Details of remuneration paid to all Group staff (including Code Staff) are as follows:

	Fixed remuneration £'k	Variable remuneration £'k	Total remuneration* £'k	Proportion of variable remuneration to total remuneration %	Number of beneficiaries
Retail financial services	19,183	2,812	21,995	13	756
Commercial lending	961	120	1,081	11	21
Secured personal lending	3,787	387	4,174	9	119
Property services	4,632	693	5,325	13	231
	28,563	**4,012**	**32,575**	**12**	**1,127**

Aggregate Code Staff remuneration data

Details of remuneration paid to Code Staff are as follows:

	Fixed remuneration £'k	Variable remuneration £'k	Total remuneration* £'k	Proportion of variable remuneration to total remuneration %	Number of beneficiaries
Group	2,087	975	3,062	32	19

* *Total remuneration = fixed remuneration, variable remuneration, director fees, car allowance, pension and benefits in kind.*

3. Capital Resources

3.1 Total Available Capital

As at 31 December 2010 and throughout the year, the Group complied with the capital requirements that were in force as set out by the FSA. The following table shows the breakdown of the total available capital for the Group as at 31 December 2010:

	Notes	2010 £m	2009 £m
Tier 1 Capital			
General reserve	1	310.6	287.9
Permanent Interest Bearing Shares (PIBS)	2	59.2	59.1
		369.8	**347.0**
Deductions from Tier 1 Capital			
Intangible assets	3	(2.2)	(2.5)
Total Tier 1 Capital		**367.6**	**344.5**
Tier 2 Capital			
Subordinated debt	4	109.9	119.7
Investment in joint venture		-	(1.9)
Total Capital Resource		**477.5**	**462.3**

3.2 Notes and General Information on Capital Resources

1. The general reserve represents the Group's accumulated profits. The regulatory capital rules allow the pension scheme deficit to be added back to regulatory capital, less associated tax.

2. Permanent Interest Bearings Shares (PIBS) are unsecured deferred shares and rank behind the claims of all subordinated noteholders, depositors, creditors and investing members of the Society. Further details about PIBS are provided in note 36 to the 2010 Annual Report and Accounts.

   The Group has no innovative Tier 1 instruments.

3. Intangible assets include software development costs where they meet certain criteria. Intangible assets do not qualify as capital for regulatory purposes and therefore have been deducted from capital.

4. Subordinated notes are unsecured and rank behind the claims of all depositors, creditors and investing members (other than holders of PIBS) of the Society. 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. Further details of the subordinated notes are included in note 35 to the 2010 Annual Report and Accounts.

4. Capital Adequacy

4.1 Capital Management

The Group has adopted the standardised approach to both credit and operational risk since 1 January 2008 in order to calculate the BASEL II Pillar 1 minimum capital requirement.

Pillar 1 capital adequacy is reviewed and approved monthly with capital forecasts formally reviewed and approved at least annually. Pillar 2 risks are considered at least quarterly with the exception of pension funding risk which is considered annually. Forecast capital requirements together with actual capital levels are considered monthly by Group Credit Risk.

The Group's minimum capital level is that which the Board considers necessary to protect unsecured creditors from loss and reflects the Group's planned activity as a whole, set in the competitive and economic environment in which it operates. The assessment of the minimum capital requirement is a combination of model outputs from its standardised systems, supplemented by the use of internal ratings systems and other risk models, together with judgement, exercised by the Board.

4.2 Internal Capital Adequacy Assessment Process

The Group undertakes an Internal Capital Adequacy Assessment Process (ICAAP) which is an internal assessment of its capital needs. The internal assessment takes account of the minimum capital requirement and other risks not covered by the minimum capital requirement (Pillar 2). The ICAAP is performed annually or more frequently should the need arise.

The outcome of the ICAAP is presented in a document covering the Society and its subsidiaries. This document covers all material risks to determine the capital requirement over a five-year horizon, and includes stress scenarios which are intended to meet regulatory requirements. Where capital is deemed as not being able to mitigate a particular risk, alternative management actions are identified and described within the ICAAP.

The ICAAP is presented to the Board for challenge and approval with the most recent review being approved in March 2010.

4.3 Capital Requirement

The Group's Pillar 1 capital requirement based on 8% of its risk-weighted assets is derived from capital held against risks from the following exposure classes.

	2010 £m	2009 £m
Retail exposure classes		
Retail financial services	99.0	89.2
Secured personal lending	25.7	27.7
Past due items	5.3	10.9
	130.0	**127.8**
Commercial exposure classes		
Commercial lending	59.0	55.8
Past due items	0.8	2.0
	59.8	**57.8**
Other exposure classes		
Financial institutions	9.9	16.8
Other		
Fixed and other assets	7.0	4.6
Credit risk minimum capital requirement	**206.7**	**207.0**
Operational risk (Standardised)	13.8	13.2
	220.5	**220.2**
Total own funds (per section 3.1)	477.5	462.3
Excess of own funds over minimum capital requirement under Pillar 1	**257.0**	**242.1**

5. Credit Risk Measurement, Mitigation and Reporting

5.1 Credit Risk Overview

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

Exposures

The gross credit risk exposure (based on the definitions for regulatory capital purposes, before credit risk mitigation) is summarised as follows:

	Average to December 2010 £'m	As at December 2010 £'m
Retail financial services	3,310.2	3,465.3
Secured personal lending	687.9	677.6
Commercial lending	1,042.2	1,034.4
	5,040.3	**5,177.3**
Treasury		
Central governments or central banks	490.8	572.0
Financial institutions	866.2	589.2
	1,357.0	**1,161.2**

The geographical distribution of these exposures at 31 December 2010 is as follows:

	UK £'m	Other European Countries £'m	North America £'m	Rest of the World £'m	Total £'m
Retail financial services	3,465.3	-	-	-	3,465.3
Secured personal lending	677.6	-	-	-	677.6
Commercial lending	1,034.4	-	-	-	1,034.4
	5,177.3	**-**	**-**	**-**	**5,177.3**
Treasury					
Central governments or central banks	545.4	26.6	-	-	572.0
Financial institutions	413.6	153.2	11.4	11.0	589.2
	959.0	**179.8**	**11.4**	**11.0**	**1,161.2**

The following table shows the residual maturity of the exposures at 31 December 2010:

	Up to 12 months £'m	1-5 years £'m	More than 5 years £'m	Total £'m
Retail financial services	159.4	613.6	2,692.3	3,465.3
Secured personal lending	41.1	165.0	471.5	677.6
Commercial lending	259.4	302.5	472.5	1,034.4
	459.9	**1,081.1**	**3,636.3**	**5,177.3**
Treasury				
Central governments or central banks	411.9	160.1	-	572.0
Financial institutions	442.7	13.1	133.4	589.2
	854.6	**173.2**	**133.4**	**1,161.2**

The maturity of exposures is shown on a contractual basis. This does not take into account any installments receivable over the life of the exposure.

5.2 Retail Financial Services Credit Risk

Credit risk is inherent in the Group's retail mortgage book. Credit risk is assessed both for the Group's existing mortgage assets and also for mortgage lending to which the Group is committed, for example through a firm commitment to lend against a mortgage offer or through a facility to increase the amount of lending on an existing mortgage.

A series of specific limits and thresholds have been established and reflect the Group's view of and appetite for risk in relation to the retail mortgage portfolio. These limits are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Board's retail lending risk appetite. The Building Society Management Board reviews comprehensive risk based information on a monthly basis and has robust controls in place to ensure that new lending complies with the Board's stated risk appetite. Limits and thresholds are reviewed regularly by Group Risk Committee and annually by the Board, and adjusted in the light of prevailing external conditions and internal experience, which reflects the profile of new business written, portfolio performance, and trends in arrears and crystallised losses.

The Group's residential loan portfolio is managed using a rating system which has been developed in line with BASEL II IRB principles and is therefore more sensitive at measuring risk than the Standardised methodology, as used in the ICAAP.

The detailed controls in place to manage credit risk in the retail mortgage book include:

- clear credit approval criteria;
- strict management of product offerings;
- application of risk parameters, product and geographic limits;
- restricted criteria for acceptance of interest only applications;
- maximum advance for loans secured by 'new build' properties and apartments, limited by LTV;
- restricted criteria for 'buy to let' products by reference to LTV and geography;
- restricted availability of products between 75% and 85% LTV;
- use of an affordability model based on prudent criteria reviewed and adjusted as appropriate;
- robust and fair arrears management processes which comply with TCF principles.

Mortgage intake is monitored daily by reference to product type, LTV, channel and property location. Subject to Building Society Management Board approval, criteria are adjusted, or products withdrawn, if trends are inconsistent with risk appetite.

Credit risk under Pillar 1 is calculated using the Standardised methodology with the Society's IRB model being used to support the Standardised calculations. In line with BIPRU 3.4, non-defaulted retail mortgage assets up to 80% LTV attract a 35% risk weighting, whilst the proportion above 80% LTV attracts a 75% risk weighting. Mortgages in default attract a risk weighting of 100% if no provisions are held and LTV is less than or equal to 80%, and 150% where the LTV is greater than 80% and no provisions are held.

5.3 Secured Personal Lending Credit Risk

The Group's subsidiary, Nemo Personal Finance Limited (Nemo), offers loans to individuals secured by way of second charge over residential property. All customers therefore have an existing first mortgage, and a typical borrower is seeking to finance the purchase of fixed assets or to consolidate existing debts. Depending on the borrower's status, loans are available from £10,000 to £100,000 and are repayable over terms between five and twenty-five years.

The Board's overall appetite for credit risk in secured personal lending is reflected in the Group's business plan and asset growth targets over the planning horizon. Limits and tolerance thresholds are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Board's risk appetite. These are subject to regular review by Group Risk Committee and adjusted in the light of prevailing external conditions and internal experience, which reflects the profile of new business written, portfolio performance, and trends in arrears and crystallised losses.

Risk appetite is articulated through Nemo Board approved specific portfolio limits which measure aggregate exposure through the proportion of new lending made in various LTV bands and this is monitored monthly. Internal targets are also used to monitor arrears performance.

Management Information is presented regularly to Nemo Board, Group Risk Committee and the Group Board. This ensures that the risk appetite, exposure and portfolio limits, product design and arrears management performance can be reviewed in the light of emerging trends.

Credit risk assessment of individual new loans is based on comprehensive policy rules primarily based on credit history, customer profile, affordability, and LTV. Other considerations include, but are not confined to, credit score, property type, the market standing of the first mortgage lender, the nature of the first mortgage, and the extent of available credit history. Exceptions are individually assessed by experienced underwriters.

Credit risk under Pillar 1 is calculated using the Standardised methodology, and risk weightings of 35% and 75% are applied to non-defaulted exposures, depending on the LTV. At the point of application no LTV is greater than 100% although historically it has been possible for capitalised PPI premiums to raise the LTV above 100%. Defaulted exposures attract a risk weighting of between 50% and 150% depending on the LTV and the level of provisions held.

5.4 Commercial Lending Credit Risk

Commercial lending activity is split between lending to private sector landlords and property investors, registered social landlords, and funding for commercial projects.

The following table provides an analysis of commercial lending exposure by industry sector as at 31 December 2010:

	Drawn commitments £m	Un-drawn commitments £m	Total £m
Registered social landlords	135.4	48.8	184.2
Residential investments	220.2	6.5	226.7
Retail outlets, offices and industrial	597.0	26.5	623.5
	952.6	**81.8**	**1,034.4**

Limits and tolerance thresholds are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Board's commercial lending risk appetite. These are subject to monthly review by CLAMCO and quarterly review by Group Risk Committee. They are adjusted in the light of prevailing external conditions and internal experience, which reflects the profile of new business written, portfolio performance, and trends in arrears and crystallised losses.

The Commercial Lending Division operates a relationship management approach - each customer has a specific lending manager who is responsible for submitting credit applications for that customer (whether existing or new customer) and for managing the customer/lender relationship. Each lending manager is a highly experienced property lender with a strong track record gained in a traditional banking environment and/or within the division itself over the past 6 years.

Commercial lending exposures are underwritten judgementally against comprehensive and well established criteria which are articulated in the Division's Policy Manual. A risk grading framework has been developed, and the entire portfolio is risk graded.

Credit risk capital for the Society's commercial lending under Pillar 1 is determined by reference to the Standardised methodology. Risk weights of 100% are applied to lending secured on commercial property and risk weights of 35% or 100%, depending on LTV, are applied to residential lending. Exposures to registered social landlords are risk weighted at 35%.

5.5 Treasury Credit Risk

The Group has exposures to banks, building societies and sovereigns in its non-trading book treasury portfolio. The Group does not operate a trading book. Exposures in the treasury portfolio are held for liquidity purposes or in the case of fair value exposures on derivatives, for hedging purposes. The Group's policy is to carry an amount of liquid assets equivalent to between 16% and 24% of savings, deposits and loans (SDL).

The Board's policy on managing credit risk relating to treasury exposures is set out in detail within the Group's Treasury Policy Statement (TPS). In particular, credit limits are set for individual counterparties based on external credit ratings (Moody's and/or Fitch). Institutions, including building societies which do not have external ratings, are individually assessed and approved by the Board. Limits are also in place for instrument type and country to mitigate against concentration risk arising in the treasury portfolio.

Limits and tolerance thresholds are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Board's risk appetite. These are subject to monthly review by ALCO and adjusted in the light of prevailing external conditions and internal experience.

The management of credit risk relating to treasury exposures is set out in detail within the Group's TPS. In particular:

- credit ratings are obtained for all bank or sovereign counterparties;
- investment is limited to counterparties on a list approved by ALCO;
- exposures are monitored on a real-time basis, with exposure reports run at the end of each day;
- ALCO receives reports at the end of every month of exposures and limits for all counterparties; and
- The TPS defines clearly the responsibilities of individuals involved in the management of treasury assets and the action plans and escalation processes in place in relation to credit rating downgrades and other indicators of worsening credit risk.

The following tables show the exposure values associated with each credit quality step for treasury exposures under the standardised approach:

Central governments or central banks

Credit step quality	Risk weighting	Moody's ratings	Fitch's ratings	Exposure values £m
1	0%	Aaa to Aa3	AAA to AA-	572.0

Financial Institutions

Credit step quality	Risk weighting	Moody's ratings	Fitch's ratings	Exposure values £m
1	20%	Aaa to Aa3	AAA to AA-	441.2
2	20%/50%	A1 to A3	A1 to A3	122.4
3	20%/50%	Baa1 to Baa3	BBB+ to BBB-	25.6
				589.2

5.6 Impairment Provisions

Assets held at amortised cost

The Group assesses at each balance sheet date whether, as a result of one or more events that occurred after initial recognition, there is objective evidence that a financial asset or group of financial assets are impaired. Evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficultly, default or delinquency in interest or principal payments or the debt being restructured to reduce the burden on the borrower.

The Group first assesses whether objective evidence of impairment exists either individually for assets that are separately significant or collectively for assets that are not separately significant. If there is no objective evidence of impairment for an individually assessed asset it is included in a group of assets with similar risk characteristics and collectively assessed for impairment.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the carrying amount of the assets and the present value of estimated future cash flows, discounted at the asset's original effective interest rate. The resultant provisions are deducted from the appropriate asset values in the balance sheet.

The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any difference between loss estimates and actual experience.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the provision is adjusted and the amount of the reversal is recognised in the income and expenditure statement.

Where a loan is not recoverable, it is written off against the related provision for loan impairment once all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the impairment loss recorded in the income and expenditure statement.

Loans subject to individual impairment assessment are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

The following table shows the net past due loans and provisions for impaired exposures (equivalent to value adjustments) and charges to the income and expenditure statement for the year to 31 December 2010.

	Retail financial services £'m	Secured personal lending £'m	Commercial lending £'m	Total £'m
Neither past due nor impaired	3,349.0	627.1	1,019.8	4,995.9
Past due:				
Up to 3 months	85.7	29.7	7.1	122.5
3 to 6 months	19.6	7.9	-	27.5
6 to 12 months	6.9	3.1	4.9	14.9
Over 12 months	0.9	9.8	2.6	13.3
Possessions	3.2	-	-	3.2
	116.3	**50.5**	**14.6**	**181.4**
Total exposures	**3,465.3**	**677.6**	**1,034.4**	**5,177.3**
Provisions	5.7	35.5	14.3	55.5
Charge for the year	**2.8**	**9.8**	**9.6**	**22.2**

For the purposes of this table, past due is defined as one day or over. The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due. Past due loans, impaired loans and provisions are all UK based.

The following table summarises the movement in impairment provisions for the year ended 31 December 2010.

	Individual provisions £'m	Collective provision £'m	Total £'m
Balance at 1 January 2010	42.6	6.7	49.3
Charge for the year	17.0	5.2	22.2
Write-offs	(16.0)	-	(16.0)
Balance at 31 December 2010	**43.6**	**11.9**	**55.5**

Available for sale assets

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets are impaired. As at 31 December 2010, none (0.0%) of the treasury portfolio exposure was either past due or impaired. There are no assets that would otherwise be past due or impaired whose terms have been renegotiated. In assessing impairment, the Group evaluates among other factors, the normal volatility in valuation, evidence of deterioration in the financial health of the investee, industry and sector performance and operational and financing cash flows.

The Group has a £10.0m (2009: £10.0m) exposure to Anglo Irish Bank Corporation Ltd due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. The Group continues to monitor this exposure in light of the ongoing political and economic situation in Ireland but, based on the current guarantee in place, we do not consider any impairment to be necessary at this time. Further detail is provided in note 2 to the Annual Report and Accounts.

5.7 Credit Risk Concentrations

Policy limits have also been set to enable the management of treasury credit risk concentration. These limits are actively monitored and relate to aggregate counterparty, country and asset class exposures.

For residential mortgages, LTV concentration limits are set within policy. Geographic concentration of risk is also monitored, but no specific parameters are deemed necessary for domestic lending. The Group operates across the majority of the UK with a bias towards Wales. As at 31 December 2010, approximately 37.3% of residential exposures by account and 37.5% by value were concentrated in Wales.

By their nature, residential mortgages comprise a large number of intrinsically highly diversified small loans and have a low volatility of credit risk outcomes.

For commercial lending, exposure to each of the principal lending categories is monitored and total portfolio exposures constrained via an internal limit set at 17.5% of the Society's total risk weighted assets. Limits are also set restricting the aggregate exposure to any single counterparty or group of closely connected counterparties. Concentration of risk within the portfolio is monitored using indicators such as maturity, industry sector and geography. In terms of counterparty concentration, the largest single commercial customer, including un-drawn commitments, represents 4% of the commercial book.

5.8 Credit Risk Mitigation

The Group uses a wide range of techniques to reduce credit risk associated with its lending. The most basic of these is performing an assessment of the ability of the borrower to service the proposed level of borrowing without distress. However the risk is further mitigated by obtaining security for the funds advanced.

Residential mortgages

Residential property is the Group's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolio. All mortgage lending activities are supported by an appropriate form of valuation using typically either an independent firm of valuers for mortgages and loans outside Wales or in-house valuation for loans and mortgages within Wales.

All residential property must be insured to cover property risks and this may be effected through a third party. Additional protection is also afforded to borrowers through optional payment protection insurance.

Commercial mortgages

Commercial property is the Group's main source of collateral and means of mitigating credit risk inherent in its commercial mortgage portfolio. Collateral for the majority of commercial loans comprises first legal charges over freehold and long leasehold property but guarantees may also be taken as security. Guarantees and other off-balance sheet security are not used in the calculation of Pillar 1 capital requirements therefore the exposure values before and after credit risk mitigation are identical.

For property-based lending, supporting information such as professional valuations are an important tool to help determine the suitability of the property offered as security and, in the case of investment lending, generating the cash to cover interest and repay the advance. All valuations are undertaken by members of an approved panel of independent valuers.

A syndication strategy may be adopted to avoid large concentrations of risk. Hedging strategies are considered as part of the approval process and unless borrowers have chosen fixed rates, their exposure to interest rate movements must be deemed acceptable.

Insurance requirements are always fully considered as part of the application process and the Society ensures that appropriate insurance is taken out to protect the property.

Treasury

The credit limits for each counterparty are derived using a matrix based on external credit ratings. The limits are then calculated by reference to the general reserves of the Group, where the maximum exposure for each institution will be determined by the external rating. Typically all banks will have a minimum rating of A-/A3 and all building societies will be assessed individually. Specific limits may not exceed 10% of the institution's equity without prior approval of the Board. Subsidiaries of any institution will be assessed as a separate entity according to its own ratings. However, in those circumstances the overall exposure cannot exceed the aggregate group limit.

The net exposure value of derivatives as at 31 December 2010 was a liability of £14.2m with £19.3m deposited with financial institutions as collateral.

6. Market Risks

6.1 Market Risk Overview

Market risk is the risk that the value of income arising from the Group's assets and liabilities varies as a result of changes in interest rates or exchange rates and typically arises from imperfect matching and different interest rate features, repricing dates and maturities of mortgages, savings, and wholesale products.

Market risk incorporates a range of risks, but the most significant elements are interest rate risk and foreign currency risk.

6.2 Interest rate risk

Interest rate risk is the risk of loss resulting from adverse movements in market interest rates.

The Group is exposed to interest rate risk principally arising from the fixed rate mortgage and savings products that it offers. The various interest rate features and maturities on these products, and the use of wholesale funds to support these products, create interest rate risk exposures due to the imperfect matching of interest rates between different financial instruments and the timing differences on the re-pricing of assets and liabilities.

Another significant form of interest rate risk arises from the imperfect correlation between re-pricing of interest rates on different assets and liabilities – often referred to as basis risk. The basis risk on the Group's balance sheet arises from administered liabilities which are typically priced relative to base rate, but are invested in money market assets earning a LIBOR return.

Use of derivatives

The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, interest rate options and interest rate caps.

The Group uses derivatives in accordance with the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes and, accordingly, they are used exclusively to reduce the risk of loss arising from changes in interest rates, foreign exchange rates or other factors specified in the legislation.

The Group's Treasury Policy Statement describes processes and controls in place to manage interest rate risk, including:

- monthly agreement at ALCO of the Group's view of the interest rate outlook to act as a basis for liquidity investment and hedging decisions for the coming month;
- day to day review of exposures and market outlook by both the Treasury and Balance Sheet Risk teams and fine-tuning of ALCO's view as appropriate, with agreement from the Group Finance Director;
- all new mortgage and savings ranges reviewed by the Balance Sheet Risk team to determine appropriate hedging activity;
- all new mortgage and savings ranges signed by either the Group Finance Director or Finance Controller (Building Society and Commercial Lending), to ensure appropriate pricing and to ensure risks are appropriately identified;
- monthly full review of interest rate risk exposures and hedging by the Balance Sheet Risk team, to review actual outcomes against plans for the month and allow hedging proposals to be formed;
- monthly reporting to ALCO, chaired by the Group Finance Director and attended by senior managers including the Group Chief Executive and Chief Operating Officer; and
- the Treasury and Balance Sheet Risk teams involved in interest rate risk management have gained extensive experience and are monitored closely through robust governance processes.

In assessing interest rate risk exposure relating to fixed-rate mortgage assets it is necessary to make assessments of likely prepayment. The risk of prepayment assumptions being inaccurate is mitigated if too low, by additional unexpected early redemption charges, and if too high through additional interest income.

These effects broadly offset each other; although timing of cash flows differ (early repayment charges not received in year 1 will be offset by additional margin over several years).

The Group uses interest rate gap sensitivity analysis to assess exposure to interest rate risk. This analysis shows the Group's exposure to interest rate risk in terms of the net risk after taking account of management action to hedge inherent exposures. The Group's Finance function is responsible for reporting monthly the Group's interest rate risk exposure to ALCO.

At 31 December 2010, the Group's interest rate gap sensitivity given a 200bp parallel shift in interest rates was £7.98m, taking account of the effect of derivatives.

6.3 Currency risk

Currency risk is the risk of a loss resulting from movements in foreign exchange rates or changes in foreign currency interest rates, particularly on the Group's non-sterling funding.

Currency risk is managed through the use of derivatives, primarily in the form of cross currency swaps.

In line with the prudential guidance applying to all building societies, and after taking account of foreign currency derivatives, the Group has no substantial net exposure to foreign exchange rate fluctuations or changes in current interest rates. ALCO sets limits on the level of exposures by currency which are monitored daily.

7. Operational Risk

The Group has adopted the standardised approach to operational risk and has applied the industry standard definition namely: 'the risk of loss arising from inadequate or failed internal processes, people and systems or from external events'. This has been aligned to the Group corporate risk registers and ensures that there is appropriate oversight of the key risk exposures facing the Group.

Risk appetite for all prudential risk categories expressed by the Board by reference to the most significant net risks recorded on the Group's risk registers. Each risk on the risk register is assessed using a 'Probability/Impact' matrix which is used to quantify, in financial terms, potential risk to the Group, after taking into account the effectiveness of management controls, and other forms of mitigation.

The risk registers are subject to monthly review by each risk owner (Executive Management) and Group Risk Department with the highest scoring risks for the Group as a whole reported to the Board each month. For individual risks which are deemed unacceptable, remedial action is taken, where such falls within the Group's control [this is particularly relevant in relation to other prudential risk categories e.g. strategic risk, which may be influenced by macroeconomic factors] and which will include introducing or enhancing the operational controls and/or risk mitigants related to the individual risk, or taking appropriate action to eliminate the risk altogether.

The risk registers and risk assessment framework are subject to review by Group Internal Audit. The focus and prioritisation of the Internal Audit annual programme is linked closely to an assessment of the risk registers and highest scoring risks.

The effectiveness of management controls are reviewed by the Director of Group Risk and the Operational Risk Manager by reference to key risk indicators and operational loss reports. Where appropriate, initial challenge to individual risk owners is provided by Group Risk, and subsequently by EXCO prior to completion of the Group key risk report which is submitted to the Board each month.

Operational losses are recorded as they arise, and reported to Group Risk Department each month. A report of all operational losses and 'near misses' is submitted to Group Operational Risk Committee on a quarterly basis. Group Risk Committee will determine whether any review of internal procedures or controls is required in order to mitigate against any potential recurring operational losses.

Under the Basel Capital Accord, for the standardised approach to operational risk, gross income is regarded as a proxy for the operational risk exposure within each business line. The capital charge for operational risk is calculated separately, based upon gross income over the proceeding three years.

8. Glossary of Terms

Basel II framework	The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. The Accord is structured around Pillars 1, 2 & 3, became law in the EU Capital Requirements Directive, and was implemented in the UK in 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.
CQS (Credit Quality Steps)	A credit quality assessment scale as set out in BIPRU 3.4 (Risk weights under the standardised approach to credit risk) and BIPRU 9 (Securitisation).
Code Staff	Executive and non-executive directors, senior management and members of staff whose actions have a material impact on the risk profile of the Group.
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 meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.
ECAI	External Credit Assessment Institution. An ECAI (e.g. Moody's, Standard and Poor's and 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.
Guarantee	An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.
ICA	Internal Capital Assessment. The document produced as a result of the ICAAP.
ICAAP	Internal Capital Adequacy Assessment Process. The process the Group follows to determine capital requirements under Basel II Pillar 2.
ICG	Individual Capital Guidance. The minimum amount of capital the Group should hold as set by the FSA under Basel II Pillar 2.
Interest rate risk	Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates.
LIBOR	London Inter Bank Offered Rate.
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 in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, 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.
Netting	The ability to reduce credit risk exposures by offsetting the value of any deposits against loans to the same counterparty.
Operational risk	Operational risk is the risk of loss arising from inadequate or failed internal processes, people and systems or from external events.
PFE	Potential Future Exposure. An estimate of the exposure relating to the future cash flows of derivatives, it is based upon the remaining duration and the type of the derivative.
PIBS	Permanent Interest Bearing Shares. Unsecured, deferred shares that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors and creditors of the Society.
Pillar 1	The part of the Basel II Framework which sets out the regulatory minimum capital requirements for credit and operational risk.
Pillar 2	The part of the Basel II Framework which sets out the processes by which financial institutions review their overall capital adequacy. Supervisors then evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments. This includes all risks (including Pillar 1 risks) - ICG is an outcome from Pillar 2.
Pillar 3	The part of the Basel II Framework which sets out the disclosure requirements for firms to publish details of their risks, capital and risk management. The aims are greater transparency and strengthening market discipline.
Provisions	Amounts set aside to cover losses associated with credit risks.
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.
Stress testing	Various techniques that are used to gauge the potential vulnerability to exceptional but plausible events.
Subordinated debt	A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing members (other than holders of PIBS).
The Standardised Approach (credit risks)	The standardised approach to credit risk, calculated by applying varying RWA percentages to credit exposures, depending on the underlying risk.
The Standardised Approach (operational risks)	The standardised approach to operational risk, calculated using three year historical net income multiplied by a factor of 12-18%, depending on the underlying business being considered.

Total Remuneration	The sum of fixed pay, variable pay, director fees, car allowance, pension and benefits in kind.
Value at Risk (VaR)	A statistical technique to estimate the maximum loss that could be made for a given factor of confidence over a set time horizon under normal market conditions.