Coventry Building Society

Pillar 3 Disclosures
31 December 2009

Contents

1. Overview 02
2. Scope of IRB permission granted 03
3. Risk management policies and objectives 03
4. Capital resources 07
5. Capital adequacy 08
6. Risks and their management 09
7. IRB rating system 17

1. Overview

1.1 Background

The European Union Capital Requirements Directive ('CRD') came into effect on 1 January 2007. Commonly referred to as Basel II, the legislative framework introduced capital adequacy standards governing how much capital all banks and building societies must hold to protect their members, depositors and shareholders.

In the UK, implementation of the Directive has been through rules introduced by the Financial Services Authority ('the FSA'). These rules dictate the disclosure requirements relevant to banks and building societies under the provisions of Chapter 11 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms ('BIPRU'). These are known as Pillar 3 disclosures because they complement the minimum capital requirements in Pillar 1 and the supervisory review process in Pillar 2. The Pillar 3 disclosures are aimed at promoting market discipline by providing information on risk exposures and the management of those risks.

The FSA granted Coventry Building Society and its subsidiary Godiva Mortgages Limited, (together 'the Society'), permission to use the Basel II Internal Ratings Based ('IRB') approach to retail credit risk and capital management from 1 January 2008. This permission reflects the Society's detailed understanding of its customer base and control of its credit risk profile. It allows the Society to set capital levels using internally developed models rather than through percentages set by the FSA.

The Society uses the standardised approach in calculating the capital requirements for other risk areas.

1.2 Basis and frequency of disclosures

This document sets out the 2009 Pillar 3 disclosures for the Society. These disclosures have been prepared solely to give information on the basis of calculating Basel II requirements and on the management of risks faced by the Group in accordance with the rules laid out in BIPRU Chapter 11. The disclosures may differ from similar information in the Annual Report and Accounts 2009 prepared in accordance with International Financial Reporting Standards ('IFRS'); the information in these disclosures may therefore not be directly comparable with that information. All figures are as at 31 December 2009, the Society's year end, unless otherwise stated.

The information in these disclosures has not been audited. Future disclosures will be issued on an annual basis and published as soon as practicable after the publication of the Annual Report and Accounts.

1.3 Scope of disclosures

The Pillar 3 disclosures in this document include both Coventry Building Society (FSA registered number 150892) and its wholly owned subsidiary, Godiva Mortgages Limited (FSA registered number 457622).

Godiva Mortgages Limited distributes products solely through mortgage intermediaries. All funding comes from the Society.

This consolidated treatment reflects the scope of the Society's solo consolidation waiver approval from the FSA. This means that there are no differences between the basis of consolidation of the Society for accounting and prudential purposes.

The Society does not foresee any practical or legal impediments to the transfer of capital resources or the repayment of liabilities between Coventry Building Society and Godiva Mortgages Limited.

1.4 Location and verification

These disclosures have been reviewed by the Society's Audit Committee but have not been, and are not required to be, subject to independent external audit. They are published on the Society's website www.thecoventry.co.uk.

The Society has drawn up a formal Pillar 3 policy document which has been approved by the Board and is subject to periodic review.

1.5 Recent Developments – Stroud & Swindon Building Society

Coventry Building Society merged with Stroud & Swindon Building Society on 1 September 2010. Consolidated Pillar 3 disclosures representing the enlarged Group will be produced as soon as practicable after the completion of the 2010 Annual Report & Accounts.

2. Scope of IRB permission granted

The FSA has granted approval for the Society to use the IRB approach for prime residential and buy-to-let mortgage exposures, covering 99% of its mortgage assets.

In line with industry best practice the Society is continuously reviewing the IRB models used and the assumptions within them.

3. Risk management policies and objectives

3.1 Approach to risk management

The Society is a mutual organisation owned by and run for the long term benefit of its members. As such the Board adopts a prudent approach to accepting risk geared towards long term value creation for the benefit of members. This is known throughout the Society as the 'Members First' principle. This low risk appetite is monitored and enforced through the Society's risk management structure described below.

3.2 Risk management structure

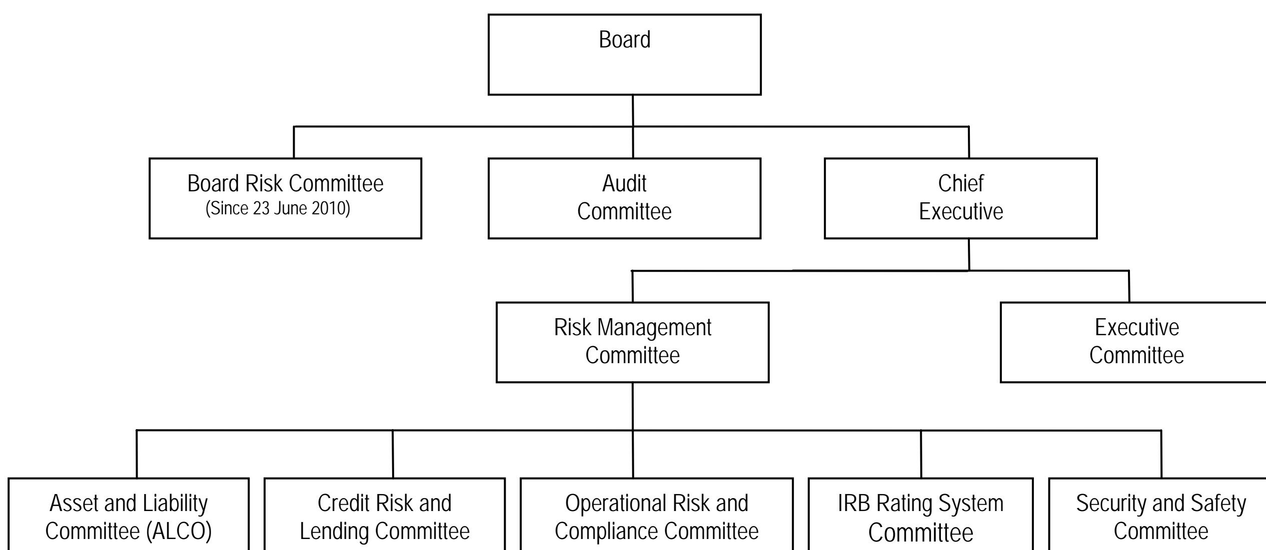
The Society's risk management structure is based on a three lines of defence model:

- **First line of defence –** this model recognises that risk management is the responsibility of all managers and staff of the Society. Management have a responsibility to understand how risk impacts their area of the business and for putting in place controls or mitigating activities.

- **Second line of defence –** policies and oversight are required to effectively challenge managers and staff in their performance of risk management activities and to provide risk management expertise. This is provided through risk support functions and risk committees. The Head of Risk reports to the Chief Executive and since 23 June 2010 has an independent reporting line directly to the Chairman of the Board Risk Committee.

- **Third line of defence –** finally, the Society's internal audit function is responsible for independently reviewing the effectiveness of the risk management structure and adherence to processes. The Chief Internal Auditor reports to the Chief Executive but has an independent reporting line directly to the Chairman of the Audit Committee. The Audit Committee approves the work programme of internal audit and receives reports of the results of the work performed.

The structure and responsibility of committees are set out below:



3.3 Governance and oversight of risk

Board

The Board is responsible for setting the Society's strategy and risk appetite, and ensuring risk management is appropriate and effective. In carrying out these duties the Board is responsible for the Society's Internal Capital Adequacy Assessment Process ('ICAAP'). The ICAAP brings together the risk management framework and the financial disciplines of business planning and capital management in order to assess for the Society:

- the significant risks to which it is exposed;
- the adequacy of its risk assessment and management; and
- the capital resources it needs to address its risk exposures over its planning horizon.

In addition, there are other committees for managing certain risks that have their own terms of reference. Details are presented below.

Board Audit Committee

The Audit Committee is a Board committee and is made up of the Society's non-executive directors. The responsibilities of the committee comply with the provisions of the Combined Code (as annotated for building societies) on Audit Committees. The main function of the committee is to assist the Board in fulfilling its responsibilities with specific regard to risk:

- reviewing the adequacy of systems of internal control and risk management processes;
- ensuring that the risk management framework is appropriate; and
- considering compliance with relevant laws and regulations.

The external auditors, the Society's Chief Executive, Finance Director, Secretary and Solicitor, Chief Internal Auditor and also certain executive directors and senior managers (if required) attend Board Audit Committee meetings. In addition, the Society's external auditors are provided with the opportunity to meet the members of the committee in private session.

Board Risk Committee

Since the year end the Board Risk Committee was formed on 23 June 2010. The Board Risk Committee is a Board committee and is made up of the Society's non-executive directors and the Head of Risk of the Society. The committee meets on a monthly basis and has the responsibility for overseeing risk strategy, risk policies and risk appetite and making recommendations to the Board. The main function of the committee is to assist the Board in fulfilling its responsibilities with specific regard to risk:

- review and challenge material risks in relation to the Board's risk appetite and the Society's liquidity and capital adequacy;
- review and approval of the IRB models; and
- review and challenge material breaches and control weaknesses and responses.

The Society's executive directors, Secretary and Solicitor and also certain senior managers (if required) attend Board Risk Committee meetings.

Executive Committee

Chaired by the Chief Executive and comprised of executive directors and senior management, the committee meets weekly and oversees the operational and business performance of the Society.

Risk Management Committee

Chaired by the Finance Director and comprised of the executive directors and senior management with non-executive directors in attendance by rotation and the external auditors in attendance by invitation. Since 26 June 2010 the committee has been chaired by the Chief Executive.

The committee ensures that risk is being managed effectively across the Society, in accordance with the corporate plan. It considers reports in relation to risk provided by the finance, internal audit, operational risk and compliance functions and the external auditors:

- to provide the Board with assurance that risk is being effectively and consistently managed across the Society;
- to oversee the Society's risk management process; and
- to overview and take responsibility for all compliance matters.

The Society also has a number of sub-committees that report to the Risk Management Committee. The details of these committees are as follows:

Asset and Liability Committee (ALCO)

Chaired by the Finance Director and comprised of executive directors and senior management, the committee oversees the management of the Society's asset and liability management strategy.

The committee's terms of reference include:

- to determine and implement an asset and liability management strategy for the Society;
- to determine strategy for, and exercise control over, the funding and lending activities of the Society;
- to develop and ensure compliance with the Board approved risk management, liquidity and wholesale funding policies; and
- to approve product design and pricing.

Credit Risk and Lending Committee

Chaired by the Deputy Finance Director and comprised of senior management, the committee monitors the risks associated with lending policy, credit systems and credit processes.

The committee's terms of reference include:

- the setting and authorising of changes to lending policy, credit systems and credit processes;
- to ensure that the lending policy, credit systems and credit processes are designed to meet the volume, mix and quality of lending, as set by the corporate plan and agreed with the Board; and
- to ensure that the Society complies with the requirements of the Mortgage Conduct of Business regulation, the FSA guiding principles of treating customers fairly and the Banking Code of Practice in relation to credit risk and lending policy.

Operational Risk and Compliance Committee

Chaired by the Chief Operating Officer and comprised of senior management, the committee monitors operational risk, financial crime, regulatory compliance and business continuity in the Society.

The committee's terms of reference include:

- to oversee the implementation of operational risk, financial crime and compliance management frameworks to ensure that the Society is appropriately protected from adverse consequences of potential material risks;
- to review and challenge the risk profile and management of operational functions; and
- to review and approve the high level control policies.

IRB Rating System Committee

Chaired by the Finance Director and comprised of executive directors and senior management, the committee monitors the performance of the Society's Basel II IRB credit risk rating system.

The committee's terms of reference include:

- to ensure compliance with the Basel II Accord and approve the resulting capital requirements;
- to approve the rating system and any subsequent amendments;
- to ensure that appropriate action is taken to address issues raised from performance monitoring;
- to regularly review and approve the policy statement defining the overall approach to materiality in relation to the rating system; and
- to perform ongoing and formal annual reviews of the accuracy and adequacy of the rating system.

Security and Safety Committee

Chaired by the Sales and Marketing Director and comprised of executive directors and senior management, the committee oversees security and health and safety issues as they apply to staff and customers.

The committee's terms of reference include:

- approving the Society's security and health and safety policies and monitoring adherence thereto;
- to provide oversight to ensure that staff and members are adequately protected from security risks, and operate within a safe working environment;
- to consider and approve recommendations to improve physical security arrangements;
- to ensure that the security concerns raised by staff are given consideration and responded to in an appropriate manner;
- to ensure that the security and health and safety arrangements deployed by the Society meet with best practice and all applicable legislation; and
- to promote awareness of security and health and safety issues.

4. Capital resources

4.1 Compliance with capital requirements

Throughout 2009 the Society has complied in full with all its externally imposed capital requirements. The table below breaks down the components of capital available to the Society as at 31 December 2009.

4.2 Capital available

	Notes	As at 31 December 2009 £m
Tier 1		
General reserve		616.0
Pension fund surplus adjustment		(6.9)
Intangible assets		(9.9)
Deductions from tier 1 capital	1	(19.2)
Core tier 1 capital		580.0
Permanent interest bearing shares	2	160.0
Total tier 1 capital		740.0
Tier 2		
Collective provisions for impairment	3	0.3
Subordinated debt	2	70.0
Deductions from tier 2 capital	1	(19.2)
Total tier 2 capital		51.1
Total capital		**791.1**

1. Under Basel II a deduction is made for the excess of expected losses on loans and advances to customers, calculated on an IRB basis, over accounting provisions.
2. Principal amount outstanding only.
3. Under Basel II collective provisions for impairment relating to loans and advances to customers, calculated on a standardised basis, are included as tier 2 capital.

Tier 1 capital

Tier 1 capital comprises the general reserve, permanent interest bearing shares and adjustments for the defined benefit pension fund surplus. Intangible assets do not qualify as capital for regulatory purposes and are deducted from capital. The Society's available-for-sale reserve is excluded from tier 1 capital.

The Society has £160 million of subscribed capital which comprises permanent interest bearing shares (PIBS). Interest is paid in arrears on £40 million of PIBS at the rate of 12 1/8% p.a. in half-yearly instalments, and paid in arrears on £120 million of PIBS at the rate of 6.092% p.a. in half-yearly instalments. The shares are repayable only in the event of a winding up of the Society or otherwise with the consent of the FSA. In a winding up or dissolution of the Society the claims of the holders of PIBS would rank behind all other creditors of the Society and the claims of members holding shares as to principal and interest. The holders of PIBS are not entitled to any share in any final surplus upon a winding up or final dissolution of the Society.

Tier 2 capital

Tier 2 capital comprises subordinated debt and the collective impairment provisions, for impairment relating to loans and advances to customers, calculated on a standardised basis.

The Society has £70 million of subordinated debt which is made up of the following:

Subordinated note	Maturity date	Step up date	Type	Amount
Fixed rate subordinated notes 2015	16 December 2015	14 December 2010	Fixed 5.875%	£30 million
Fixed rate subordinated notes 2015	8 November 2015	8 November 2010	Fixed 5.250%	£25 million
Fixed rate subordinated notes 2022	25 June 2022	23 June 2017	Fixed 6.469%	£15 million

The rights of repayment of the holders of the notes are subordinated to the claims of all depositors, creditors and shareholders in the Society, as regards the principal of the notes and interest due on them.

The notes are repayable at the dates stated, or earlier at the option of the Society, with the prior consent of the FSA.

5. Capital adequacy

5.1 Capital management

The Society's capital management objective is to maintain sufficient capital resources to ensure the financial security of the Society. In order to maintain this capital the Society needs to generate and retain profits that will add to the general reserves, the main source of capital.

5.2 Internal capital adequacy assessment process

The Society internally assesses its capital requirements through the Internal Capital Adequacy Assessment Process ('ICAAP'). The ICAAP brings together the risk management framework and the financial disciplines of business planning and capital management in order to assess for the Society:

- the significant risks to which it is exposed;
- the adequacy of its risk assessment and management; and
- the capital resources it needs to address its risk exposures over its planning horizon.

5.3 Challenge and adoption of the ICAAP

The ICAAP document is prepared by the finance team, working in conjunction with credit risk, treasury, operational risk and compliance functions.

The ICAAP is considered within the overall strategic planning process, which maintains a strong focus on the ability of the Society's corporate plan to generate sufficient capital to meet the requirements of balance sheet growth, making an accounting profit in each year and other factors.

The ICAAP is reviewed by the Risk Management Committee to ensure that executive directors and senior management are given a forum to challenge the scope of the risks within the ICAAP and confirm that the capital requirements are appropriate. After review and sign off by the Risk Management Committee, the ICAAP is reviewed and adopted by the Board. The Society's internal audit function reviews the accuracy and consistency of the financial information included within the ICAAP document.

5.4 Minimum capital requirement – Pillar 1

The Society's minimum capital requirement under Pillar 1 is the sum of the credit risk capital requirement and the operational risk capital requirement.

The credit risk capital requirement is largely dependent upon residential mortgage capital calculated under the IRB approach. The remaining credit risk capital requirement is calculated using the standardised approach. The capital requirement under both the IRB and standardised approaches is calculated as 8% of the risk weighted exposure amounts for each of the applicable credit risk exposure classes. The operational risk capital requirement is calculated using the standardised approach.

The following table shows the Society's overall minimum capital requirement as at 31 December 2009:

	As at 31 December 2009 £m
IRB approach	
Credit risk – Retail exposures	84.3
Standardised approach	
Credit risk – Retail exposures	13.7
Credit risk – Liquidity book	49.9
Credit risk – Other	2.5
Operational risk	15.8
Total minimum capital requirement	**166.2**

6. Risks and their management

6.1 Overview

The Society seeks to understand and manage the various risks that arise from its operations. The principal risks facing the Society and the procedures put in place to manage them are described below.

The Society defines the significant risks it faces in a number of categories. These are:

- credit risk;
- market risk;
- liquidity risk;
- operational risk;
- concentration risk; and
- pension obligation risk.

6.2 Credit risk

Credit risk overview

Credit risk is the risk that customers or counterparties will not be able to meet their financial obligations to the Society as they fall due. Credit risk is sub-divided into:

- credit risk for retail exposures; and
- credit risk for the treasury liquidity book and derivatives.

Credit risk exposures

The gross credit risk exposure and the average for the period 1 January 2009 – 31 December 2009 is as follows:

	Note	Average 1 January 2009 - 31 December 2009 £m	As at 31 December 2009 £m
Residential mortgages	1	13,532.3	13,991.3
Unsecured lending	1	91.5	83.4
Total		13,623.8	14,074.7
Treasury:			
Sovereign		1,118.8	1,682.3
Financial institutions		2,491.4	2,103.0
Mortgage-backed securities		409.2	380.1
Total		4,019.4	4,165.4
Total		**17,643.2**	**18,240.1**

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.

The exposures above are stated before credit risk mitigation techniques have been employed.

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

	Notes	United Kingdom £m	Rest of Europe £m	Rest of the World £m	Total £m
Residential mortgages	1	13,991.3	-	-	13,991.3
Unsecured lending	1	83.4	-	-	83.4
Total		14,074.7	-	-	14,074.7
Treasury:					
Sovereign		1,682.3	-	-	1,682.3
Financial institutions		1,534.7	411.5	156.8	2,103.0
Mortgage-backed securities		380.1	-	-	380.1
Total		3,597.1	411.5	156.8	4,165.4
Total		**17,671.8**	**411.5**	**156.8**	**18,240.1**

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.

The residual maturity of the exposures at 31 December 2009 is as follows:

	Notes	Up to 12 months £m	1-5 years £m	5-10 years £m	More than 10 years £m	Total £m
Residential mortgages	1	1,028.1	3,746.6	3,804.8	5,411.8	13,991.3
Unsecured lending	1	7.6	17.4	15.1	43.3	83.4
Total		1,035.7	3,764.0	3,819.9	5,455.1	14,074.7
Treasury:						
Sovereign		379.0	850.1	105.1	348.1	1,682.3
Financial institutions		1,917.9	183.4	1.7	-	2,103.0
Mortgage-backed securities		-	11.6	-	368.5	380.1
Total		2,296.9	1,045.1	106.8	716.6	4,165.4
Total		**3,332.6**	**4,809.1**	**3,926.7**	**6,171.7**	**18,240.1**

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.

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

Credit risk for retail exposures

Credit risk for retail exposures is the risk that lending will result in losses because the advances and interest due are not repaid, or not repaid in full, and because the recovery on the related security will be insufficient to cover the outstanding loan. This is the largest risk for the Society and relates directly to the primary purpose of the Society, which is to advance loans for the purpose of buying residential property.

The Society has obtained permission to use the retail IRB approach to determine the required level of capital to support the majority of its credit risk for retail exposures. All lending is covered by the IRB approach with the exception of the following, where capital is calculated using the standardised approach:

- unsecured personal loans;
- lifetime mortgages (equity release);
- housing association loans; and
- credit impaired loans.

This retail credit risk is managed at a strategic level through a risk appetite set and monitored at Board level including risk limits for new lending, established as part of the corporate planning process and taking into account IRB modelling. These risk limits include consideration of income multiples and prudent loan to value ratios, for example during 2009 the Society did not lend on residential buy-to-let properties where the loan to value ratio was above 65%. In addition, at an operational level the Society's underwriting process seeks to ensure that customers only assume a debt that they can afford to repay, thereby safeguarding both themselves and the Society. Should customers find themselves in financial difficulty, the Society has established procedures to manage the situation to a satisfactory conclusion. Usually, this involves working with the customer to clear arrears or making other arrangements commensurate with the customer's circumstances; should the situation deteriorate significantly, it can involve the Society taking possession of the underlying security. Where possession does take place, the properties repossessed represent the collateral held against these cases.

The Society's exposure to retail credit risk is managed by a specialist department that reports to the Deputy Finance Director. Policies, oversight and review of the risk are provided by the Credit Risk and Lending Committee, the Risk Management Committee and Board.

The exposure values relating to the Society's retail exposures, by risk grade (where 1 is the lowest risk grade), at 31 December 2009 are as follows:

	Notes	Outstanding loans £m	Undrawn loans £m
Risk grades:			
1		7,379.7	95.5
2		3,479.5	67.1
3		1,566.2	51.8
4		836.0	42.6
5		387.3	35.4
6		108.5	12.7
7		70.3	5.4
8		41.0	1.6
9		69.0	0.3
10		132.4	0.2
Past due		289.0	0.0
Total IRB		14,358.9	312.6
Standardised		345.5	0.0
Total retail exposures	1	**14,704.4**	**312.6**

1. Stated at values before applying the effective interest method and before deduction of impairment provisions.

Credit risk for the treasury liquidity book

Credit risk within the treasury function arises from the risk that counterparties will be unable to repay loans and other financial instruments that the Society is obliged to hold as part of its liquidity portfolio to mitigate liquidity risk. The structure of the liquidity book complies with FSA regulations. Credit risk is managed by restrictions on the type of assets held, an assessment of the credit worthiness of counterparties and by the maintenance of exposure limits with each counterparty. Treasury counterparties primarily comprise banks and building societies, but liquidity investments include Aaa rated mortgage-backed securities and UK sovereign debt instruments, such as gilts.

The ALCO, a sub-committee of the Risk Management Committee, is responsible for approving and monitoring the Society's non-retail credit exposures. It does this through the review and approval of the Society's lending policy and the setting of limits on credit exposures to individual counterparties and across countries and industrial sectors.

The approval of new credit limits and the removal of existing limits are reviewed by the Treasury Credit Committee, through ALCO and by the Board. No dealing takes place with counterparties who have not had a limit approved by the Board. Exposure to counterparties is monitored and reported by the Treasury Credit Committee to ALCO.

Counterparty limits are established by considering the financial position, background and external credit rating of the counterparty.

The allocation of capital to the credit risk within the liquidity book is calculated using the standardised approach defined within FSA regulations.

The exposure values relating to the Society's liquidity book at 31 December 2009 are as follows:

	Exposure value by Moody's rating				
	Aaa–Aa3 £m	A1–A3 £m	Baa1–Baa3 £m	Unrated £m	Total £m
Central banks and sovereigns	1,682.3	-	-	-	1,682.3
Financial institutions	1,539.4	273.4	120.0	170.2	2,103.0
Mortgage-backed securities	380.1	-	-	-	380.1
Total	**3,601.8**	**273.4**	**120.0**	**170.2**	**4,165.4**

Unrated institutions are all smaller building societies and local authorities.

Impairment provisions

Assets held at amortised cost

The Society assesses its loans and advances to customers for objective evidence of impairment at each balance sheet date. An impairment loss is recognised if, and only if, there is a loss event (or events) that has occurred after initial recognition and before the balance sheet date that has a reliably measurable impact on the estimated future cash flows of the loan amount.

Impairment is categorised as either individual impairment (where individual assets have been assessed for loss) or collective impairment (where losses are assessed as being present in a portfolio of loans, but they cannot be identified to individual accounts).

If there is objective evidence that an impairment loss on loans and advances to customers has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows (excluding future credit losses that have not been incurred). The carrying amount of the asset is reduced through the use of an impairment allowance and the amount of the loss is recognised in the income statement.

When a loan is not collectable, it is written off against the related provision for loan impairment. Such loans are written off after 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 movement in the provision for loan impairment in the income statement.

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 (such as an improvement in the customer's credit rating), the previously recognised impairment loss is reversed by adjusting the impairment allowance. The amount of the reversal is recognised in the income statement.

These provisions have been deducted from the appropriate asset values shown in the 2009 Annual Report and Accounts.

Provisions below are as at 31 December 2009, the latest externally audited information.

	Residential Mortgages £m	Unsecured loans £m	Total £m
At 1 January 2009			
Individual impairment	11.5	3.9	15.4
Collective impairment	4.7	0.8	5.5
Total	16.2	4.7	20.9
Charge for the year			
Individual impairment	15.8	4.0	19.8
Collective impairment	0.6	(0.5)	0.1
Total	16.4	3.5	19.9
Amounts written off individual impairment	(12.0)	(5.4)	(17.4)
At 31 December 2009			
Individual impairment	15.3	2.5	17.8
Collective impairment	5.3	0.3	5.6
Total	**20.6**	**2.8**	**23.4**

The performance of past due loans as at 31 December 2009 is as follows:

	Notes	£m	%
Not impaired			
Neither past due nor impaired		13,376.7	95.04
Past due up to three months but not impaired		484.5	3.44
Impaired:			
Past due three to six months		104.4	0.74
Past due over six months or in litigation		96.6	0.69
In possession		12.5	0.09
Total exposures	1,2,3	**14,074.7**	**100.00**

1.The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due.
2: All loans are UK-based.
3: The Society has no exposure to commercial property lending.

Available-for-sale-assets

Unrealised gains and losses from changes in the fair values of available-for-sale assets are recognised in the available-for-sale reserve, except for impairment losses, and foreign exchange gains and losses, which are recognised in the income statement.

The Society assesses at each balance sheet date whether there is objective evidence that available-for-sale assets are impaired. If such evidence exists, the cumulative loss measured as the difference between the initial cost and the fair value, is recognised in the income statement.

As at 31 December 2009 no amounts in the treasury portfolio were either past due or impaired for which provision in full had not been made.

Credit risk mitigation

The Society uses a range of techniques to reduce its exposure to credit risk.

For the residential mortgage portfolio credit risk is mitigated by assessing the credit quality of borrowers before loans are approved to ensure that the servicing of the loan falls within the customer's capacity to repay. This assessment process utilises automated credit scoring systems for decisions on small advances and multiple external ratings methodologies to inform the decision on individual large values. Exposures against limits are monitored monthly.

The residential property upon which the mortgage is granted represents the Society's collateral against the loan.

For the treasury liquidity book credit risk is similarly mitigated through the approval and monitoring of credit exposures. The ALCO approves and monitors treasury exposures by setting limits on exposures to individual counterparties and across countries and industrial sectors. Treasury book exposures are monitored daily.

Securitisation

None of the assets originated by the Society have been securitised.

The Society's exposure to purchased securitisation positions amounted to £380.1 million at 31 December 2009 and comprises residential mortgage-backed securities. This entire exposure falls within Moody's credit grading Aaa-Aa3.

Counterparty credit risk

The Society uses derivative instruments to hedge its exposure to interest rate and foreign exchange risk. Counterparty credit risk is the risk of default of a counterparty to such a derivative instrument.

Credit Support Annexes (CSA) exist for collateralising derivative transactions with counterparties to which the Group has its largest derivative exposures in order to mitigate the risk of loss on default.

The exposure values of derivative instruments at 31 December 2009 are given in the following table:

	31 December 2009 Exposure value £m
Interest rate contracts	27.8
Foreign exchange contracts	1.5
Gross positive fair value of contracts	**29.3**
Credit risk mitigation	(29.8)
Net derivatives credit exposure	**(0.5)**

All counterparties with whom the Society holds derivative instruments fall within Moody's credit grading Aaa-Aa3.

Credit Rating Downgrades

If the Society experienced a downgrade in its credit rating, it is likely that in order to secure the AAA rating of its covered bond, additional collateral would have to be placed with its subsidiary undertaking Coventry Building Society Covered Bonds LLP. The value of this collateral would depend upon market conditions at the time.

6.3 Market risk

Market risk is the risk that the value of income arising from the Society's assets and liabilities may change adversely as a result of changes in interest rates or exchange rates. For capital adequacy purposes the Society is not directly exposed to this risk because it does not engage in trading activity and the related foreign exchange risk that arises as a result of funding in other currencies is hedged. Control of market risk exposure is managed by the ALCO, which makes regular reports to the Risk Management Committee and Board.

The most significant elements of market risk are interest rate risk and foreign exchange risk, each of which are described below.

Interest rate risk

Interest rate risk arises from the different interest rate characteristics of the Society's mortgages, savings products and other financial instruments. In particular, the issue of fixed and capped rate mortgages and fixed rate savings products exposes an organisation that principally operates within a variable rate environment (such as the Society), to the risk that the interest rate fluctuations could cause either a reduction in interest income or an increase in interest expense relative to the other interest flows.

The Society's policy is to manage its exposure to these risks within prudent limits governed by the Risk Management, Liquidity and Wholesale Funding Policy. This policy is subject to annual review by the Board. The detailed implementation of the policy, and compliance with the limits set within it, is monitored by the monthly meeting of the ALCO, which receives a formal report from the asset and liability risk management team.

The specific management of these risks involves a combination of matching assets and liabilities with offsetting interest rate characteristics and by the use of derivative financial instruments such as interest rate swaps and caps.

Where the Society has issued fixed rate mortgages, the risk is that a general increase in interest rates would leave the Society facing higher interest expense, but without a compensating increase in interest income. In these circumstances, the Society would take out an interest rate swap with a counterparty bank under which the Society's fixed rate income is exchanged for one based on a variable rate which would be expected to follow the general pattern of interest rate movements and thereby reduce the Society's exposure. Similarly, in cases of issuing fixed rate savings products, the Society would take out an interest rate swap under which the Society receives a fixed rate of interest and pays a variable rate. With capped rate mortgages, the risk is that if the rates increase above a pre-determined level, the Society will be unable to increase its mortgage rate on these products to compensate. In these circumstances, the Society would purchase a rate cap that will pay a variable rate if an agreed index rate (generally LIBOR) exceeds a certain level.

The Society evaluates the impact on margin of various interest rate scenarios to monitor interest rate risk. The Society uses basis point sensitivity analysis to assess the change in the value of the Society's balance sheet net worth against discrete parallel shocks to interest rates. Details of this sensitivity analysis are set out below. The limits around these scenarios are proposed by the ALCO and approved by the Board.

The following table shows the impact on net worth through the reporting period:

	+100bps 2009 £m	-100bps 2009 £m
Impact on equity reserves	(39.8)	38.7
Impact on profit and loss	5.4	(1.6)

The Society also maintains a significant proportion of its assets and liabilities on administered rate products which gives it the opportunity to compensation for any adverse change in interest rates.

All exposures include investment of the Society's reserves.

Interest rate risk exposure to the potential impact of such shifts is maintained within an envelope of exposures over the next five years, consistent with the corporate plan approved by the board. The sensitivity on equity is calculated by re-measuring the fair values of all available-for-sale assets for the effects of the assumed changes in interest rates, and the impact on the income statement arises from the assumed changes in the interest rate relating to floating rate assets and liabilities. The total sensitivity is based on the assumption that there are parallel shifts in the yield curve. In the table above, the values represent the positive and negative impacts on equity and profit and loss faced by the Society due to the effect of a rate shock.

Other interest rate risk exposures, such as basis risk (the risk of loss arising from changes in the relationship between interest rates which have similar but not identical characteristics – such as LIBOR and Bank of England Base Rate) and prepayment risk (the risk of loss arising from early repayment of fixed rate mortgages and loans) are also monitored.

Foreign currency risk

Foreign currency risk arises as a result of the Society's activities in raising funds and making investments in foreign currencies. This is done to ensure wholesale funds are obtained cost effectively across a wide pool of potential providers, but exposes the Society to the risk of an appreciation in the value of foreign currency denominated liabilities or a deterioration in the value of the foreign currency denominated assets. The risk is managed through the use of currency swaps and foreign currency forward contracts and also, where appropriate, by the matching of foreign currency liabilities with assets denominated in the same currency.

After taking into account the effects of cross currency swaps, the Society has no material net exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates. The ALCO sets limits on the level of exposure by currency which are monitored daily.

6.4 Liquidity risk

Liquidity risk is the risk that the Society will be unable to meet its financial obligations as they fall due. The risk is managed principally by the holding of cash and other easily realisable liquid assets. The minimum ratio of these liquid assets to the Society's liabilities is set by statute and adherence to this is monitored internally by the ALCO and externally by the FSA.

The Society maintains a Contingency Funding Plan, reviewed annually by the Board, which evaluates the amount of assets held available-for-sale that would need to be liquidated at short notice to meet a variety of scenarios. In addition daily cash flow projections are stressed to ensure that sufficient liquidity is maintained.

Day-to-day management of the Society's liquidity position is the responsibility of the treasury function and is monitored by the ALCO and, through this committee, by the Risk Management Committee and Board.

Since the year end, the FSA have developed and implemented the Internal Liquidity Adequacy Assessment (ILAA) regime. The ILAA assesses the Society's liquid resources (current and projected) and confirms that these resources are sufficient to meet a projected defined Combination Stress. In addition the Society must also meet the Individual Liquidity Guidance (ILG) issued by the FSA. The Society currently meets the FSA's ILG requirements and passes the Combination Stress test, and will ensure that it continues to do so.

6.5 Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Risk Management Committee annually reviews and approves an Operational Risk Management Policy and an Operational Risk Management Framework.

The Operational Risk Management Framework is built upon the principles of the three lines of defence model. This model recognises that operational risk management is the responsibility of all managers and staff of the organisation. Management have a responsibility to understand how operational risk impacts their area of the business and for putting in place controls or mitigating activities. A report of significant risks, including but not limited to operational risks, is reviewed each month by the managers allocated responsibility for their mitigation, and reported to the relevant management committee with oversight responsibility for the risk. As such, the effective execution of the Society's operations is the first line of defence against operational risk events occurring.

Oversight is required to effectively challenge managers and staff in their performance of operational risk management activities and to provide risk management expertise. The Operational Risk function provides this oversight and expertise, and in so doing acts as the second line of defence, reporting to the Operational Risk and Compliance Committee and through this committee to the Risk Management Committee and Board.

Finally, internal audit is responsible for independently reviewing the effectiveness of the Operational Risk Management Framework and adherence to processes. This represents the third line of defence.

The Society uses the standardised approach for the calculation of the operational risk capital requirement.

6.6 Concentration risk

Concentration risk is the risk that accrues from a high degree of concentration in one particular business area. The Society operates within the UK mortgages and retail savings markets and as such accepts a degree of sectoral concentration risk.

The Society's natural concentration in the UK mortgage market can be exacerbated by over exposure to one geographical location or counterparty, or reliance on particular product types within the mortgage portfolio. This risk is managed by having business strategies that aim to maintain a balance of lending across the UK and regularly monitoring the Society's exposures by region.

The Society manages this risk by monitoring the geographic distribution of lending, the distribution of gross lending by channel of acquisition and by setting new lending risk limits on specific segments of the mortgage market.

6.7 Pension obligation risk

Pension obligation risk for the Society arises from the defined benefit pension scheme. This scheme has been closed to new members since the end of 2001 and, as a result of additional Society contributions, is shown in the 2009 Annual Report and Accounts to have a surplus of £6.9 million using the conservative assumptions under International Accounting Standard 19. The risk is generated by the potential liability of the Society for unexpected future contributions arising from variations in asset values and revised actuarial assessments of the liabilities.

The Society takes a prudent view of pension obligation risk and acts to ensure that any reported deficit is limited, as evidenced by the special contributions made by the Society in 2002, 2004 and 2006. The assumptions used to evaluate the position of the pension fund are discussed with the scheme actuary and are prudent. These assumptions are independently audited by the Society's external auditors.

7. IRB rating system

7.1 The internal rating model and process

The Society has built a set of internal rating models, based on its own data, that assess the credit risk of over 99% of the residential mortgages on its book.

The models that provide the rating of credit risk are split into two types:

- probability of default model; and
- loss given default model.

Probability of default model

The Society uses a probability of default (PD) model to determine the risk of default of a mortgage within the retail IRB exposure class. The PD model is built on a default definition of six or more months in arrears in the next twelve months, or earlier if there is an indication that the borrower has severe payment difficulties (e.g. if the borrower is less than six months in arrears but has been made bankrupt or has entered into an Individual Voluntary Arrangement). This definition corresponds with that used by the Basel Committee on Banking Supervision.

The PD model uses internal data about the borrower and property, and external data in the form of regularly updated credit bureau information, to derive a credit score for each borrower within the IRB exposure class. The score is then calibrated to a PD prediction.

The individual components of the PD model comprise an application model and a behavioural model.

The application model assesses the risk of default of new applications and is built using a combination of loan data and borrower credit details. The application model provides a point-of-application assessment (via the application credit score, which is calibrated to PD).

The behavioural model is built using a combination of internal mortgage performance data with regular updates of the borrower's credit behaviour. The behavioural model produces a behaviour credit score which is also calibrated to PD.

Either the application PD (for new accounts), behaviour PD (for seasoned accounts), or a blend of the two (for accounts that have been open for a short period but are not yet considered seasoned) is taken to be the overall PD rating for the mortgage.

Loss given default model

The Society also uses a loss given default (LGD) model which is calibrated to downturn conditions.

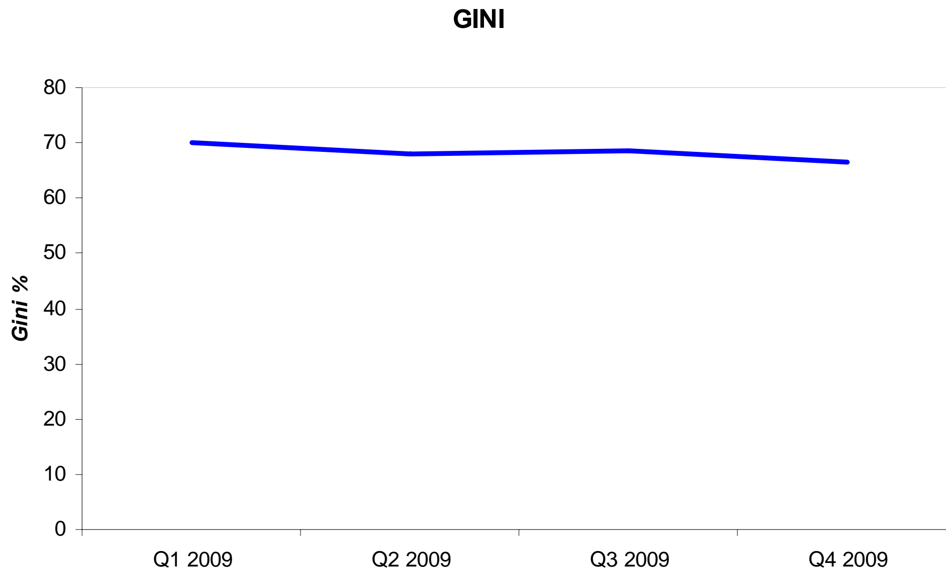
There are a number of sub-models, built using internal data from the last downturn in the early 1990s, which contribute to the overall LGD model. These include models to assess the likelihood of repossession once an account defaults, the forced sale discount that is likely to be experienced in selling a property from possession (the 'haircut') and, if repossessed, the likelihood and amount of loss.

The combination of PD and LGD models is used to determine the expected loss and capital requirement for all mortgages within the retail IRB exposure class.

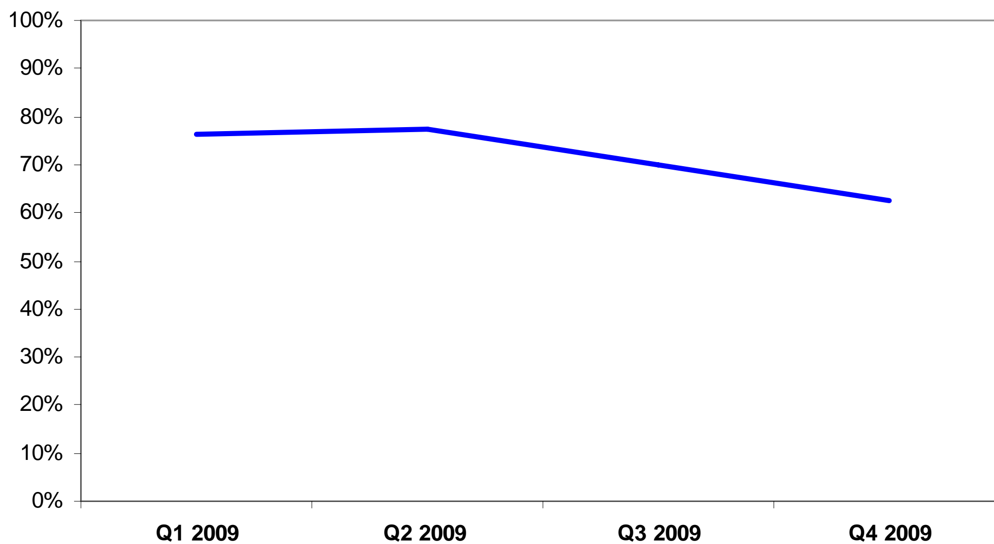
Experience over time

Over time, both the power of the model to discriminate between good and bad accounts across the score range (as measured by the Gini co-efficient) and the accuracy of predictions in terms of actual defaults against expected defaults, is monitored.

The PD model has been shown to be consistently good at providing a high level of discrimination across the score range throughout the period.



The correlation of recent experience of losses to predicted shortfalls is shown in the following graph. Predicted shortfalls in the capital calculation are made using the downturn LGD model, which are set to an assumed peak-to-trough fall in house prices that mirror a downturn in the housing market. Average actual losses are consistently below predictions.



Data integrity

The models have been implemented on the Society's internal systems with no reliance on external systems. This gives the Society complete control over how the models are maintained, how data flows into and out of the models and provides a large degree of flexibility and reporting capability, allowing the risk team to drill into any aspect of model performance.

7.2 Controls and governance

Systems and change control

Physical control of the IRB models resides within the Society's business systems function. Changes to the models (for example in terms of score to PD calibrations) can only be carried out by appropriately designated staff in this area who must follow an audited sign-off and change process.

The models are subject to the back-up and disaster recovery processes that govern all Society systems.

Monitoring and oversight

Monitoring of the IRB models is the responsibility of the Society's credit risk function. The credit risk function undertakes all monitoring required to properly assess the performance of the models, using various statistical techniques, and presents reports to the IRB Rating System Committee, a sub-committee of the Risk Management Committee.

Monitoring reports include an assessment of performance against trigger limits. If appropriate, the credit risk function will make recommendations for amendments or updates to the models. The IRB Rating System Committee, which is chaired by the Finance Director and comprises executive directors and senior management from the credit risk, finance and internal audit functions, is the designated committee through which authority for changes to models is obtained.

External verification

An independent external expert has been appointed to provide the IRB Rating System Committee with an annual review of the work of the credit risk function.

The independent external expert:

- reviews the frequency, quality and appropriateness of the monitoring reports;
- reviews the appropriateness of the credit risk function's analysis and conclusions about model performance;
- provides comment on changes to models recommended by the credit risk function; and
- comments on the documentation surrounding all aspects of the models.

Use of models

The models are designed for use within the Society's operations in addition to providing the ratings required for the performance of regulatory capital calculations. Examples of use within the business include:

- the application PD model is integrated into the application decision making process – the same application model that provides the PD assessment of new applications is used to determine the credit risk, and hence the level of underwriter involvement (alongside lending policy considerations and valuations) of new mortgage applications;
- various aspects of the behavioural model contribute to the prioritisation of collections activity;
- outputs from the shortfall model are used in retention activity, for example at product maturities; and
- shortfall model outputs are also used to assist in impairment provision calculations.