Pillar 3 Disclosures

for Year Ended 31 December 2009

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1 Overview

1.1 Background

The European Union Capital Requirements Directive came into effect on 1 January 2007. Implementation of the Directive in the UK was by way of rules introduced by the Financial Services Authority ("the FSA").

The Capital Requirements Directive implemented in EU law the changes to the capital adequacy regime proposed in the Basel 2 framework, agreed by the G10 and implemented across many nations worldwide. The new framework consists of three 'pillars'. Pillar 1 of the new standards sets out the minimum capital requirements firms are required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1 and demonstrate their ability to manage their capital position through a period of stress. The aim of Pillar 3 is to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

Yorkshire Building Society ("YBS") 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.

1.2 Basis and frequency of disclosures

This disclosure document has been prepared by YBS in accordance with the requirements of Pillar 3. Unless otherwise stated, all figures are as at 31/12/2009, our financial year-end.

1.3 Scope

YBS is an EEA parent institution that is regulated in the UK by the FSA. The Basel II Framework therefore applies to YBS and its subsidiary undertakings (together "the Group").

Consolidation of the Group position for regulatory capital purposes (the "Capital Group") is similar to the statutory consolidated Group position produced for the Annual Report and Accounts but differs in the following respects:

- There are two Group companies that, due to the nature of their activities, are outside the scope of the Basel II framework to be included for capital purposes, but are fully consolidated in the Annual Report and Accounts. These companies are immaterial in their impact on Group capital positions.
- Some definitions of assets and capital differ between the regulated capital adequacy rules and the statutory accounting balance sheet standards.

One of the undertakings included in the Capital Group is Yorkshire Guernsey Limited, which is regulated by the Guernsey Financial Services Commission ("GFSC") and has its own regulatory capital requirements, hence it is required to retain a minimum level of capital on Guernsey for the protection of its creditors. With that exception, there are no restrictions and impediments to the movement of capital between legal entities within the consolidated Capital Group, and there is no material capital surplus or deficiency for legal entities that comprise the statutory accounting group but not the Capital Group.

Under FSA rules, YBS as a legal entity must also maintain a solo capital requirement. In this area, YBS has made use of the provisions laid down in BIPRU 2.1 (Solo consolidation) to provide capital resources and requirements to the FSA under a solo consolidated basis. This enables both the major intra group exposures and investments of YBS in its subsidiaries within the solo-consolidated group to be eliminated when calculating capital resource requirements and the reserves of such solo subsidiaries to be aggregated to the parent when calculating capital resources.

The principal subsidiaries included under solo consolidation are:

- Yorkshire Building Society
- Accord Mortgages Limited
- Yorkshire Investment Services Limited
- Yorkshire Building Society Covered Bonds LLP

Full details of the principal subsidiary undertakings are included in Note 10 to the Annual Report and Accounts.

1.4 Location and verification

These disclosures have been reviewed by the Group's Risk Committee on behalf of the Group's Board and are published on the Group's corporate website (www.ybs.co.uk). The disclosures are subject to periodic internal independent review by Group Internal Audit but are not subject to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Group's Annual Report and Accounts.

1.5 Recent Developments – Chelsea Building Society

Yorkshire Building Society merged with Chelsea Building Society on 1 April 2010.

The enlarged society has assets of approximately £35bn and, although the capital ratios of the enlarged Group will initially be below those of YBS on a standalone basis, the Group remains one of the most strongly capitalised of any UK building society or bank.

As part of the merger agreement, a capital exchange was negotiated with Chelsea's existing subordinated bond holders which has the result of supporting the Group's tier one capital position. This capital exchange involved the use of a new form of contingent convertible capital or 'CoCo'.

A consolidated Pillar 3 disclosure representing the enlarged Group will be produced as soon as practicable after the completion of the 2010 interim results and 2010 ICAAP.

2 Risk Management Objectives and Policies

2.1 Risk management objectives

The activities of financial institutions inevitably involve a degree of risk taking. With this in mind the Group's risk management framework and governance structure is intended to provide appropriate and comprehensive monitoring, control and ongoing management of the major risks to which it is exposed, so as to ensure the security of its members' funds. The Group's ability to properly identify, measure, monitor and report risk is critical to its soundness and its ability to provide value to its membership.

2.2 Risk appetite

The Board has defined its risk appetite to establish how far the Group is prepared to go up the entity-wide risk curve, always seeking to balance risk and reward whilst remaining within acceptable risk exposure limits. At a more pragmatic level, the Group's risk appetite is used for several practical purposes:

- To provide an objective measure against which the Group's various risk committees can measure the Group's current and proposed risk positions, ensuring compliance with the strategic direction set by the Board
- To provide a set of measures against which the management can look to optimise the risk versus reward equation
- To provide a base for setting objective measures for different parts of the business, giving them clarity over the parameters within which they must operate.

The Group's overall statement of risk appetite is:

"The organisation will not take risk positions that threaten its ability to remain a sustainable and independent mutual organisation.

That implicit within this is an assumption that we will not take positions that might:

- **result in a loss for the members themselves; or,**
- **threaten the sustainability of our market position and ability to grow"**

Underneath this overall statement of appetite are a number of metrics that are used to measure actual levels of different risks within the organisation, covering:

- capital adequacy
- external ratings
- income volatility
- balance sheet risk
- profitability
- strength of the control framework and fulfilment of regulatory obligations

A risk that, at the net level, contradicts one of these statements is deemed to be outside of appetite.

2.3 Risk management framework

The following principles underpin the Group's approach to its risk management framework:

- It remains the Board's responsibility to assess, monitor and react to the risks faced and taken by the Group. Nevertheless the Board strongly believe that responsibility for managing risk lies with operational management. Therefore the structures and processes put in place by the Board aim to achieve a balance between the retention by the Board of overall responsibility for setting the Group's risk appetite and monitoring performance against this, and the pragmatic delegation of authority and responsibility for the assessment and control of risks to management.
- It is imperative that senior management be closely involved in both the design and maintenance of risk management systems, and in the ongoing monitoring of risk positions. The most effective and efficient manner to

achieve this is to embed senior management within the risk governance process, above and beyond their individual operational responsibilities for risk management.

- There is a fundamental need to maintain a clear distinction, within the over-arching regime of risk management, between:
  - The "risk takers" – i.e. those within the senior management team and within individual business units or portfolios responsible for assessing and accepting a specific risk against the commercial environment within which the Group must operate; and,
  - The "risk monitors" – i.e. those responsible for measuring and reporting the current and forecast risk positions and mitigants. This is achieved through adoption of a "three lines of defence" model, as described in section 2.5 below, and appropriate systems of Board and management/committee oversight.

2.4 Risk identification, measurement and control

The Group aims to identify the major sources of risk to its assets and operations and to deploy, in response to these, appropriate measures to control and monitor those risks. To this end the Group has developed a matrix of the key risks it faces, being those that, in the view of the Board and senior management, represent the greatest threat to the Group's sustainability in terms of combined impact and likelihood. At an operational level, these principal risks and uncertainties can be considered in a number of categories, around which the Group has constructed its systems of monitoring and control, these categories being:

- Legal and regulatory
- Credit
- Market, liquidity and financial
- Governance and strategy
- Product and service
- Process and systems
- People and resources
- Theft and financial crime

The individual risks, and the Group's response to them, are considered in more detail within the context of the risk committees established to oversee them under delegated authority of the board, see below. The risk categories into which the key risks to the Group can be categorised are in turn considered as part of the Group's ICAAP (internal capital adequacy assessment process).

2.5 Risk oversight

The Group Risk Committee has been established by the Board to oversee the Group's risk governance framework and to provide an entity-wide perspective on all risk matters. It comprises non-executive directors and senior executives and is chaired by a non-executive director. It is responsible for establishing appropriate risk management committees as detailed below. Its terms of reference include:

- Establishing methods for measuring risk appetite and positions
- Recommending for Board approval the Group risk management policy (see below for further details)
- Monitoring of risk positions, in particular for compliance with Group risk management policy and the statement of risk appetite
- Ensuring that the Group's internal capital adequacy assessment process accurately reflects its risk profile.

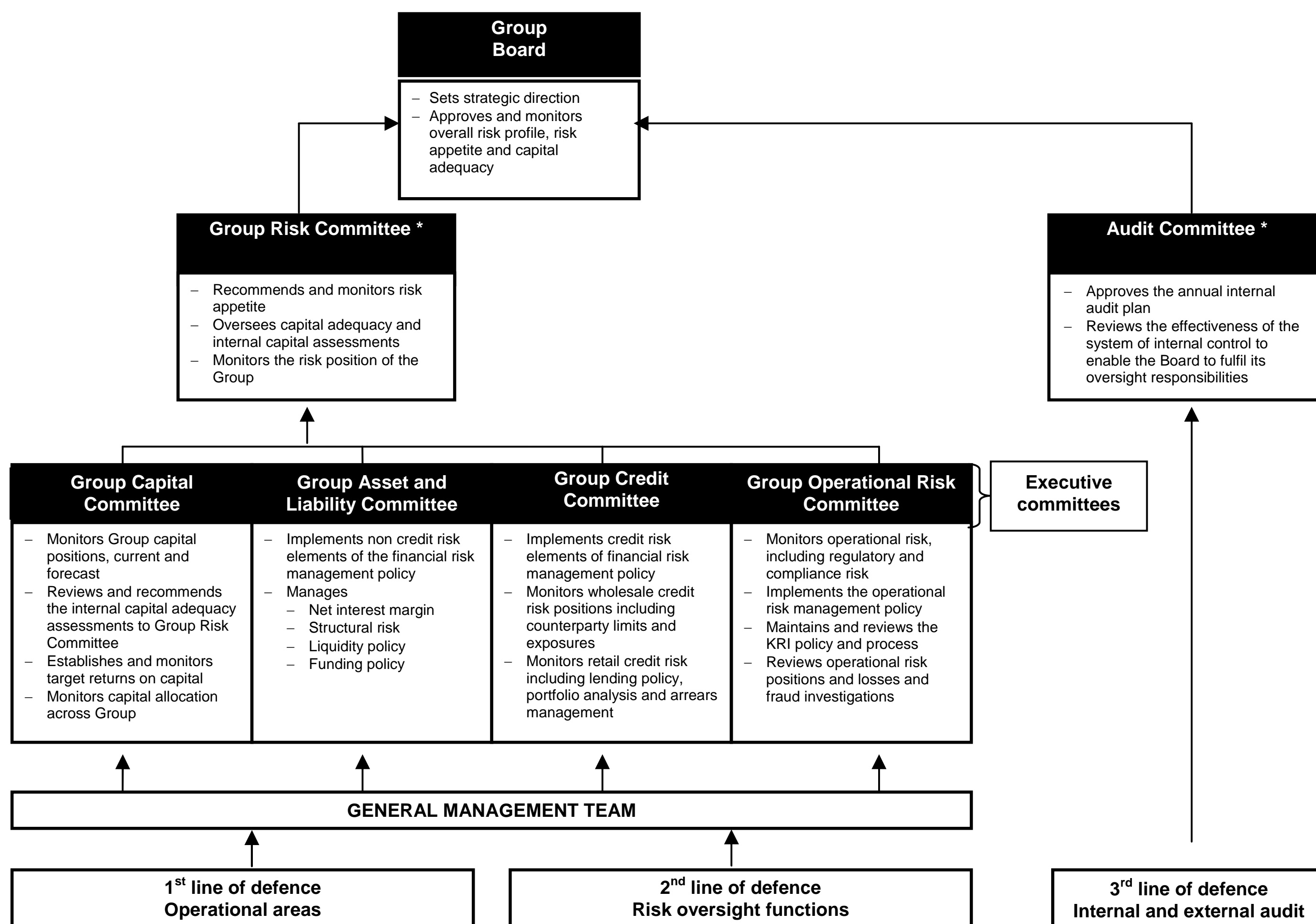
The Group Risk Committee has put in place a risk management policy which documents the Group's approach to risk management across its major risk categories, the governance structure it has put in place, responsibilities of individual risk committees and functions within the risk framework and a comprehensive set of limits and triggers used by the Board and its sub committees to monitor the risk profile of the Group against its risk appetite.

The Group's risk management policy provides a "three lines of defence" model for risk management, as follows:

- The first line of defence is operational management, who manage risk by maintaining appropriate controls on a daily basis.

- The second line of defence comprises oversight functions including advisory functions that set and maintain policy, and Group Risk. These functions cover all significant risk areas, such as credit risk, interest rate risk, operational risk and liquidity risk. Their role is described more fully under “Risk monitoring and reporting” below.
- The third line of defence is independent assurance and challenge, which includes Group Internal Audit and the external auditors. Via the Audit Committee, Group Internal Audit assists the Board in fulfilling its oversight responsibilities.

The risk governance structure of the Group and operation of the three lines of defence is illustrated in the following diagram:



***** - These committees (along with the Group Board) include both executive and non-executive representation. All other committees have executive representation only.

2.6 Risk monitoring and reporting

The Group maintains an independent risk management function (Group Risk) that is responsible for ensuring that appropriate risk management techniques and measures are deployed, and that they reflect leading practice and remain commensurate with the Group’s strategic aims, its appetite for risk and the actual risks it faces at any time. The Group Risk function provides periodic independent reports on risk positions and risk management activities for consideration by the General Managers of the business, the Group Risk Committee, its sub-committees and the Board. The General Manager Risk and Planning provides a formal update to each board meeting covering all areas of risk management, including both routine reporting and ad hoc issues.

3 Capital Resources

3.1 Total available capital

At 31 December 2009 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 capital group and solo-consolidated group as at 31 December 2009:

Table 1 - Capital resources	Group £m	Solo £m
Tier 1		
General reserve	975.6	868.6
Permanent Interest Bearing Shares (PIBS)	159.3	159.3
Pension fund adjustment	(0.6)	(0.6)
Intangible fixed assets	(10.6)	(10.3)
Investments in non consolidated subsidiaries[a]	(0.5)	-
Investments in non solo-consolidated subsidiaries[b]	-	(3.9)
Total tier 1 capital	**1,123.2**	**1,013.1**
Tier 2		
Subordinated liabilities	111.7	111.7
Collective provisions for impairment	3.7	3.7
Investments in non consolidated subsidiaries[a]	(0.5)	-
Investments in non solo-consolidated subsidiaries[b]	-	(3.9)
Total tier 2 capital	**114.9**	**111.5**
Other items excluded	(0.2)	(0.2)
Total capital available	**1,237.9**	**1,124.4**

[a]*– As Yorksafe and YKS are outside the scope of the "capital group" the capital held in these subsidiaries is not included in capital and is consequently deducted 50% from Tier 1 and 50% from Tier 2.*
[b] *– Under solo consolidation, investments are not included in capital and are consequently deducted 50% from Tier 1 and 50% from Tier 2.*

3.2 Tier 1 capital

Tier 1 capital comprises the general reserve, Permanent Interest Bearing Shares (PIBS) and adjustments for items reflected in the general reserve which are treated separately for capital adequacy purposes.

- PIBS are unsecured deferred shares and rank behind the claims of all subordinated noteholders, depositors, creditors and investing members of YBS. Further details about PIBS are provided in note 29 to the Annual Report and Accounts.
- An adjustment is made to Tier 1 capital in respect of the Group's defined benefit pension obligations. For accounting purposes, the present value of obligations less the fair value of plan assets in respect of the YBS pension fund ("the fund") is included as an asset or liability as appropriate and hence is included in the general reserve. Where a liability exists, this amount may be reversed out of the Group's capital and be replaced by the 'deficit reduction amount'. The deficit reduction amount is equivalent to the additional funding that is to be paid to the fund over the next 5 years for the purpose of reducing the liability. At 31 December 2009, this adjustment gave rise to a net decrease in Tier 1 capital of £0.6m
- An adjustment is also made in respect of intangible assets. For accounting purposes software development costs are capitalised as intangible fixed assets where they meet certain accounting criteria. However, because intangibles do not qualify as capital for regulatory purposes, intangible assets are reversed out of capital. At 31 December 2009, £10.6m had been deducted from capital in respect of intangible assets.

3.3 Tier 2 capital

Tier 2 capital comprises the Group's qualifying subordinated liabilities, the collective impairment provision, and adjustments for items treated separately for capital adequacy purposes.

- Subordinated notes are unsecured and rank behind the claims of all depositors, creditors and investing members (other than holders of PIBS) of YBS. More details of the subordinated liabilities are included in note 28 to the Annual Report and Accounts.
- To the extent that collective provisions for impairment have been recognised in the income and expenditure account these may be added back to tier 2 capital.

4 Capital Adequacy

4.1 Capital management

The Group's management of its capital is based on a number of key principles:

- The maintenance of sufficient regulatory capital to meet solvency requirements and to ensure the Group's risk appetite is not breached. This relates to both current and projected capital (i.e. the levels of capital in the light of the Group's strategy and corporate plans, current capital and risk weighted assets combined with future balance sheet movements and profitability, and with the potential for raising external capital)
- The maintenance of sufficient capital strength within the balance sheet to provide comfort to interested third parties, and to generate a degree of funding cost benefit in the retail and wholesale markets, in particular with regard to retail savings customers and external credit rating agencies, and
- The efficient and effective allocation of capital across the Group's operations. Again, this needs to be commensurate with its status as a deposit taker and a mutual organisation.

The Group considers its overall capital requirement as part of its internal capital adequacy assessment process (ICAAP), which is detailed below.

Summarised regulatory capital positions and forecasts (including forecasts under stress scenarios) are reported monthly to the Board and quarterly to the Group Risk Committee. The Group Capital Committee, a sub-committee of the Group Risk Committee, receives detailed reports of the capital positions and the results of stress testing on a quarterly basis. Based on these, the Group Capital Committee considers whether capital plans should be reviewed. Business stream-specific reports of regulatory capital are also included in the monthly packs of the appropriate risk committees e.g. Group Credit Committee.

Regulatory capital covers the following risks across the capital Group:

- Pillar 1 risks (i.e. credit risk and operational risk). The minimum capital requirement is calculated using regulatory-prescribed risk weightings laid out in the FSA's rulebooks. The Group has adopted the standardised approach to both credit and operational risk since 1 January 2008 in order to calculate the Pillar 1 minimum capital requirement.
- Pillar 2 risks (i.e. all other material risks for the Group which does not require the provision of regulatory capital under Pillar 1). Each material risk that the Group has identified outside the scope of Pillar 1 (e.g. pension obligation risk, interest rate risk, concentration risk) has undergone considered and vigorous stress testing to calculate an economic value for each of the material risks across the Group.
- Capital Planning. The Group calculates an additional capital requirement (in addition to the Pillar 1 and Pillar 2 amounts above) representing the amount by which the Group's capital surplus would reduce through a 'severe but plausible' stress scenario over the Group's planning horizon This additional requirement is called the Capital Planning Buffer and does not technically form part of the overall regulatory minimum capital requirement.

4.2 Internal capital adequacy assessment process

The Group undertakes at least annually an ICAAP which is an internal assessment of its capital requirement. The ICAAP is performed more frequently should a significant shift in the Group's risk profile arise.

In performing the ICAAP, the Group considers the key risks to which the Group is exposed, and the levels of capital and other financial resources that should be held to safeguard the interests of its members and depositors, particularly during times of stress.

This process includes:

- Identification by senior managers of the relevant risk categories for the Group;
- Establishment, under the sponsorship of individual General Managers, of separate work streams to consider each risk category in detail;
- Analysis of the risks within each work stream, involving relevant personnel from across the business, and documented in individual risk assessment documents;
- Consideration of whether capital is an appropriate mitigant to the risk. Where this is deemed to be the case, capital requirements are calculated based on the results of severe stress testing for each risk category. Where capital is not

deemed as being able to mitigate a particular risk, alternative management actions are identified and described within the risk assessment;

- Calculation of an appropriate 'Capital Planning Buffer' to absorb a 'severe but plausible' stress event over the Group's planning horizon should such a scenario materialise, thereby ensuring ensure minimum capital requirements are maintained.
- Approval of individual risk assessment documents by the relevant sponsor, the General Manager Risk and Planning and Group Capital Committee;
- Documentation of the overall process and assessment, which is presented to Group Capital Committee before being presented to Group Risk Committee and the Board (with whom ultimate responsibility lies) for challenge and approval.

Further information on the material risks identified as part of the ICAAP can be found in Section 7 of this document.

During 2009, the FSA formally agreed the YBS's Individual Capital Guidance (ICG). This provides the Group with a specific regulatory minimum and replaced the 'Interim ICG' which was a transitional amount that became effective on the 1st January 2008 when the capital requirement framework changed from Basel 1 to Basel 2.

4.3 Minimum capital requirement (Pillar 1)

Credit risk

The following table shows YBS'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 2009. Details of the standardised approach to calculation of regulatory requirements are contained in the FSA handbook.

Table 2 - Credit risk pillar 1 requirements	Group £m	Solo £m
Retail exposure classes		
Secured on real estate property	440.1	440.1
Past due items	30.5	30.5
Retail credit risk pillar 1 requirement	**470.6**	**470.6**
Wholesale exposure classes		
Central governments or central banks	0.0	0.0
Financial institutions	62.4	61.7
Securitisation positions	63.5	63.5
Short term claims on financial institutions and corporates	8.7	7.1
Wholesale credit risk pillar 1 requirement	**134.6**	**132.3**
Other credit risk assets	11.0	9.3
Credit risk minimum capital requirement	**616.2**	**612.2**

Operational risk

YBS's overall minimum capital requirement under Pillar 1 is calculated by adding the credit risk charge described in section 4.3 to that required for operational risk using the standardised approach. The operational risk charge is calculated by applying the Group's average gross income across the FSA defined income streams (over a 3 year period) to FSA defined ratios (that represent the relative risk in the various income streams).

Overall minimum capital requirement

The table below shows both the Group's overall minimum capital requirement and capital adequacy position under Pillar 1 at 31 December 2009.

Table 3 – Total capital resource less total pillar 1 capital requirement	Group £m	Solo £m
Credit risk (standardised)	616.2	612.2
Operational risk (standardised)	18.0	17.0
Total pillar 1 capital requirement	**634.2**	**629.2**
Total available capital	**1,237.9**	**1,124.4**
Excess of own funds over minimum capital requirement under Pillar 1	**603.7**	**495.2**

Section 5 and 6 provide further detail on the significant risks captured under Pillar 1, i.e. credit risk and operational risk, including the nature of the exposures and the key risk management techniques. A summary of other significant risks captured under Pillar 2 is contained in Section 7.

Given the total minimum capital requirements are not materially different on a Group or solo consolidated basis, the disclosures in the remainder of this document are on a Group basis.

5 Significant risk categories - Credit Risk

5.1 Credit risk overview

5.1.1 Introduction

Credit risk is defined as the risk that circumstances emerge such that counterparties fail to meet loan payment obligations resulting in financial loss.

For the purposes of Pillar 3 disclosures, credit risk is sub-divided into retail (secured on real estate property) credit risk and wholesale (treasury) credit risk. 99.97% of the Group's retail exposures are secured on residential real estate property of which £18m relates to lending to housing associations (not separated out due to immateriality).

The Group has in place a range of risk management tools and methods to ensure that risk exposures remain within overall risk appetite. These tools and methods cover both probability of default and loss given default, i.e. likelihood of a borrower to be unable to meet their obligations, and any potential loss mitigation, such as any collateral provided for a loan.

Risk exposures are closely monitored by the Group Credit Committee and at a higher level by Group Risk Committee and the Board.

5.1.2 Exposures

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

Table 4 – Credit risk exposure	Average during 2009 £m	31 Dec 2009 £m
Retail		
Secured on real estate property	15,322.6	14,751.0
Total retail exposure	**15,322.6**	**14,751.0**
Wholesale		
Central governments & central banks	2,154.3	3,487.6
Financial institutions	4,047.2	3,700.5
Securitisation positions	832.4	800.3
Total wholesale exposure	**7,033.9**	**7,988.4**
Total credit risk exposure	**22,356.5**	**22,739.4**

The geographical distribution of these exposures at 31 December 2009 is as follows:

Table 5 – Retail exposure – geographic distribution	Secured on real estate property £m
Scotland	1,652.5
North East	813.3
Yorkshire & Humberside	2,597.4
North West	2,018.9
Midlands	1,742.1
East Anglia	435.5
South West	733.8
Greater London	1,660.7
South East	2,265.4
Wales & Northern Ireland	831.4
Total retail credit risk exposure	**14,751.0**

Table 6 – Wholesale exposure – geographic distribution (plus total)	UK £m	Other European Countries £m	North America £m	Rest of the World £m	Total £m
Central governments & central banks	3,315.0	0.0	0.0	172.6	3,487.6
Financial institutions	2,636.3	886.2	32.1	145.9	3,700.5
Securitisation positions	708.3	57.4	8.8	25.8	800.3
Total wholesale credit risk exposure	**6,659.6**	**943.6**	**40.9**	**344.3**	**7,988.4**
Total credit risk exposure	**21,410.6**	**943.6**	**40.9**	**344.3**	**22,739.4**

The following table shows the residual maturity of the exposures at 31 December 2009:

Table 7 – Credit risk exposure – residual maturity	Up to 12 months £m	1-5 Years £m	5 –10 Years £m	> than 10 Years £m	Total £m
Retail					
Secured on real estate property	28.6	442.8	1,412.7	12,866.9	14,751.0
Total retail exposure	**28.6**	**442.8**	**1,412.7**	**12,866.9**	**14,751.0**
Wholesale					
Central governments & central banks	2,370.8	1,007.3	109.5	0.0	3,487.6
Financial institutions	2,471.1	1,197.2	30.2	2.0	3,700.5
Securitisation positions	0.0	6.2	56.7	737.4	800.3
Total wholesale exposure	**4,841.9**	**2,210.7**	**196.4**	**739.4**	**7,988.4**
Total credit risk exposure	**4,870.5**	**2,653.5**	**1,609.1**	**13,606.3**	**22,739.4**

The maturity of exposures is shown on a contractual basis. In addition, it does not take into account any instalments receivable over the life of the exposure.

5.2 Retail credit risk

The most significant credit risk that the Group is exposed to relates to its core business of providing loans secured on residential property (retail credit risk), as befits its purpose.

Retail credit risk is overseen by the Group Credit Committee, a sub committee of the Group Risk Committee, which meets at least monthly. Its terms of reference, membership and responsibilities are documented in the Group's Risk Management Policy which is formally updated annually and approved by Group Risk Committee. A summary of its key responsibilities is:

- Maintaining and reviewing the Group's Lending Policy, and recommending amendments thereto to the Group Risk Committee
- Managing the composition of the Group's mortgage portfolio and new lending business in line with the Board approved Lending Policy
- Monitoring and managing mortgage arrears balances and potential default exposures
- Monitoring the effectiveness of the Group's mortgage credit scorecards and recommending amendments where appropriate.

In addition, the Lending Criteria Committee, which is a sub committee of the Group Credit Committee, reviews in detail lending criteria proposals to assess them for their impact on the risk of the portfolio.

The primary considerations when determining whether a loan should be made are ensuring that the applicant is able and willing to service the loan, and that the property provides adequate security for the loan.

In assessing willingness and ability to service the loan, the Group uses credit scoring systems that factor in the profile of the borrower, the nature of the loan, evidence that the prospective borrower can service other debt obligations satisfactorily and environmental conditions. These scoring systems, and the way they are used within the initial lending process, are varied to suit the different risks and profiles of the Group's underlying mortgage portfolios. The score decision is combined with a number of other factors such as lending criteria, value of the collateral to be taken as security and affordability of loan repayments to determine whether a loan should be made. To enhance the scope of the assessment of customer creditworthiness, an affordability model was introduced across the Group in 2009.

The maximum percentage of the value of a property (loan-to-value, LTV) that an applicant may borrow is calculated in relation to the credit score and lending criteria. This is based on the market value of the property. No lending is undertaken based solely upon security provided by the value of the underlying assets. Once a mortgage application is made, the sales force has no bearing on the final decision. All mortgages are secured by way of a first legal charge against the property.

The Retail Credit Risk unit within Group Risk monitors the risk profile of new business taken on and outstanding pipeline. The key measure of this is an expected loss measure which considers the potential losses emerging from a tranche of lending over the lifetime of the loans in an appropriate economic scenario. Other risk measures include credit score, LTV, region and buyer type. The Board sets exposure limits in relation to these exposures consistent with its risk appetite each year and these are monitored monthly through the Group Credit Committee in the Lending Exposure report.

The Retail Credit Risk unit also provides reports on risk trends within the full mortgage book, particularly considering arrears trends by risk segment.

The Group Risk committee receives a half-yearly report on the mortgage book composition and trends, and a quarterly report on the status of retail credit risk in the Group, including key risk indicators, latest market developments and initiatives.

The Board receives a report monthly covering the status of the key credit risk measures plus any other points of note.

5.3 Wholesale credit risk

The Group's wholesale credit risk arises principally from assets held for liquidity purposes. The risk is that counterparties with whom the Group invests liquid assets fail to repay those investments when they fall due.

The Group Credit Committee takes primary responsibility for the task of assessing and monitoring wholesale counterparty creditworthiness and conducting credit research and analysis. It does this by reviewing the Group's exposures and through setting limits to individual counterparties based on its internal ratings methodology. The internal ratings model takes into account a range of factors, incorporating both qualitative and quantitative measures, and the outputs are periodically compared with those produced by external rating agencies to provide a benchmark. Limits are also set against the aggregate exposure to all institutions based in any one country. Once in place, all individual counterparty limits are reviewed at least annually, with revocation or suspension taking place where considered appropriate.

Risk positions are managed in accordance with limits set out in the Group Risk Management Policy. The policy also sets out powers which require higher levels of authorisation according to the size of the transaction or the nature of the associated risk.

Positions against limits and ongoing asset quality monitoring is undertaken by the Treasury Risk function in Group Risk, which is independent to senior executive level from the risk taking (Group Treasury) and back office (Treasury Operations) functions. Reports are sent to the Group Credit Committee on a monthly basis, incorporating:

- Overall wholesale credit exposures, split between core liquidity and structured credit, analysed by both internal and external credit rating bands and showing exposures, expected losses and capital requirements
- Overall distribution of internal and external credit ratings through wholesale portfolio
- High risk exposures (i.e. low rated investments) and large exposures (amounts classed as large exposures ranked by percentage of capital resources)

Treasury uses a number of risk mitigation techniques including netting and collateralisation agreements, which are considered further in section 5.6.

For the purposes of generating risk weightings for its wholesale exposures, YBS uses Standard and Poor's (S&P), Fitch and Moody's as External Credit Assessment Institutions (ECAIs), using a composite rating where a counterparty is rated by more than one agency.

The Board recognises that it is not possible to limit the Group's exposure to just institutions with the very highest credit ratings. Nevertheless it considers that the Group's approach (outlined above) is prudent and is designed to minimise the risk of losses.

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

Table 8 – Wholesale exposure credit quality steps – Central government and central banks

Credit quality step	Risk weight (<3months/ >3months)	S & P ratings	Fitch ratings	Moody's ratings	Exposure values £m	Exposure values after mitigation[1] £m
1	0%/0%	AAA to AA-	AAA to AA-	Aaa to Aa3	3,487.6	2,989.4
2	20%/20%	A+ to A-	A+ to A-	A1 to A3	0.0	0.0
Total					**3,487.6**	**2,989.4**

Table 9 – Wholesale exposure credit quality steps – Financial institutions

Credit quality step	Risk weight (<3months/ >3months)	S & P ratings	Fitch ratings	Moody's ratings	Exposure values £m	Exposure values after mitigation[1] £m
1	20%/20%	AAA to AA-	AAA to AA-	Aaa to Aa3	2,455.7	2,453.9
2	20%/50%	A+ to A-	A+ to A-	A1 to A3	845.0	587.2
3	20%/50%	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	398.8	398.8
4	20%/50%	Unrated	Unrated	Unrated	1.0	1.0
Total					**3,700.5**	**3,440.9**

[1]- Mitigation recognises the benefit of collateral held against these investments – see Section 5.6 Credit Risk Mitigation: Wholesale

5.4 Securitisation

The Group has not, to date, securitised assets that we have originated. The Group's involvement in securitisation extends only to its small investment portfolio. The Group's main exposure to purchased securitisation positions relates to UK prime residential mortgage-backed securities, accounting for £708m of a total exposure of £800m. The following table illustrates the breakdown of investment by type:

Table 10 - Securitised Assets by Investment type	Exposure values £m
CDO	15.6
CLO	33.8
Credit Fund	6.2
Principal Protected Note	8.8
UK Prime RMBS	708.3
Securities Investment Conduit	4.7
Synthetic CDO	22.9
Total	**800.3**

For the purposes of generating risk weightings for its investments in securitisations, YBS uses Standard and Poor's (S&P), Fitch and Moody's as External Credit Assessment Institutions (ECAIs), using a composite rating where a counterparty is rated by more than one agency. Risk weights are calculated under the standardised approach. The following table shows the Group's aggregate exposure to purchased securitisations, split by their associated credit quality steps:

Table 11 – Securitised asset exposure credit quality steps

Credit quality step	Risk weight	S & P ratings	Fitch ratings	Moody's ratings	Exposure values £m
1	20%	AAA to AA-	AAA to AA-	Aaa to Aa3	711.9
2	50%	A+ to A-	A+ to A-	A1 to A3	5.9
3	100%	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	26.3
4	350%	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	9.0
5	1250%	B+ and below	B+ and below	B1 and below	47.2
Total					**800.3**

The table above shows the total for all securitisation positions that fall into credit quality step 5 (i.e. rated B+ and below or unrated). The table below shows the breakdown of these positions as at the end of 2009:

Table 12 – Securitised asset exposure – credit quality step 5 (CQS5)

Investment	Type	Rating	Exposure £m
Aura	Synthetic CDO	B	7.2
BlackRock C	CLO	B+	1.2
Contego D	CLO	B	8.9
Euclid	Synthetic CDO	CCC-	0.5
FAB A2BE	CDO	B+	10.7
FAB Equity	CDO	Unrated	0.3
Fair Isle Equity	Principal Protected Note	Unrated	3.2
Dryden	Synthetic CDO	CCC-	13.1
Valleriite	Synthetic CDO	CCC-	2.1
Total			**47.2**

No benefit is taken for mitigation for securitised exposures.

5.5 Impairment provisions

5.5.1 Loans secured on real estate property

At each statement of financial position date the Group assesses whether or not there is objective evidence that individual financial assets (or groups of financial assets with similar credit characteristics) are impaired. In determining whether an impairment loss should be recognised, the Group makes judgments as to whether there is any evidence indicating a measurable decrease in the present value of cash flows expected from a financial asset or group of financial assets, resulting from an event (or events) that have occurred after initial recognition of the asset, but before the statement of financial position date.

Individual assessments are made of all loans and advances on properties which are in possession, or in arrears by two months or more. All other loans and advances are grouped according to their credit characteristics, and a collective review undertaken of any evidence of impairment. Future cash flows are estimated on grouped credit characteristics in all cases.

Where there is objective evidence of impairment or that trigger events exist at the statement of financial position date, then the impairment loss is calculated as the difference between the assets' carrying value and the present value of the estimated cash flows from those assets. In assessing these cash flows a number of factors are taken into account, including the Group's

historic default experience, historic and current loss emergence periods, the effect of changes in house prices and adjustments to allow for ultimate forced sales discounts.

Any increases or decreases in projected impairment losses are recognised through the income statement. If a loan is ultimately uncollectable, then any loss incurred by the Group on extinguishing the debt is written off against the provision for loan impairment. Any subsequent recoveries of amounts previously written off are recognised through the income statement as an adjustment to the loan impairment provision. If, in a subsequent period, the extent of impairment loss decreases, and that decrease can objectively be related to an event occurring after the initial impairment was recognised, then the impairment provision is adjusted accordingly and the reversal recognised through the income statement.

The following table shows the past due loans and provisions for impaired exposures (equivalent to value adjustments) and charges to the income statement for the year ended 31 December 2009:

Table 12 - Loans secured on real estate property - past due loans and provisions for impaired exposures	**Total £m**
Neither past due nor impaired	**13,712.9**
Past due:	
Up to 3 months	612.2
3 to 6 months	221.4
6 to 12 months	116.8
Over 12 months	32.4
Possessions	55.3
Total Past Due	**1,038.1**
Total exposures	**14,751.0**
Provisions	**50.7**
Charge/(credit) for the year	**59.0**

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 during the year in impairment provisions. Further information on the charge to the income statement for provisions and more detailed analysis is included in note 9 to the Annual Report and Accounts:

Table 13 - Individual/collective provisions	**Individual provisions £m**	**Collective provisions £m**	**Total £m**
Balance at 31 December 2008	35.6	5.8	41.4
Charge for the year	61.0	(2.0)	**59.0**
Write-offs	(49.6)	(0.1)	**(49.7)**
Recoveries	-	-	-
Balance at 31 December 2009	**47.0**	**3.7**	**50.7**

The interest arising from the unwind of the discount of expected future recoveries is not material.

5.5.2 Debt instruments

At each balance sheet date the Group assesses whether or not there is objective evidence that individual available for sale debt instruments are impaired. In determining whether there is any objective evidence of impairment the Group takes into account a number of factors including:

- significant financial difficulties of the issuer or obligor;
- any breach of contract or covenants;

- the granting of any concession or rearrangement of terms;
- the disappearance of an active market;
- any significant downgrade of ratings; and
- any significant reduction in market value.

In some cases a significant adverse change in one of the above factors will cause the Group to determine that there is objective evidence of impairment. In other cases it may not be possible to identify a single event that identifies impairment. The Group may additionally determine that there is impairment where there are a number of factors contributing to that view.

Where the Group determines that there is objective evidence of impairment or that trigger events exist at the balance sheet date, in the case of available for sale instruments, the cumulative loss that had been recognised directly in reserves is removed from reserves and recognised in the income statement. In the case of held to maturity instruments an appropriate charge is made to the income statement.

If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be related to an event occurring after the impairment loss was recognised through the income statement, the impairment loss shall be reversed, with the amount of the reversal recognised through the income statement.

As at 31 December 2009, 99.9% of the wholesale portfolio exposures were neither past due nor 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.

At the end of the year, the Group had an impairment provision of £7.8m on wholesale investments relating to cash collateralised debt obligations, as shown in note 9 to the Group's Annual Report and Accounts.

5.6 Credit risk concentrations

As a UK residential mortgage lender, the Group is inevitably concentrated in this market. Within this overall concentration however, the Group has put in place controls to mitigate undue concentration risk.

For residential mortgages, a number of concentration limits are set for new business and for the full portfolio in the Group Risk Management Policy. These cover:

- High LTV concentrations
- Concentrations within specific segments of the portfolio such as non-standard lending
- Regional concentrations

Exposures against these limits are monitored by Group Credit Committee. The Board does not believe any undue concentrations of risk exist in the retail portfolio. Further detailed analysis of geographic, LTV and buyer type concentrations is included within Note 38 to the Annual Report and Accounts.

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

5.7 Credit risk mitigation

The Group uses a range of techniques to reduce credit risk of its retail and wholesale lending. The most basic of these is performing an assessment of the ability of a borrower to service the proposed level of borrowing without distress, and further details on the tools used to perform this assessment are contained in Section 5.2. However, the risk can be further mitigated by obtaining security for the funds advanced.

5.7.1 Retail

Residential property is the Group's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolios. All current mortgage lending activities are supported by an appropriate form of valuation using either

an independent firm of valuers (except historic low LTV re-mortgage cases valued without independent valuation) or indexed valuation for further advances.

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

5.7.2 Wholesale

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

Guarantees from national governments or connected legal entities may be available for some treasury counterparty debt. Where available, these guarantees may enhance the credit profile of the exposure and provide security in the event of default. Such exposures will then qualify for a lower risk weighting. As at 31 December 2009, £338.7m of wholesale exposures benefited from the UK government guarantees. There were no other guarantees in place.

The Group's legal documentation with its counterparties for derivative transactions grants legal rights of setoff for those transactions. Accordingly, for credit exposure purposes, negative market values on derivatives will offset positive market values on derivatives with the same counterparty in the calculation of credit risk, subject to a minimum absolute exposure of zero by counterparty.

International Swaps and Derivatives Association (ISDA) documentation confers the ability to use designated cash collateral to set against derivative credit exposures in the event of counterparty default. Frequent rebalancing of the collateral requirements reduces the potential increase in future credit exposure. For such collateralised exposures, the posting of collateral reduces the impact of the current market value to the difference between the market value of the derivatives and the value of the collateral. This difference is limited by the operational use of 'thresholds' and 'minimum transfer amounts', which set criteria to avoid the movement of small amounts of collateral. At 31 December 2009, £259.6m was held as collateral against derivative exposures.

5.8 Counterparty credit risk for derivative contracts

The Group uses derivative instruments to hedge interest rate risk, foreign currency risk or other factors of a prescribed description arising from fixed rate mortgage lending and savings products, funding and investment activities. Derivatives are only used by the Group in accordance with the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes. Counterparty credit risk in the context of this disclosure is the risk that a counterparty to a derivative instrument we hold could default before the final settlement of the transaction's cash flows.

As described in section 5.6, risk is mitigated by offsetting the amounts due to the same counterparties ('Netting benefits") and by cash deposited by certain of the counterparties ('Collateral held'). The following table shows the exposures to counterparty credit risk for derivative contracts at 31 December 2009:

Table 14 - Counterparty credit risk for derivative contracts	Total £m
Interest rate contracts	861.9
Foreign exchange contracts	4,990.6
Other contracts	2.1
Gross positive fair value of contracts	**5,854.6**
Netting benefits	(5,156.1)
Netted current credit exposure	**698.5**
Collateral held	(259.6)
Net derivatives credit exposure	**438.9**

The net derivatives credit exposure represents the credit exposure to derivative transactions after taking account of legally enforceable netting agreements and collateral arrangements. The net exposure value of derivatives at 31 December 2009 was £779.3m, which includes future credit exposure.

6 Significant risk categories - Operational Risk

6.1 Operational risk overview

YBS has adopted the standardised approach to operational risk, compliant with the requirements set out in BIPRU 6, and has defined operational risk as: “the risk of loss arising from inadequate or failed internal processes, people and systems or from external events, including legal risk”.

This means that for calculation of minimum capital requirements, the Group calculates its average annual income from prescribed business lines over the past three years. Capital is then held to support operational risk for each business line at prescribed rates from 12% to 18% of its average annual relevant income.

For the amount of capital required to be held against operational risks, please refer to Section 4.3.

There are certain qualitative requirements for the standardised approach to operational risk which the Group has adopted. The key areas are described in more detail in the sections below.

6.2 Operational risk framework

Underpinning the Group’s approach to operational risk measurement and management is the enterprise-wide risk map. This covers all key risks to which the Group is exposed, including key operational risks, and therefore incorporates the operational risk framework. Each key risk identified is assigned to a risk owner, all of whom are General Managers. As described previously, YBS operates within a three lines of defence model. Each business stream has delegated officials who are responsible for embedding the operational risk framework within their stream. The Group-wide network of business stream officials are supported by a centralised Operational Risk team providing the second line of defence to ensure consistency across the Group.

6.3 Operational risk oversight and governance

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

6.4 Operational risk monitoring and reporting

In support of the enterprise-wide risk map, the Group has in place a risk dashboard supporting each key risk. These risk dashboards integrate all the available information about a risk, and summarise the status of the risk, identifying:

- Whether a key risk may be changing
- Whether the operational environment is under stress, stable or improving
- Whether key controls relied on to mitigate the risks are operating effectively

Operational risk assessments and operational risk management information are reported to the Board via the monthly board risk report. In addition, there is an operational risk update to the Group Risk Committee every quarter, including review of the enterprise-wide risk map.

A detailed information pack covering each of the following areas is reported to the Group Operational Risk Committee on a monthly basis:

- Risk Map
- Key Risk Indicators
- Operational Risk Losses
- Risk Acceptance and Updates
- Supplier Risk Assessment

- Controls Risk Self Assessment Update
- FSA Activity Update
- Regulatory Risk Update
- Fraud and Money Laundering Update
- Business Continuity Update
- Risk Transfer Update
- Information Security and Data Protection Update
- TCF Update
- Audit Agreed Action Status Update

7 Other significant risks - Pillar 2

7.1 Pillar 2 overview

As noted in section 4.2, the Group undergoes its Internal Capital Adequacy Assessment Process (ICAAP) at least annually in line with Basel II Pillar 2 requirements. The outcome of the ICAAP is presented within an Internal Capital Assessment document (ICA) and in 2009 was subject to the FSA's Supervisory Review and Evaluation Process (SREP). The result of which was the formalisation the Group's ICG, the regulatory minimum level of capital the Group must hold at any point.

The process is led by the Group Risk department, but involves a wide range of personnel from across the Group, including General Management and Executive Directors. The ICA, including underlying individual risk assessments for material risk categories, is reviewed by General Management, the Group Capital Committee, the Group Risk Committee and the Board.

The purpose of the process is to identify the key risks to which the Group is exposed, and the levels of capital and other financial resources that should be held to meet the Group's risk appetite during a period of severe stress and to the extent to which minimum Pillar 1 requirements do not satisfy the findings of the ICA.

The ICA is prepared at a Group level, and at 31 December 2009 identified the following key risk categories:

- Retail credit risk*
- Wholesale credit risk*
- Interest rate risk
- Pension risk
- Operational risk*
- Concentration risk
- Liquidity risk^

** - These risks are Pillar 1 risks that are considered in detail within Sections 5 and 6 of this document.*
^ - Liquidity Risk does not result in additional capital requirement and is will be covered in more detail going forwards within the Individual Liquidity Adequacy Standards (ILAS) process.

Capital is required to be held against all of these key risk categories (with the exception of liquidity risk) over and above the amounts required under Pillar 1 rules (see Section 4.3). See below for further details.

Additional capital is required to be held in the form of the 'Capital Planning Buffer' which is the result of a stress test that assesses the capital impact of an 'severe but plausible' economic downturn on the Group's strategic plan. Further consideration is provided below with the 'Capital Planning Stress Test' section.

7.2 Interest rate risk in the banking book

Interest rate risk relates to the impact of repricing of assets/liabilities through interest rate movements. Given the nature of our operations, the resulting inevitability of some degree of exposure and the fact that crystallisation of such positions is a possibility, the Group's risk appetite in this area can be characterised as medium i.e. even in unstressed scenarios some losses are expected.

The Group has a formal structure for managing all its market risks, including interest rate risk, using established risk limits, reporting lines, mandates and other control procedures. This structure is reviewed regularly by Group Asset and Liability Committee ("GALCO"), which is responsible for managing and controlling the balance sheet exposures of the Group. GALCO meets at least monthly and the Board receives monthly summaries of risk positions and GALCO activity.

The Group has four main measures for managing interest rate risk:

7.2.1 Value at Risk

Value at Risk ("VaR") evaluates the potential losses that may be incurred as a result of movements in market conditions over a specified holding period and to a given level of confidence. The model used is based on a 10-day holding period and a 99%

confidence level. The VaR model calculates potential movements in market prices by reference to market data from the last 90 days, and incorporates underlying risk factors based on historic interest rate volatilities and correlations.

VaR for the treasury portfolios is calculated and reported on a daily basis and for the Group balance sheet on a monthly basis. A quarterly back test of the VaR model is performed to test the validity of the assumptions and parameters within the model.

A number of limitations should be considered in relation to the VaR model:

- Historic data is not necessarily a good guide to future events
- The model, by definition, does not capture the potential losses outside the 99% confidence level, particularly those events that are extreme in nature, and
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures

7.2.2 Balance sheet structure analysis (basis risk)

An analysis of interest bearing items by rate type is performed to illustrate key areas of structural mismatch. It identifies mismatches between administered rates, fixed rates and other rates including those linked to bank base rate and LIBOR. The effect of LIBOR mismatches within the balance sheet is measured as the impact on net interest income (for a 12 month rolling period) of an isolated increase in LIBOR of one basis point (0.01%)

7.2.3 Basis point value sensitivity

This measure calculates the change in value of the assets and liabilities resulting from a one basis point parallel shift in interest rates. Within the treasury portfolio this is calculated and reported on a daily basis separately for each currency and at the full balance sheet level on a monthly basis.

7.2.4 Repricing gap analysis

An analysis of repricing dates is performed, primarily for the avoidance of repricing risk concentrations, i.e. to prevent the situation whereby too great a proportion of the Group's assets and liabilities see the interest rates earned or charged on them resetting within a given time period. The aim is to prevent excessive volatility in the net interest margin that could arise if rates shifted adversely within a given time period, and since we cannot dictate interest rate movements themselves the best approach is to limit the amount of assets or liabilities that are exposed in this way. The analysis identifies the net asset/liability repricing position across a series of time intervals. Positions are calculated using nominal amounts and exclude interest flows. General reserves, fixed assets and other liabilities are classified as having "non-specific" repricing characteristics with a zero rate of interest. The measure is calculated as a reverse cumulative gap.

7.2.5 Stress testing

For assessment of capital requirements, YBS has modelled its interest rate exposure in three areas: mismatch risk (i.e. in relation to the repricing gap mentioned above), prepayment risk (i.e. the risk that through higher or lower than anticipated prepayment rates further mismatches are generated between the underlying balance and the associated funding) and basis risk.

YBS has stressed asset/liability positions by way of a 200 basis point shock (interest rates going up and down) as required by BIPRU rules to assess the quantity of Pillar 2 capital requirement for interest rate risk. This is calculated on an annual basis as part of the ICAAP. As at 31 December 2009 the result of this stress test gave an amount at risk figure of £60.5m (pre tax).

7.2.6 Interest rate risk summary

The average gross Sterling exposures (before deduction of the above mentioned benchmark profile) through 2009 were as follows:

Table 15A – Interest rate risk summary	31/12/2009 £m	Average £m	Maximum £m	Minimum £m
VaR	**6.85**	11.25	17.45	5.20
Basis risk	**0.08**	0.27	0.44	0.08
BP sensitivity (1bp)	**(0.01)**	0.03	0.23	(0.06)

Table 15B – Interest rate risk summary	> 1 year £m	>5 years £m	>10 years £m
Repricing gap	516.0	(94.0)	(25.0)

All exposures include investment of Group's reserves.

7.3 Pension obligation risk

YBS is exposed to pension risk through its defined benefit scheme i.e. it has contractual obligations which vary through causes outside of its control. The scheme is closed to new members, but a material degree of risk remains through obligations already in place. This means that whilst the risk appetite here is low this is not reflected in the scale of risk already in place, but through the closure of the scheme to new members and the intention to hedge the risks involved as far as it is sensible to do so.

The risk has been modelled, with the help of external actuaries, by identifying the key factors likely to affect future obligations to fund the existing liabilities, namely:

- Interest rates (the AA corporate bond yield)
- Implied inflation rates
- Life expectancy assumptions; and
- Equity values.

YBS has taken these assumptions and stressed them severely to assess the quantity of Pillar 2 capital requirement for pension obligation risk.

7.4 Concentration risk

The Group routinely considers concentrations in products, geographies, channels, income streams and funding sources as part of its strategic planning and has stress tested any such concentrations as part of the ICAAP. A degree of concentration risk is inevitable given the Group's focus in the UK residential mortgage market.

Details of the controls in place to mitigate concentration risk in the mortgage portfolio are discussed within section 5.5 of this document.

7.5 Capital Planning Stress Test

A Capital Planning Buffer has been generated from the results of the Capital Planning Stress Test. This stress test is defined and articulated with the assistance of key business experts and is set at a severity level that is consistent with the FSA's 'severe but plausible' requirement.

The test calculates the impact to both capital requirements and resources across the strategic planning period. Based upon the results (after management actions are considered) an additional amount of capital is held above the proposed regulatory minimum. This Capital Planning Buffer can, in extreme times of stress, be absorbed without breaching the regulatory minimum.

7.6 Other risks

After detailed stress testing, no other risks were considered material from a capital perspective.

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).
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, Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.
EEA parent institution	A parent financial institution situated in a Member State of the European Economic Area which is not a subsidiary of another financial institution also situated in the EEA.
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.
GFSC	Guernsey Financial Services Commission. The financial services regulator in Guernsey.
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.
ISDA	International Swaps and Derivatives Association is the global trade association for over-the-counter (OTC) derivatives, and providers of the industry-standard ISDA documentation.
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.
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 YBS.
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 incurred 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.
Securitisation	A transaction or scheme where assets are sold to a Special Purpose Vehicle (SPV) in return for immediate cash payment. That vehicle raises the immediate cash payment by issuing debt securities in the form of tradable notes or commercial paper to wholesale investors who receive an income from the underlying assets. Some risk is retained on the balance sheet while the remaining risk is transferred to investors. Securitisations may be purchased or retained.
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 between 12-18%, depending on the underlying business being considered.
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.