# Coventry Building Society

Pillar 3 Disclosures
31 December 2010

the
COVENTRY
TLC not PLC

# Contents

# 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, and are prescribed within 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.

In January 2008, the FSA granted Coventry Building Society and its subsidiary Godiva Mortgages Limited, 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 standardised percentages set by the FSA.

In 2010, the Coventry Building Society merged with Stroud & Swindon Building Society, which used the standardised approach to retail credit risk management in respect to Stroud & Swindon Building Society originated assets, and the mortgages originated and acquired by its subsidiary ITL Mortgages Limited. The Society intends to adopt the IRB approach for mortgages acquired during the merger in due course. The Society uses the standardised approach in calculating the capital requirements for other risk types – for example, operational risk.

## 1.2 Scope of disclosures

The Pillar 3 disclosures in this document relates to Coventry Building Society (FSA registered number 150892) and its subsidiary undertakings (together referred to as 'the Society'). The Society also includes the business combination that occurred in 2010 from the merger with Stroud & Swindon Building Society. The subsidiary undertakings included within these disclosures are Godiva Mortgages Limited (FSA registered number 457622), ITL Mortgages Limited (FSA registered number 302608), Stroud and Swindon Funding Company, Stroud and Swindon Funding Company (No. 2) Limited and Five Valleys Property Company Limited.

Godiva Mortgages Limited and ITL Mortgages Limited distribute products solely through mortgage intermediaries. All funding comes from the Society. Stroud and Swindon Funding Company and Stroud and Swindon Funding Company (No.2) Limited provide funding for the acquisition of mortgage books. Five Valleys Property Company Limited undertakes investment in residential property for letting purposes.

This consolidated treatment reflects the scope of the Society's solo consolidation waiver approval from the FSA. This means that for prudential purposes the Society and its subsidiaries can be viewed as a single entity. This is consistent with the basis of consolidation for accounting 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 its subsidiary undertakings.

## 1.3 Basis and frequency of disclosures

This document sets out the 2010 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 Society in accordance with the rules laid out in BIPRU Chapter 11. The disclosures may differ from similar information in the Annual Report and Accounts 2010 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 2010, the Society's year end, unless otherwise stated.

Future disclosures will be issued on an annual basis and published as soon as practicable after the publication of the Annual Report and Accounts.

## 1.4 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.

## 1.5 Remuneration

Following the introduction of the FSA's Remuneration Code, a new section has been included within section 8, in order to comply with the disclosure requirements of the Capital Requirements Directive (CRD 3). This outlines the responsibilities and decision-making process for determining remuneration policy, the link between pay and performance and the design and structure of remuneration, including the performance pay plans.

# 2. Scope of IRB permission granted

On the 1 January 2008, the FSA granted approval for the Society to use the IRB approach for prime residential and buy-to-let mortgage exposures, for assets included within Coventry Building Society and Godiva Mortgages Limited. As at 31 December 2010, this covered 98% of the mortgage assets held, after excluding assets acquired as a result of the merger with the Stroud & Swindon Building Society. Assets acquired as a result of the merger, continue to be assessed using the standardised approach, however, the Society intends to assess these mortgages under the IRB approach in due course.

In line with industry best practice the Society is continuously reviewing the IRB models used and the assumptions within them are reviewed annually by independent specialists.

# 3. Risk management policies and objectives

## 3.1 Approach to risk management

The Society is a mutual organisation run for the long term benefit of its members. This objective is known throughout the Society as 'Members First'. In keeping with its mutual status, the Society's Board adopts a prudent approach to managing risk geared towards long-term value creation for the benefit of members. 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** – risk management is primarily 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 has an independent reporting line directly to the Chairman of the Board Risk Committee. In April 2011, a Chief Risk Officer was appointed, who now directly reports to the Chief Executive in place of the Head of Risk.

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

The structure and responsibility of management and board committees as at 31 December 2010 are set out below:

## 3.3 Governance and oversight of risk

### Board

The Board is accountable to the Society's members for the overall direction and management of all affairs and business of the Society and places the highest priority on good corporate governance. 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 membership is made up of four of the Society's non-executive directors. The Society's external auditors, the Chief Executive, Finance Director, Secretary and Solicitor, Head of Risk, Head of Internal Audit and also certain senior managers (if required) attend Board Audit Committee meetings. In addition, the external auditors meet members of the committee in private session.

The responsibilities of the committee comply with the provisions of the Smith Guidance on Audit Committees and the UK Corporate Governance Code. The main function of the committee is to assist the Board in fulfilling its oversight responsibilities with specific regard to:

- monitoring the integrity of the half-year and annual financial statements and any formal announcements relating to financial performance, focusing particularly on the financial reporting judgements contained in them;
- reviewing the adequacy of systems of internal control and risk management processes;
- assessing the effectiveness of internal audit;
- considering compliance with relevant laws and regulations, including the Financial Services and Markets Act 2000;
- reviewing the performance of external auditors and overseeing the appointment by the Society of the external auditors for non audit work; and
- making recommendations to the Board on the appointment, re-appointment or removal of external auditors and the amount of their remuneration.

### Board Risk Committee

The Board Risk Committee was formed in June 2010 as a Board committee. During 2010 it was chaired by the Society's Chairman, and membership was made up of the Society's non-executive directors and the Head of Risk. In addition, the Society's executive directors and the Secretary and Solicitor attended Board Risk Committee Meetings. 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 by:

- reviewing and challenging material risks in relation to the Board's risk appetite and the Society's liquidity and capital adequacy;
- reviewing and challenging the Society's rating systems; and
- reviewing and challenging material breaches and control weaknesses and responses.

### Executive Committee

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

### Risk Management Committee

Chaired by the Chief Executive and comprised of executive directors and senior management, with non-executive directors in attendance by rotation and the external auditors in attendance by invitation.

The committee ensures that risk is being managed efficiently across the Society, in accordance with the corporate plan. The minutes of the committee are presented to the Board Risk Committee.

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, including the Chief Executive. The committee oversees the management of the Society's asset and liability strategy. The minutes of the committee are presented to the Board Risk Committee.

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 Finance Director and comprised of the Sales and Marketing Director, Head of Risk and senior management. The committee monitors the performance of the Society's mortgage book to ensure compliance with limits approved by the Board. This committee is also responsible for revising and amending lending policy in response to changes in the market.

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.

## Rating System Committee

Chaired by a non-executive director (Ian Pickering) and comprised of executive directors and senior management. The committee monitors the performance of the Society's Basel II 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 2010 the Society has complied in full with all of its externally imposed capital requirements. The table below breaks down the components of capital available to the Society as at 31 December 2010.

## 4.2 Capital available

| | Notes | As at 31 December 2010 £m |
|---|---|---|
| **Tier 1** | | |
| General reserve | | 704.5 |
| Pension fund surplus adjustment | | (7.2) |
| Intangible assets | | (12.2) |
| Deductions from tier 1 capital | 1 | (15.3) |
| **Core tier 1 capital** | | 669.8 |
| Permanent interest bearing shares | 2 | 160.0 |
| **Total tier 1 capital** | | 829.8 |
| | | |
| **Tier 2** | | |
| Collective provisions for impairment | 3 | 0.8 |
| Subordinated debt | 2 | 67.0 |
| Deductions from tier 2 capital | 1 | (15.3) |
| **Total tier 2 capital** | | 52.5 |
| **Total capital** | | **882.3** |

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 and are allocated 50% to tier 1 and 50% to tier 2 capital.
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 £67 million of subordinated debt which is made up of the following:

| Subordinated note | Maturity date | Option to call date | Step up date | Type | Amount |
|---|---|---|---|---|---|
| Fixed rate subordinated notes 2016 | 4 December 2016 | No option | n/a | Fixed 12.25% | £7 million |
| Fixed rate subordinated notes 2017 | 3 June 2017 | 3 June 2012 | n/a | Fixed 8.37% | £10 million |
| Fixed rate subordinated notes 2021 | 8 November 2021 | 8 November 2016 | n/a | Fixed 6.12% | £10 million |
| Fixed rate subordinated notes 2022 | 25 June 2022 | 23 June 2017 | 23 June 2017 | Fixed 6.469% | £15 million |
| Fixed rate subordinated notes 2026 | 29 August 2026 | 29 August 2021 | n/a | Fixed 6.33% | £10 million |
| Fixed rate subordinated notes 2032 | 23 August 2032 | 23 August 2027 | n/a | Fixed 7.54% | £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 in accordance with their terms at the option of the Society, with the prior consent of the FSA.

During the year ended 31 December 2010 the Society, acquired subordinated liabilities maturing in 2016, 2017, 2021, 2026 and 2032 as a result of the merger with Stroud & Swindon Building Society.

# 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 Society's finance team, working in conjunction with the 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 ALCO to ensure that 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 ALCO, 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 2010:

| | As at 31 December 2010 £m |
|---|---|
| **IRB approach** | |
| Credit risk – Retail exposures | 121.8 |
| **Standardised approach** | |
| Credit risk – Retail exposures | 71.7 |
| Credit risk – Liquidity book | 27.2 |
| Credit risk – Other | 4.0 |
| Operational risk | 18.8 |
| **Total minimum capital requirement** | **243.5** |

# 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 2010 – 31 December 2010 is as follows:

| | Note | Average 1 January 2010 - 31 December 2010 £m | As at 31 December 2010 £m |
|---|---|---|---|
| Residential mortgages | 1 | 15,738.5 | 17,485.7 |
| Unsecured and other lending | 1, 2 | 85.8 | 88.0 |
| Total | | 15,824.3 | 17,573.7 |
| | | | |
| Treasury: | | | |
| Central banks and sovereigns | | 2,261.7 | 2,817.6 |
| Multilateral development banks (supranational bonds) | | 54.2 | 108.4 |
| Financial institutions | | 1,647.1 | 1,214.6 |
| Mortgage-backed securities | | 370.6 | 361.0 |
| Local authorities | | 15.1 | 30.3 |
| Total | | 4,348.7 | 4,531.9 |
| **Total** | | **20,173.0** | **22,105.6** |

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.
2. Other lending includes loans fully secured on land.

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

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

| | Notes | United Kingdom £m | Rest of Europe £m | Rest of the World £m | Total £m |
|---|---|---|---|---|---|
| Residential mortgages | 1 | 17,485.7 | - | - | 17,485.7 |
| Unsecured and other lending | 1,2 | 88.0 | - | - | 88.0 |
| Total | | 17,573.7 | - | - | 17,573.7 |
| Treasury: | | | | | |
| Central banks and sovereigns | | 2,762.8 | 54.8 | - | 2,817.6 |
| Multilateral development banks (supranational bonds) | | - | 108.4 | - | 108.4 |
| Financial institutions | | 817.3 | 313.3 | 84.0 | 1,214.6 |
| Mortgage-backed securities | | 361.0 | - | - | 361.0 |
| Local authorities | | 30.3 | - | - | 30.3 |
| Total | | 3,971.4 | 476.5 | 84.0 | 4,531.9 |
| **Total** | | **21,545.1** | **476.5** | **84.0** | **22,105.6** |

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.
2. Other lending includes loans fully secured on land.

The residual maturity of the exposures at 31 December 2010 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 | 1,305.5 | 4,735.6 | 6,528.9 | 4,915.7 | 17,485.7 |
| Unsecured and other lending | 1,2 | 6.6 | 17.6 | 32.5 | 31.3 | 88.0 |
| Total | | 1,312.1 | 4,753.2 | 6,561.4 | 4,947.0 | 17,573.7 |
| Treasury: | | | | | | |
| Central banks and sovereigns | | 1,432.6 | 457.4 | 615.1 | 312.5 | 2,817.6 |
| Multilateral development banks (supranational bonds) | | - | - | 108.4 | - | 108.4 |
| Financial institutions | | 1,110.3 | 87.4 | 16.9 | - | 1,214.6 |
| Mortgage-backed securities | | - | - | 51.6 | 309.4 | 361.0 |
| Local authorities | | 30.3 | - | - | - | 30.3 |
| Total | | 2,573.2 | 544.8 | 792.0 | 621.9 | 4,531.9 |
| **Total** | | **3,885.3** | **5,298.0** | **7,353.4** | **5,568.9** | **22,105.6** |

1. Stated at amortised cost using the effective interest method and after deduction of impairment provisions.
2. Other lending includes loans fully secured on land.

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 against which the loan is secured.

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.

Mortgages acquired as a result of the merger with Stroud & Swindon continue to be assessed for capital requirements under the standardised approach until the IRB approach is adopted in due course.

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. 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 reported throughout 2010 to the Finance Director. Following the creation of a Chief Risk Officer role in 2011, this department is now managed as part of the Society's risk management structure. Policies, oversight and review of the risk are provided by the Credit Risk and Lending Committee, the Risk Management Committee and Board, through the Board Risk Committee.

The exposure values relating to the Society's retail exposures, by risk grade (where 1 is the lowest risk grade), at 31 December 2010 are as follows:

| | Notes | Outstanding loans £m | Undrawn loans £m |
|---|---|---|---|
| **Risk grades:** | | | |
| 1 | | 8,522.6 | 164.6 |
| 2 | | 3,849.9 | 114.5 |
| 3 | | 1,685.0 | 88.4 |
| 4 | | 908.5 | 85.3 |
| 5 | | 423.9 | 65.5 |
| 6 | | 129.3 | 19.3 |
| 7 | | 79.2 | 11.1 |
| 8 | | 36.1 | 3.1 |
| 9 | | 74.8 | 0.5 |
| 10 | | 149.0 | 0.3 |
| Past due | | 280.3 | - |
| Total IRB | | 16,138.6 | 552.6 |
| Standardised | | 2,138.6 | 111.0 |
| **Total retail exposures** | 1 | **18,277.2** | **663.6** |

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. This risk is monitored on a weekly basis by the Treasury Credit Committee which is chaired by either the Finance Director or the Chief Executive. The Society has restrictions on the type of assets it holds, undertakes assessments of the credit worthiness of counterparties, and works strictly within exposure limits for each counterparty, that are set by the Board. These limits require formal review annually but in practice are reviewed by the Society's specialist credit analyst and reported to the Treasury Credit committee as required in response to changing economic conditions. The treasury risk management team and the Treasury Credit Committee report through ALCO to the Risk Management Committee and to the Board Risk Committee.

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

The exposure values relating to the Society's liquidity book at 31 December 2010 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 | 2,817.6 | - | - | - | 2,817.6 |
| Multilateral development banks (supranational bonds) | 108.4 | - | - | - | 108.4 |
| Financial institutions | 1,014.8 | 91.2 | 28.7 | 79.9 | 1,214.6 |
| Mortgage-backed securities | 361.0 | - | - | - | 361.0 |
| Local authorities | - | - | - | 30.3 | 30.3 |
| **Total** | **4,301.8** | **91.2** | **28.7** | **110.2** | **4,531.9** |

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 2010 Annual Report and Accounts.

Provisions below are as at 31 December 2010, the latest externally audited information.

| | Residential Mortgages £m | Unsecured loans £m | Total £m |
|---|---|---|---|
| At 1 January 2010 | | | |
| Individual impairment | 15.3 | 2.5 | 17.8 |
| Collective impairment | 5.3 | 0.3 | 5.6 |
| Total | 20.6 | 2.8 | 23.4 |
| Charge for the year | | | |
| Individual impairment | 7.7 | 3.5 | 11.2 |
| Collective impairment | 0.1 | 0.5 | 0.6 |
| Total | 7.8 | 4.0 | 11.8 |
| Amounts written off individual impairment | (8.7) | (5.4) | (14.1) |
| At 31 December 2010 | | | |
| Individual impairment | 14.3 | 0.6 | 14.9 |
| Collective impairment | 5.4 | 0.8 | 6.2 |
| **Total** | **19.7** | **1.4** | **21.1** |

The performance of past due loans as at 31 December 2010 is as follows:

| | Notes | £m | % |
|---|---|---|---|
| Not impaired | | | |
| Neither past due nor impaired | | 16,588.5 | 94.40 |
| Past due up to three months but not impaired | | 736.7 | 4.19 |
| Impaired: | | | |
| Past due three to six months | | 120.2 | 0.68 |
| Past due over six months or in litigation | | 117.2 | 0.67 |
| In possession | | 11.1 | 0.06 |
| **Total exposures** | 1,2 | **17,573.7** | **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.

### Available-for-sale-assets

Unrealised gains and losses arising from changes in the fair values of Available-for-sale assets are recognised directly in the Available-for-sale reserve, except for impairment losses and foreign exchange gains and losses, which are recognised in the income statement. Gains and losses arising on the sale of Available-for-sale assets, including any cumulative gains or losses previously recognised in the Available-for-sale reserve, 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 2010 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 supplemented where appropriate by a risk based assessment from experienced underwriters. The residential property upon which the mortgage is granted represents the Society's collateral against the loan.

For wholesale lending which is undertaken as part of the Society's treasury operations, multiple external ratings methodologies are used to inform lending decisions. Counterparty limits are set by the Board and are reviewed by the Society's Treasury Credit Committee on a regular basis.

For the treasury liquidity book credit risk is similarly mitigated through the approval and monitoring of credit exposures. The ALCO monitors treasury exposures and sets limits on exposures to individual counterparties and across countries and industrial sectors. These limits are reviewed by the Society's Board Risk Committee and approved by the Board. Treasury book exposures are monitored daily.

### Securitisation

None of the assets originated by the Society have been securitised. Certain loans and advances to customers were transferred from the Society to Coventry Building Society Covered Bonds LLP in order to secure £2,000.0 million of covered bonds issued by the Society.

The Society's exposure to purchased securitisation positions amounted to £361.0 million at 31 December 2010 and comprises residential mortgage-backed securities. As at 31 December 2010, this entire exposure had a Moody's credit grading of 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 Society has its largest derivative exposures in order to mitigate the risk of loss on default.

The exposure values of derivative instruments at 31 December 2010 are given in the following table:

| | 31 December 2010 Exposure value £m |
|---|---|
| Interest rate contracts | 72.4 |
| Foreign exchange contracts | 1.0 |
| **Gross positive fair value of contracts** | **73.4** |
| Credit risk mitigation | (70.7) |
| **Net derivatives credit exposure** | **2.7** |

As at 31 December 2010, the counterparties with whom the Society held derivative instruments had Moody's credit grading Aaa-Aa3.

### Credit Rating Downgrades

If the Society experienced a downgrade in its credit rating, it may be required to place additional collateral with its subsidiary undertaking Coventry Building Society Covered Bonds LLP, to support its covered bond. 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, foreign exchange rates or house prices. The Society's policy is to manage these risks prudently, which is ensured through the setting of limits by the Board. The Society ensures compliance with these limits through a combination of matching assets and liabilities with off-setting interest rate or currency characteristics, and by the use of derivative financial instruments such as interest rate swaps and caps, foreign exchange swaps and foreign exchange forward purchase contracts. Control of market risk exposure is managed by ALCO, which makes regular reports to the Risk Management Committee and the Board Risk Committee.

The most significant elements of market risk for the Society are interest rate risk, foreign currency risk and house price 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 this risk 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 this risk involves a combination of matching assets and liabilities with offsetting interest rate characteristics and 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 typically take out an interest rate swap with a counterparty bank, exchanging the Society's fixed rate income 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, when issuing fixed rate savings products, the Society would typically 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 interest 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.

In addition, the Society regularly forecasts the impact of movements in the Bank of England Base Rate on the Society's balance sheet to ensure any potential adverse impact can be anticipated and reported to ALCO. 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 due to 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 2010 £m | -100bps 2010 £m |
|---|---|---|
| Impact on equity reserves | (18.7) | 18.8 |
| Impact on profit and loss | 11.8 | (8.3) |

The Society also maintains a significant proportion of it's 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.

Exposure to the potential impact of such shifts in interest rates is maintained within an envelope of exposures over the next five years, consistent with the corporate plan approved by the board. The sensitivity of 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 undertaken 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 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, and adherence to these limits are monitored daily.

### House price risk

House price risk is present in two forms. Most significantly this risk arises from the value of the property forming the security for a mortgage being insufficient to repay the loan in the event of default and subsequent repossession. The Society manages this risk through a combination of prudent loan-to-value limits at inception and ongoing monitoring to ensure that bad debt provisions are sufficient to cover the potential losses that may arise in repossession situations.

With respect to lifetime mortgages, house price risk also arises from the 'no negative equity' guarantee, whereby the borrower is guaranteed that the amount recoverable by the Society at the end of the mortgage will not exceed the value of the property.

Under these loans, the borrower receives an advance but makes no payments of interest or principal until the loan is redeemed. The interest is added to the loan and recovered by the Society when the loan is redeemed. The 'no negative equity' guarantee therefore exposes the Society to the risk that the value of the property at the time of redemption is lower than the loan plus accumulated interest. The Society manages this risk by granting loans only at relatively low loan to value ratios, subject to the age of the borrower, and through the use of statistical modelling to stress potential exposures within acceptable prudent limits. Only 2% of the Society's outstanding mortgage balances have been advanced on this type of product. The Society does not currently offer these products to new applicants.

The risks presented by house price movements are evaluated through stress testing and monitored by the Credit Risk and Lending Committee and ALCO and, through these committees, by the Risk Management Committee and the Board Risk Committee.

## 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 accounts and other easily realisable liquid assets. The amount and composition of liquid assets held is subject to guidance from the FSA and to regular stress testing. The stress programme, and other policies addressing liquidity risk, have been updated in accordance with the Internal Liquidity Adequacy Assessment ('ILAA') undertaken by the Society. The ILAA reflects the new liquidity regime introduced by the FSA in 2010, and has resulted in a greater proportion of the liquidity book being represented by Government securities or invested with the Bank of England via a current account. Whilst these assets realise a relatively low yield, this reflects the very low credit risk represented by a AAA rated sovereign entity, such as the UK Government, and ensures the assets can readily be converted into cash to meet liabilities, as they fall due.

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

### 6.5 Operational risk

Operational risk is the risk of loss arising from inadequate or failed internal processes, people and systems or from external events, including legal risks. These risks are managed as an integral part of the operation of each of the Society's business units. Management has a responsibility to understand how operational risk impacts the area of the business for which they are responsible, and for putting in place controls or mitigating activities. The operational risk department ensures co-ordination of the Society's risk assessment and resulting control activities, reporting to the Operational Risk and Compliance Committee and, through this committee, to the Risk Management Committee and the Board Risk Committee.

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 Risk Committee.

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.

New operational risks arose in 2010 following the merger with Stroud & Swindon from the integration work required to migrate the information stored on Stroud & Swindon systems onto the framework used by the Society. There are risks both in undertaking this exercise, for example, data errors on transfer, and also a risk that as a result of the scale of work required, resource will be distracted from managing the ongoing operation of the Society in a challenging external environment. The Society has a strong track record in undertaking major change programmes and has considerable project expertise. In addition an experienced Managing Director has been appointed to manage the operations at Stroud & Swindon until the migration is complete. A dedicated steering group has been set up to manage this project with responsibility of also highlighting the impact on business as usual activity. This steering group is chaired by the Chief Operating Officer and members include the Chief Executive, Sales and Marketing Director and the Managing Director of Stroud & Swindon. Updates from this steering group are provided monthly to the Risk Management Committee and Board.

Financial crime is also recognised by the Society as an evolving and substantial threat to the security and the safe operation of all financial institutions. The Society continues to invest in monitoring and control systems to prevent increasingly sophisticated criminal attacks, and has an excellent track record in this area.

The Society has a duty of care to its staff, members and visitors whilst present on Society premises. The Society has in place comprehensive health and safety polices and a compliance regime which includes internal and external inspection, the maintenance and testing of equipment as well as appropriate training programmes; these are reviewed regularly. This work is overseen by the Security and Safety Committee which reports to the Risk Management Committee and Board Risk Committee each month. In addition the Society has developed Business Continuity Plans to manage situations in which buildings, systems or significant staff are unavailable, for example, in the event of a flu pandemic or the loss of utilities. The Society's Business Continuity Plan is overseen by the Operational Risk and Compliance Committee and, through this, by the Risk Management Committee and the Board Risk Committee.

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 two defined benefit pension schemes. This 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.

Both Coventry's and Stroud & Swindon's defined benefit pension schemes were closed to new members in 2001. As a result of Society contributions, a surplus of £7.2 million was presented for the Coventry defined benefit pension scheme in the 2010 Annual Report and Accounts. The Stroud & Swindon defined benefit pension scheme deficit reduced from £6.5 million, as presented in the Stroud & Swindon 2010 cessation accounts, to £3.1 million as presented in the Society's 2010 Annual Report and Accounts.

The Society takes a prudent view of pension obligation risk and acts to ensure that any reported deficit is limited. Special contributions were made by the Society in 2002, 2004 and 2006. Stroud & Swindon Building Society made a special contribution to its pension fund in 2010, to which Coventry Building Society contributed further during 2011. 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 98% of the residential mortgages on its book (excluding assets acquired as a result of the merger with Stroud & Swindon, which continue to be assessed under the standardised approach).

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 complies with the provision in BIPRU.

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.

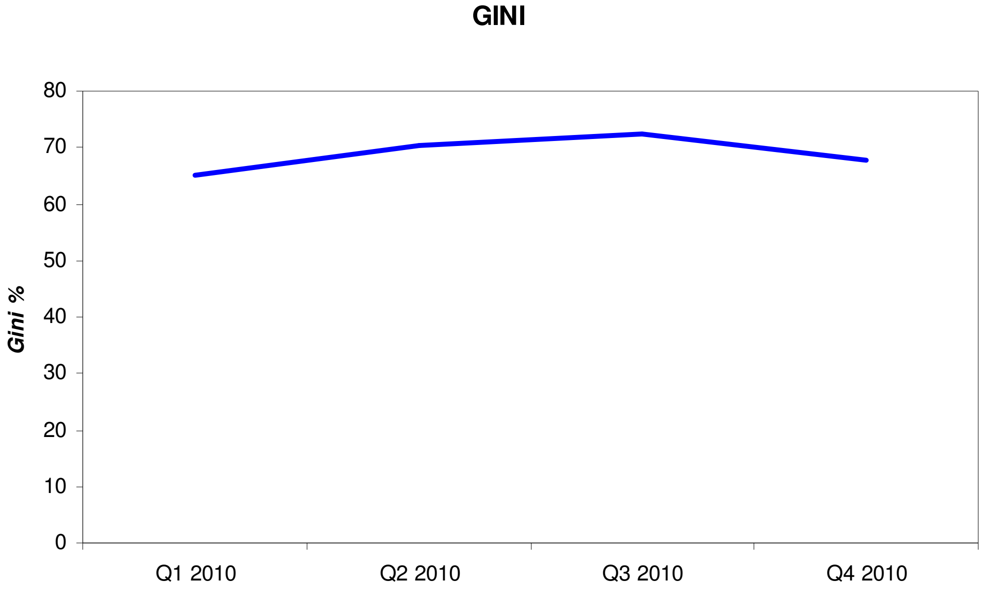
There are a number of sub-models, built using internal data from the last downturn in the early 1990s, which contribute to the overall LGD model. These include models to assess the likelihood of repossession once an account defaults, the forced sale discount that is likely to be experienced in selling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

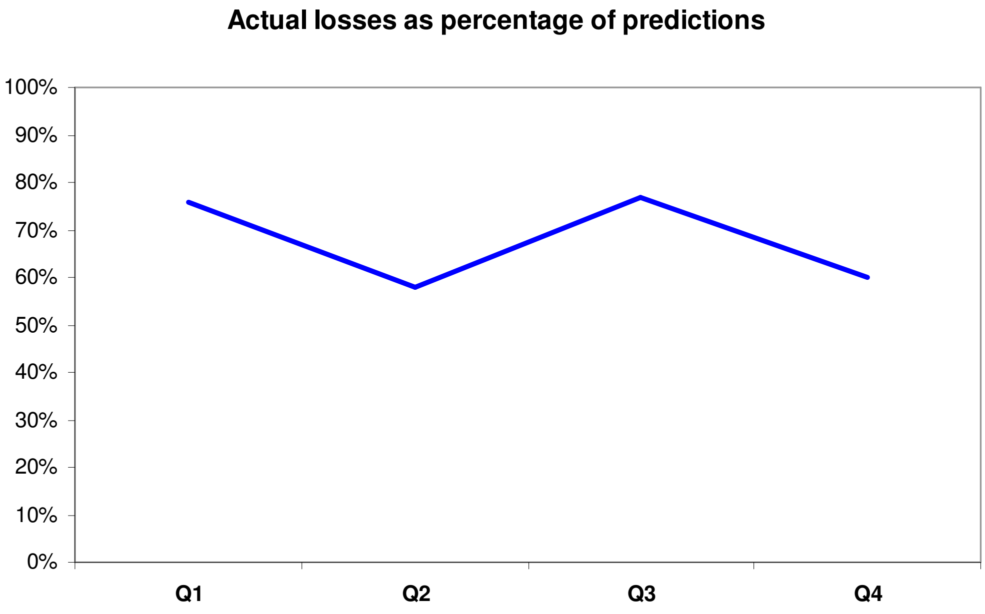
### Experience over time

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 a non-executive director (Ian Pickering) 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;
- comments on the documentation surrounding all aspects of the models; and
- provides an assessment of the use of the IRB models within the business.

### 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.

# 8. FSA Remuneration Code Disclosures

## 8.1 Remuneration disclosure requirements

The Society is committed to complying with the FSA's Remuneration Code, and meeting the additional requirements of the FSA's rules regarding remuneration disclosure, in compliance with the Capital Requirements Directive (CRD3). These additional remuneration disclosures focus on the remuneration policies and practices for members of staff ("Code Staff") who have a material impact on the Society's risk profile. "Code staff" consist of executive directors, senior management and members of staff in control functions (human resources, risk and compliance). Under the Remuneration Code non-executive directors are also treated as Code Staff.

Responsibility for the approval and periodic review of the Society's remuneration policy, while having due regard to the FSA Remuneration Code, rests with the Board Remuneration Committee. This includes ensuring that the Society complies with FSA remuneration disclosure requirements.

## 8.2 Remuneration Committee

The Board has overall responsibility for the Society's remuneration, which is delegated to the Remuneration Committee.

The committee consists of the non-executive directors of the Society and is chaired by Bridget Blow, Deputy Chairman and Senior Independent Director. The committee is responsible for considering and approving the remuneration of executive directors and senior management. The committee agrees the targets of the Long-Term Incentive Plan (LTIP) for executive directors and executives and also sets targets for the Society's annual performance related bonus scheme in which all staff members participate. In 2010 the committee met four times.

The Head of Human Resources provides advice on remuneration policies and practices and is usually invited to attend meetings, along with the Chief Executive.

The committee on occasion commissions external consultants to review the Society's remuneration for senior managers including non-executive directors; Towers Watson provides general salary benchmarking data to the Society; and KPMG LLP has provided advice on ad hoc matters relating to remuneration issues for the senior team.

Further details of the committee, the remuneration policy and directors' service contracts can be found in the Directors' Remuneration Report on pages 26 to 28 of the Society's Annual Report and Accounts 2010. The terms of reference of the Remuneration Committee are available on request from the Secretary.

## 8.3 Remuneration policy

### Non-Executive Directors

Non-executive directors are independent of the Society's management and are not required to devote the whole of their time to its affairs.

After considering recommendations from the executive directors, the Board (chaired for this purpose by an executive director) determines the remuneration of all non-executive directors. No director takes part in the discussion of his or her own remuneration. Fees of non-executive directors are reviewed annually in light of their responsibilities and comparative information from other building societies.

Non-executive directors do not participate in any performance related pay or bonus scheme, pension arrangements or other benefits.

### Senior managers with a material impact on the Society's risk profile

The Society's remuneration policy is based on the following key principles:

- the remuneration of executives, code staff and staff in 'control functions' is in line with the FSA's Remuneration Code
- total rewards should be set at levels that are competitive in the market and positioned around the market median for the comparator group
- incentive plans, performance measures and targets should be stretching and aligned with members' interests
- remuneration policy is designed to recruit and retain quality staff at all levels and to ensure that their remuneration packages reflect their responsibilities, performance and experience
- remuneration is consistent with and promotes sound and effective risk management and does not encourage excessive risk taking
- remuneration strategy is in line with the business strategy, objectives and values and long-term interests of the Society
- remuneration strategy does not result in conflicts of interests
- remuneration is consistent with the overall financial stability of the Society and does not present material risk to this stability
- bonus payments will be limited or withdrawn where individual or business performance does not merit payment of a bonus
- where staff do not perform to the required standard, under performance will not be rewarded.

- remuneration of staff in 'control functions' will not affect their independence in any way
- the performance of all staff is reviewed each year against agreed individual and business objectives. The outcome of this review is taken in to account when considering pay decisions
- no executive director, executive or member of code staff are involved in the setting of their own remuneration.

### 8.4 Remuneration elements

#### Base Salary

For all employed staff, including executive directors, the Society aims to pay fair and competitive salaries, linked to individual performance. To ensure that pay remains competitive, salaries are compared to market median rates. This means that the Society researches what is the standard rate for a job across the market and aims to be a median payer for experienced staff who have minimal training needs and who are performing to a good standard or above.

By being a median payer, the Society helps ensure that the costs of running the organisation (of which the total of all staff salaries represents approximately 60%) remain in line with those of its competitors.

For each role there is a salary range, which allows for salaries to increase as individuals become more experienced in their role. Some areas of the business have accreditation or salary progression schemes which apply a minimum salary level when certain performance criteria have been demonstrated consistently.

#### Variable pay

The Remuneration Committee believes that performance related pay enables a flexible approach to remuneration which means payments are accurately aligned to results.

The Society sets levels of variable remuneration at a conservative level so individuals are not incentivised to take risk in order to increase the amount of payments they receive. The committee supports an appropriate mix of short and long term plans, which do not exceed 60% of fixed pay.

The FSA's Remuneration Code requires that at least 50% of any variable remuneration component is to be made in shares, share linked instruments or other equivalent non-cash instruments, subject to an undefined retention period and the de minimis rules. Given the nature of the Society's mutual status, this is currently under discussion with the FSA, with resolution required by 1 July 2012. In line with the transitional relief allowed by the FSA, payments are currently made in cash.

#### i. Long Term Incentive Plan (LTIP)

In order to ensure that the remuneration package of executive directors reflects the long term performance of the Society and members' interests, the Remuneration Committee operates a Long Term Incentive Plan. The 2010 LTIP was for executive directors and satisfies the FSA Remuneration Code requirement for part of variable remuneration to be deferred for certain staff.

The primary objective of this plan is to align remuneration with the longer term goals of the Society. The LTIP also helps the Society to recruit and retain high calibre executives directors and to ensure that their remuneration packages reflect their responsibilities, performance and experience.

Under the 2010 LTIP, the executive directors are eligible to receive a performance related payment based on the financial performance of the Society over a rolling three year period. Targets are set and reviewed by the Remuneration Committee. The measures currently used under the LTIP are profit before tax before contributions to the Financial Services Compensation Scheme. There is a vesting matrix which is used to determine the amount of the award which will vest.

The plan is designed to make payments in the year following the end of the three year period provided that consistent and strong performance is achieved against the three year plan. On-plan performance over each of the three year periods provides a 20% of salary payment, with a current maximum of 40% for consistent over-performance over the period.

The committee reviews all payments and can award a lower amount if appropriate. To protect the interests of members, the committee may amend any payment if it considers it appropriate in light of either the Society's overall performance or economic conditions. In making its assessment the Remuneration Committee may take into account any one or more of the following factors:

- Market share;
- Customer and member satisfaction;
- Health and safety record;
- Risk management factors;

- Overall financial performance of the Society relative to the performance of other building societies and in light of the market conditions prevailing during the performance period;
- Individual performance;
- Business unit performance; and
- Any other factors the Remuneration Committee feels are relevant.

Payments under the LTIP are not pensionable.

### ii. Annual performance related bonus

To ensure that the Society is competitive in attracting and retaining staff, a performance related bonus scheme is offered as a key part of the reward structure. The annual performance related bonus is a discretionary annual bonus scheme which enables all staff to share in the Society's success when performance is strong. The scheme applies to all staff and on the same terms, including executive directors and executives, Code Staff and staff in 'control functions'. Details of the annual bonus scheme can be changed from time to time at management and Remuneration Committee discretion.

The scheme targets are reviewed each year in the light of business plans. The scheme is based on the level of profit achieved before contributions to the Financial Services Compensation Scheme and before the impact of the merger with Stroud & Swindon Building Society. The scheme is a percentage based payment, which is calculated as a percentage of basic annual salary as at 31 December each year, the last day of the scheme year.

In line with the FSA Remuneration Code, the Remuneration Committee retains the right to adjust the annual performance related bonus in respect of Code Staff if it deems this to be appropriate, taking in to account a range of factors including satisfactory individual performance and risk management.

## 8.5 Aggregate remuneration data

The Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) requires the Society to disclose aggregate remuneration data for all staff and separately for all Board directors, senior management and members of staff whose actions have a material impact on the risk profile of the firm ('Code Staff').

The total fixed pay paid to all employees in 2010 was £37.2 million and variable pay was £3.4 million.

The remuneration relevant to Code Staff, comprising senior management and other material risk takers was as follows for 2010:

| | Aggregate remuneration data for Jan-Dec 2010 | | |
|---|---|---|---|
| | Number of staff | Fixed pay (3) £m | Variable pay (4) £m |
| Senior managers (1) | 20 | 2.3 | 0.5 |
| Other material risk takers (2) | 13 | 0.7 | 0.1 |
| **Total** | **33** | **3.0** | **0.6** |

(1) Non-Executive Directors, Executive Directors and Executives including Stroud & Swindon Executives for period September to December 2010. Non-Executive Directors' fees are included under fixed pay; no variable pay is awarded to Non-Executive Directors.

(2) Other Code Staff to cover those whose actions have a material impact on the risk profile of the Society, including Stroud & Swindon Code Staff for period September to December 2010.

(3) Fixed pay includes basic pay, allowances and employer pension contributions.

(4) Variable pay includes the annual performance related bonus (£0.3m) for 2010 (paid March 2011) and the LTIP 2010-2012 payment granted (not paid) in 2010 (£0.3m). The LTIP payment included above is the maximum possible under the scheme (40% of salary as at the Grant Date); the actual payment will be subject to the performance criteria outlined above.