Skipton Building Society

Pillar 3 Disclosures
for the year ended 31 December 2011

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Contents

1.0 Introduction

1.1 Background

From 1 January 2007 the Capital Requirements Directive (Basel II) came into force in the UK and the Skipton Building Society Group adopted the capital adequacy rules from 1 January 2008. These rules require building societies and banks to assess the adequacy of their capital resources given the risks they face in order to ensure the continued protection of their investors' deposits. The rules are set out in the Capital Requirements Directive under three pillars:

Pillar 1 sets out the minimum regulatory capital resources requirement, predominantly comprising credit risk and operational risk.

Pillar 2 covers management's assessment of the additional capital resources required to cover specific risks faced by the institution that are not covered by the minimum regulatory capital resources requirement set out under Pillar 1. The amount of additional capital requirement is assessed by the FSA during its Supervisory Review and Evaluation Process (SREP).

Pillar 3 requires building societies and banks operating under the Basel II framework to disclose quantitative and qualitative information regarding their risk assessment processes and capital resources, and hence their capital adequacy.

1.2 Basis and frequency of disclosure

This Pillar 3 report is based upon the Group's Annual Report and Accounts for the year ended 31 December 2011, unless otherwise stated. Subsequent disclosures will be issued on an annual basis as soon as practicable after the publication of the Group's Annual Report and Accounts.

1.3 Media and location of publication

Reports of this nature will be published on Skipton Building Society's website (www.skipton.co.uk).

1.4 Verification of disclosure

These disclosures have been reviewed by the Group's Internal Audit Function and Board Risk Committee. However, there is no requirement for the disclosures to be externally audited; although some of the information within the disclosures also appears in the Group's 2011 Annual Report and Accounts which are externally audited.

2.0 Scope of application

For accounting purposes the Society's consolidation group comprises the Society and all of its subsidiaries (i.e. full group consolidation).

For prudential and Pillar 3 reporting purposes consolidation is carried out at the following levels:

- Solo consolidation group
- UK consolidation group

However, the risks within the Skipton Group are controlled and managed on a full consolidation level so for Pillar 3 purposes the capital adequacy of the full group has also been disclosed.

Solo consolidation group

As at 31 December 2011 the Solo consolidation group consists of Skipton Building Society, Amber Homeloans Limited (Amber), North Yorkshire Mortgages Limited (NYM), Skipton Building Society Covered Bonds LLP, Darrowby No.1 plc. and Beckindale No.1 Limited.

UK consolidation group

As at 31 December 2011 the UK consolidation group (UKCG) consists of the entire Group with the exception of the following entities in accordance with BIPRU 8.5.1:

- Connells Limited and subsidiary companies
- Jade Software Corporation Limited
- Mutual One Limited
- Northwest Investments NZ Limited
- Private Health Partnership group
- Skipton Trustees Limited

One of the subsidiary companies within the full group and the UK consolidation group is Skipton International Limited which is based in Guernsey and regulated by the Guernsey Financial Services Commission.

2.1 Regulatory developments

We continue to monitor key regulatory changes on the horizon including the Independent Commission on Banking reforms, Recovery and Resolution Planning and the replacement of Basel II by CRD IV (Basel III). In light of these changes we proactively manage our capital adequacy to ensure our position remains above the current and emerging regulatory requirements.

3.0 Risk management objectives and policies

3.1 Introduction

The Board understands that risks arise as a consequence of decisions taken in order to achieve its business objectives but endeavours, through positive mitigation strategies, to manage these in a manner that optimises returns whilst protecting members' interests and the Group's reserves. To this end, the Board ensures that an effective risk management framework is maintained to identify, prioritise, manage and report on the risks faced by the Group.

3.2 Risk appetite

As a mutual organisation the Skipton Board is charged with the protection of member deposits and bases its risk appetite on avoiding strategies or business practices which would in any way threaten member interests.

The Board's risk appetite, inter alia, specifically addresses the maintenance of stakeholders' confidence, profit performance, capital and liquidity adequacy, fair treatment of customers and the operational control framework and is supported by a comprehensive range of metrics used to assess business performance and risk exposure against its risk appetite.

3.3 Group risk management framework

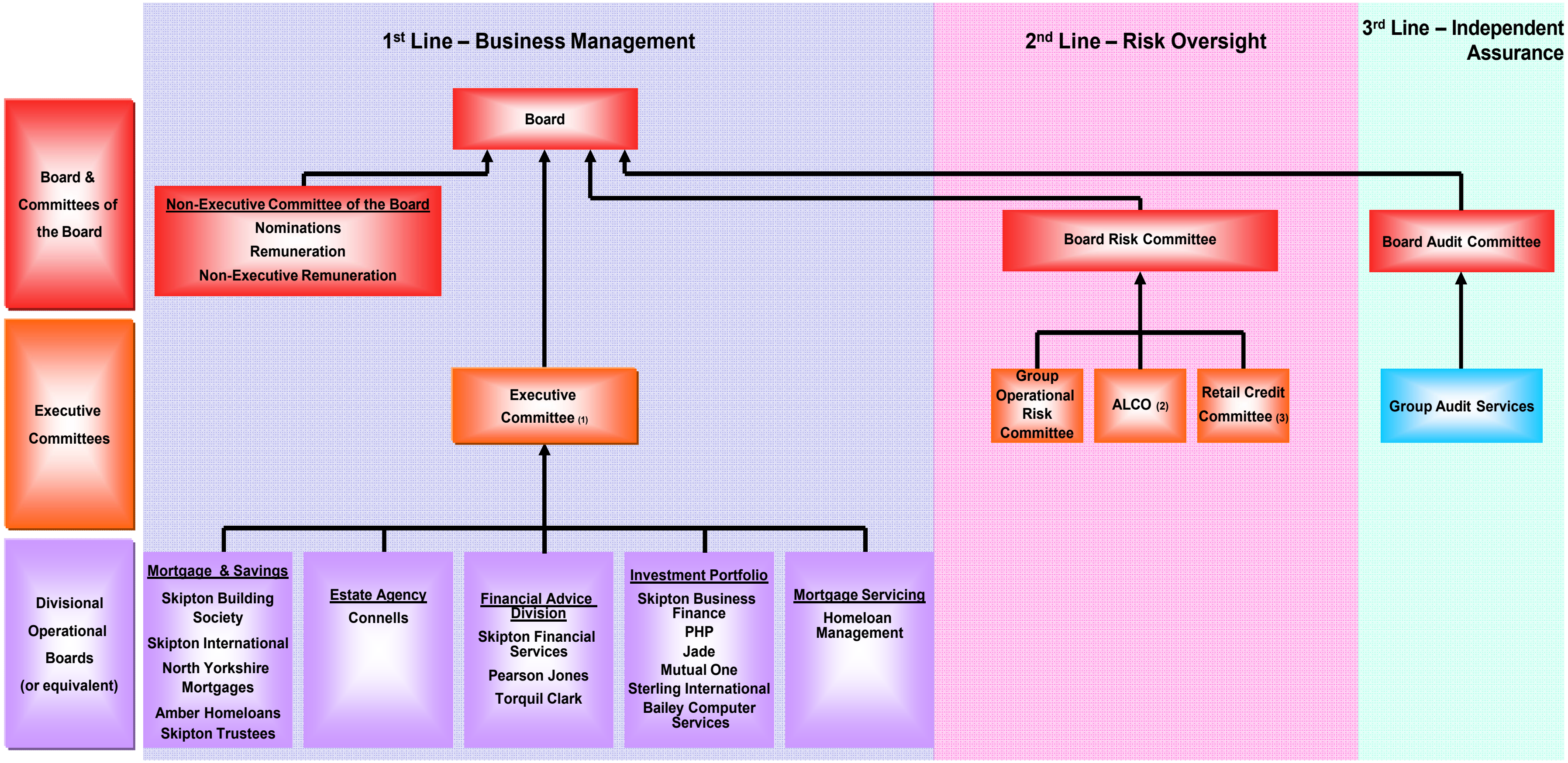
Through the Group's risk management framework and governance structure, the Group has a formal mechanism for identifying and addressing risks throughout the business. This framework is designed to deliver the corporate plan in line with the Board's overall risk appetite and is based upon the best practice 'three lines of defence' model, as follows:

- **First line** of defence, being line management within the business which, through the implementation of the organisation's risk framework, identifies, assesses and manages risk.

- **Second line** of defence, comprising independent Group Risk functions (Operational, Credit, and Market & Liquidity) and related independent Compliance, Information Security and Insurance functions. These functions challenge, monitor, guide and support the business in managing its risk exposure. The risk framework includes a number of risk committees (Asset and Liability Committee (ALCO), Retail Credit Committee (RCC) and Group Operational Risk Committee (GORC)) that are responsible for setting and monitoring the Group's adherence to policy. The independent Group risk functions are represented on each of these risk committees. A Board Risk Committee, headed by a Non-Executive Chairman, is responsible for oversight of the risk management framework and monitoring of the business risk profile against Board approved risk appetites.

- **Third line** of defence, provided by Group Audit Services, is designed to provide independent assurance to the Board (via the Board Audit Committee) of the adequacy and effectiveness of control systems operating within the first and second lines in identifying and managing risk.

Skipton Group Governance Framework



1. The Executive Committee receives reports from the Capital Committee, Project Prioritisation & Approvals Group, Products Approval Group, Health, Safety & Security Working Group and the Society Operational Risk Committee to assist in the execution of its duties.
2. ALCO receives reports from the Group Wholesale Credit Committee to assist in the execution of its duties.
3. The Retail Credit Committee receives reports from the Credit Risk Working Group, Credit Modelling Working Group and Provisions Group to assist in the execution of its duties.

The roles and responsibilities of the Board and the risk management committees are set out in the following paragraphs.

3.4 Board

The Board's terms of reference clearly set out its responsibility for the overall stewardship of the Group within the context of the Society's 'Principles of Governance', developed to ensure that:

1. **Governing Body -** The Society is headed by an effective Board which is collectively responsible for the long term success of the Group.

   The Board formulates strategy and establishes the Society's risk appetite and balance sheet strategy. It has a proper understanding of, and competence to deal with, the current and emerging issues facing the business of the Group, effectively reviewing and challenging the performance of management and exercising independent judgement.

2. **Management and Oversight -** The Society's management and oversight framework enables the Board to provide strategic guidance for and effective oversight of management throughout the Group.

   The framework clarifies the respective roles and responsibilities of Directors and Senior Executives in order to facilitate Board and management accountability to both the Society and its members and ensures a balance of authority such that no single individual has unfettered powers. It has clear, risk-based, lines of sight into activities to support challenge and direction which enable the Board to ensure that assurance is obtained over the integrity of reporting and the adequacy of the control framework and control activities.

3. **Recognise and Manage Risk** - The Board has a sound system of risk oversight, risk management and internal control.

   This framework identifies, assesses, manages and monitors risk. It informs Senior Executives and the Board of material changes to the risk profile of the Society or any of its divisions, and monitors and provides assurance over the effectiveness of the control framework and control activities and the integrity of reporting.

The Board has established a framework of authorities which maps out the structure of high level delegation below Board level and specifies those issues which remain the responsibility of the Board. The Board also has a general duty to ensure that the Group operates within the Society's rules, relevant laws, rules and guidance issued by relevant regulatory authorities and that proper accounting records and effective systems of internal control are established, maintained, documented and audited.

The Board has agreed a formal schedule of matters which are reserved to it, and has also delegated authority in other matters to a number of Board Committees, as described below. The Board has set clear terms of reference for each of these Committees, and has established an organisational structure with clearly defined and documented delegated authority to Executive management, together with reporting systems for financial results, risk exposure and control assessment.

The Board meets monthly (except August) and also holds regular strategy review meetings. The Non-Executive Directors also meet, without Executive Directors present, at least once a year.

3.5 Executive Committee

The Executive Committee is responsible for ensuring that the Group meets its strategic and operational objectives as defined in the Corporate Plan. Mr Cutter (Group Chief Executive) chairs the Committee which comprises the Executive Directors and other Senior Executives.

3.6 Asset and Liability Committee

The Asset and Liability Committee is primarily responsible for developing and maintaining policies on structural risk management, liquidity, funding and wholesale credit, recommending changes to these policies to the Board Risk Committee, monitoring implementation to ensure that the Group operates within risk limits and that the Society has adequate liquid financial resources to meet its liabilities. Mr Twigg (Group Finance Director) chairs the Committee which comprises the Group Chief Executive, Chief Financial Risk Officer and Senior Executives from Treasury, Finance, Risk and the Group's lending businesses.

3.7 Retail Credit Committee

The Retail Credit Committee is primarily responsible for developing and maintaining policies for monitoring and controlling the risks to the Group arising from the credit quality of its retail loan books and other assets, recommending changes to these policies to the Board Risk Committee and monitoring implementation to ensure that the Group operates within risk limits. Mr Cutter (Group Chief Executive) chairs the Committee which comprises the Group Finance Director, Chief Conduct Risk Officer and Secretary, Chief Financial Risk Officer, together with Senior Executives from the Credit Risk team and the Group's lending businesses.

3.8 Group Operational Risk Committee

The Group Operational Risk Committee is primarily responsible for developing and reviewing the Group's operational risk management framework. Mr Gibson (Chief Conduct Risk Officer and Secretary) chairs the Committee which comprises the Group Finance Director and Senior Executives from each of the divisions and the Operational Risk team.

3.9 Board Audit Committee

The Audit Committee, which meets at least four times a year, comprises three Non-Executive Directors, currently:

Ms Kinney, Non-Executive Director (Committee Chairman)
Mr Picken, Non-Executive Director
Mr Thompson, Non-Executive Director

In addition, the Group Chief Executive, Group Finance Director, Chief Conduct Risk Officer and Secretary, Chief Financial Risk Officer, external audit representatives and the General Manager – Audit Services, regularly attend meetings, by invitation. The Board is satisfied that the composition of the Audit Committee contains a Director with relevant, recent financial experience to provide appropriate challenge to management. Ms Kinney is a Fellow of the Institute of Management Accountants.

The responsibilities of the Committee are in line with the provisions of the Financial Reporting Council Guidance on Audit Committees. The Audit Committee's primary responsibilities include:

- monitoring the integrity of the Group's financial statements, any formal announcements relating to the Group's financial performance and significant reporting judgements contained in them;
- monitoring the effectiveness of the external audit process and making recommendations to the Board on the appointment, re-appointment and remuneration of the external auditors;
- ensuring that an appropriate relationship between the Group and the external auditors is maintained, including reviewing non-audit services which can be provided and fees payable to the auditors; and
- reviewing the effectiveness of the internal audit function. The Committee is responsible for approving, upon the recommendation of the Group Chief Executive, the appointment and removal of the General Manager – Audit Services.

The Board has delegated responsibility for reviewing the effectiveness of the Group's internal controls and risk management systems to the Audit Committee.

3.10 Board Risk Committee

The Board Risk Committee is responsible for considering and recommending the Group's risk appetite, capital adequacy and liquidity management policy to the Board. It is also responsible for ensuring that the Group maintains an effective risk governance structure to ensure that internal and external risks across the Group are identified, reviewed and managed accordingly.

The current members of the Committee are:

Mr Hales, Non-Executive Director (Committee Chairman)
Mr Cutter, Group Chief Executive
Mr East, Non-Executive Director
Mr Picken, Non-Executive Director
Mr Twigg, Group Finance Director

3.11 Capital Committee

The Capital Committee meets quarterly and is a sub-committee of the Executive Committee that reviews Group policies in relation to capital and monitors both compliance with these policies and the Group's overall capital adequacy. The Committee also reviews and manages the forecast capital adequacy of the regulated entities within the Group to ensure the Group's capital resources are utilised in the most efficient manner to achieve its corporate objectives. Mr Ndawula (Chief Financial Risk Officer) chairs the Committee which comprises the Group Chief Executive and Group Finance Director together with Senior Executives from the Treasury, Risk and Finance functions.

3.12 Nominations Committee

The Nominations Committee is responsible for assessing the necessary and desirable competencies of Board members, evaluating the Board's performance, succession planning and the appointment and removal of Directors. Director appointments and the appointment of the Group Secretary are confirmed by the full Board.

The current members of the Committee are:

Mr Ellis, Chairman (and also Committee Chairman)
Mr East, Non-Executive Director
Mr Hales, Non-Executive Director
Mr Hutton, Non Executive Director
Ms Kinney, Non-Executive Director
Mr Picken, Non-Executive Director
Mr Thompson, Non-Executive Director

3.13 Remuneration Committee

The Remuneration Committee is responsible for reviewing the adequacy and effectiveness of the Society's remuneration policy, considering the risk management implications of the policy and for approving the Directors' Remuneration Report included within the Annual Report and Accounts. The current members of the Committee are:

Mr Hutton, Non-Executive Director (Committee Chairman)
Mr East, Non-Executive Director
Mr Thompson, Non-Executive Director

Remuneration disclosures around 'Code Staff', in accordance and in compliance with FSA PS10/21, are disclosed within the Directors' Remuneration Report in the 2011 Annual Report and Accounts.

4.0 Capital resources

4.1 Total capital resources

The table below sets out the capital resources of the full group, UK consolidation group and Solo consolidation group as at 31 December 2011.

	2011 Full group[1] £m	2010 Full group £m	2011 UK group £m	2010 UK group £m	2011 Solo group £m	2010 Solo group £m
Tier 1						
Reserves	806.5	809.6	741.4	747.3	693.1	701.7
Permanent Interest Bearing Shares	90.0	90.0	90.0	90.0	90.0	90.0
Pension fund deficit adjustment	13.5	3.7	7.8	3.7	7.8	3.7
Unrealised (gains) / losses on available-for-sale debt securities	(6.0)	6.9	(6.0)	6.9	(4.9)	6.0
Unrealised (gains) / losses on cash flow hedges	19.0	(0.3)	19.0	(0.3)	18.9	(0.3)
Total Tier 1 capital before deductions	**923.0**	**909.9**	**852.2**	**847.6**	**804.9**	**801.1**
Deductions from Tier 1 capital:						
Goodwill	(171.1)	(168.6)	(34.7)	(35.7)	-	-
Intangible assets	(25.6)	(22.3)	(11.7)	(12.9)	(2.2)	(3.4)
Material holdings (50%)	-	-	-	-	(33.2)	(33.1)
Total Tier 1 capital after deductions	**726.3**	**719.0**	**805.8**	**799.0**	**769.5**	**764.6**
Tier 2						
Subordinated debt	197.4	204.4	197.4	204.4	209.9	216.9
Collective impairment allowance	14.9	21.2	14.9	21.2	14.9	21.2
Total Tier 2 capital	**212.3**	**225.6**	**212.3**	**225.6**	**224.8**	**238.1**
Deductions from Tier 1 and Tier 2 capital:						
Investment in subsidiary companies	-	-	(96.5)	(96.4)	(119.0)	(121.4)
Material holdings (50%)	-	-	-	-	(33.2)	(33.1)
Total capital after deductions	**938.6**	**944.6**	**921.6**	**928.2**	**842.1**	**848.2**

4.2 Tier 1 capital

Tier 1 capital comprises internally generated capital from retained profits and issued capital in the form of Permanent Interest Bearing Shares (PIBS). For capital purposes, unrealised gains / losses on available-for-sale debt securities and cash flow hedges are removed from reserves in accordance with GENPRU 1.3.36. In addition, an adjustment has been made for the pension fund obligation as permitted by GENPRU 1.3.9.

All PIBS are unsecured and rank pari passu with each other. They are deferred shares of the Society and rank behind the claims against the Society of all subordinated note holders, depositors, creditors and investment members of the Society. Further details regarding PIBS are set out in note 30 of the Group's 2011 Annual Report and Accounts. Under the FSA rules PIBS are included in the Group's capital resources in accordance with UK GAAP rather than IFRS.

The regulatory capital rules allow the pension fund deficit, which for accounting purposes is deducted from reserves, to be added back to reserves and instead a deduction is made for the cash that is expected to be paid in addition to the normal contributions over the next five years.

Goodwill and intangible assets are deducted from capital for regulatory purposes.

[1] The Group is not required by the FSA to hold a minimum level of capital at a full consolidation group level.

4.3 Tier 2 capital

Tier 2 capital comprises subordinated debt and collective impairment allowances. Under GENPRU 2.2.46 Tier 2 capital cannot exceed 50% of total Tier 1 capital. As set out in the table on the previous page this requirement is satisfied at all three levels of consolidation.

The subordinated note holders' rights are subordinated to those of the depositors and other creditors. Further details regarding subordinated debt are set out in note 29 of the Group's 2011 Annual Report and Accounts. Under FSA rules, subordinated debt is included in the Group's capital resources in accordance with UK GAAP rather than IFRS. In the last five years to maturity subordinated debt instruments are amortised down to zero on a straight line basis in accordance with GENPRU 2.2.196.

4.4 UK and Solo consolidation

At a Solo consolidation level the cost of investment classed as material holdings outside the Solo consolidation group is required to be deducted from capital resources. A material holding represents an investment in a financial institution or credit institution which exceeds 10% of the share capital of the issuer, e.g. the Society's investment in Skipton International Limited. This deduction is split equally between Tier 1 and Tier 2.

At both a UK and a Solo consolidation level the cost of investment in subsidiary companies outside the group is required to be deducted from Tier 1 and Tier 2 capital, to the extent it is not deducted as a material holding, in accordance with the GENPRU 2.2.239.

5.0 Capital adequacy

5.1 Summary of approach to capital adequacy planning

The Group holds capital to absorb losses which may occur in the economic cycle. The Individual Capital Adequacy Assessment Process (ICAAP) is the means by which the Group ensures:

- it has sufficient levels of capital resources to pursue the corporate objectives as set out in the Group Corporate Plan in light of the risks it faces; and
- it has sufficient capital resources to trade through a variety of scenarios including a severe recession, if necessary by applying appropriate management actions.

In formulating the Group's three year Corporate Plan, the Board considers its overall objectives and evaluates these in light of its agreed risk appetite statement.

Under FSA rules a minimum level of capital (Pillar 1) must be held for credit risk, operational risk and market risk for the Solo and UK consolidation groups. The Group has adopted the standardised approach to calculate the minimum regulatory capital resource requirement for credit risk and operational risk, and market risk has been calculated under the Position Risk Requirement (PRR) approach.

The table below sets out the minimum capital resources requirements (Pillar 1) for the Solo, UK and full consolidation groups, together with their capital adequacy positions as at 31 December 2011.

	2011 Full group[2] £m	2010 Full group £m	2011 UK group £m	2010 UK group £m	2011 Solo group £m	2010 Solo group £m
Credit Risk (Standardised)	428.8	401.7	423.1	396.0	407.9	385.3
Operational Risk (Standardised)	54.0	53.0	23.3	23.2	4.2	3.3
Market Risk (Foreign Exchange PRR)	0.6	0.5	-	-	-	-
Total minimum capital requirement	**483.4**	**455.2**	**446.4**	**419.2**	**412.1**	**388.6**
Total capital resources (section 4)	**938.6**	**944.6**	**921.6**	**928.2**	**842.1**	**848.2**
Excess of own funds over minimum capital requirement under Pillar 1	**455.2**	**489.4**	**475.2**	**509.0**	**430.0**	**459.6**
Capital ratio (%)	**194.2%**	**207.5%**	**206.5%**	**221.4%**	**204.3%**	**218.3%**

5.2 Capital reporting

The Pillar 1 regulatory capital adequacy of the Solo and UK consolidation groups is reported to the FSA quarterly and bi-annually respectively. Pillar 1 minimum capital adequacy at both a Solo and UK consolidation group level is also reported (actual and forecast) to the Board monthly.

The results of the ICAAP are articulated in a single document which is reviewed and approved by the Board and updated at least annually and more frequently should a significant change in the Group's risk profile occur.

5.3 Transferability of capital

In order to ensure the greatest degree of flexibility in the allocation of capital, the Board aims to retain the maximum possible level of capital in the Solo consolidation group and UK consolidation group – the regulated entities. However, this broad principle is subject to a number of regulatory, taxation and commercial considerations which are considered before any decisions regarding dividend payments from group entities are finalised. There are no current or foreseeable material, practical or legal impediments to the prompt repayment of liabilities among the Society and its subsidiary undertakings.

[2] The Group is not required by the FSA to hold a minimum level of capital at a full consolidation group level.

6.0 Minimum capital requirement – Pillar 1

This section sets out the details of each of the Pillar 1 components: credit risk; operational risk, and market risk. Each subsection includes the minimum capital component for the full consolidation group, the UK consolidation group and the Solo consolidation group.

6.1 Credit risk overview

Credit risk is defined as the risk of suffering financial loss should borrowers or counterparties default on their contractual obligations to the Group. The Group faces this risk from its lending to:

- individual customers (residential retail lending);
- businesses (through past commercial lending). The Society ceased new commercial lending in November 2008; and
- other financial institutions (wholesale lending).

The key driver of credit risk remains a further slowdown in the UK economy which could lead to higher unemployment, deterioration in household finances and falls in house prices, all of which would increase arrears and defaults. Whilst the economic outlook remains fragile, the Group plans to maintain a cautious approach to new lending. Wholesale markets remain volatile, particularly within the Eurozone where the uncertainties surrounding the future of countries within the single currency continues and, whilst the Group has some exposure to European entities, we continue to be vigilant and reduce our lending to counterparties accordingly.

The controlled management of credit risk is critical to the Group's overall strategy. The Group has therefore embedded a comprehensive and robust risk management framework with clear lines of accountability and oversight as part of its overall governance framework. The Group has effective processes and policies to monitor, control, mitigate and manage credit risk within the Group's risk appetite. RCC provides oversight to the effectiveness of all credit management across the Group and the controls in place ensure lending is within the Board approved credit risk appetite.

The following tables detail the minimum capital requirement for credit risk for the full group, UK consolidation group and Solo consolidation group as at 31 December 2011 broken down by exposure value.

Full Group	**Exposure value £m**	**Capital requirement £m**
Corporates – other lending to corporates	31.0	2.5
Retail – debt factoring loans	34.8	2.1
Secured on real estate property	9,648.3	323.4
Past due items[3]	351.9	29.5
Other items	34.0	1.1
Total loans and advances to customers	**10,100.0**	**358.6**
Central governments or central banks	1,416.7	-
Multilateral development banks	346.4	-
Financial institutions	712.4	15.7
Securitisation positions – see section 6.1.8	295.6	12.2
Short-term claims on institutions and corporates	240.9	5.4
Total wholesale lending	**3,012.0**	**33.3**
Other items – e.g. fixed assets, derivatives, and sundry debtors	534.9	36.9
Total other	**534.9**	**36.9**
Total	**13,646.9**	**428.8**

[3] For capital purposes, past due items in these tables relate to those accounts greater than 90 days in arrears.

UK Consolidation Group	**Exposure value £m**	**Capital requirement £m**
Corporates – other lending to corporates	31.0	2.5
Retail – debt factoring loans	34.8	2.1
Secured on real estate property	9,651.3	323.6
Past due items	351.9	29.5
Other items	32.6	1.0
Total loans and advances to customers	**10,101.6**	**358.7**
Central governments or central banks	1,416.7	-
Multilateral development banks	346.4	-
Financial institutions	715.7	15.7
Securitisation positions – see section 6.1.8	295.6	12.2
Short term claims on institutions and corporates	240.9	5.4
Total wholesale lending	**3,015.3**	**33.3**
Other items – e.g. fixed assets, derivatives, and sundry debtors	463.1	31.1
Total other	**463.1**	**31.1**
Total	**13,580.0**	**423.1**

Solo Consolidation Group	**Exposure value £m**	**Capital requirement £m**
Corporates – other lending to corporates	23.3	1.9
Retail – other	0.4	-
Secured on real estate property	9,115.1	307.7
Past due items	350.6	29.4
Other items	-	-
Total loans and advances to customers	**9,489.4**	**339.0**
Central governments or central banks	1,416.7	-
Multilateral development banks	346.4	-
Financial institutions	626.7	12.6
Securitisation positions – see section 6.1.8	295.6	12.2
Short term claims on institutions and corporates	240.9	5.4
Total wholesale lending	**2,926.3**	**30.2**
Other items – e.g. fixed assets, derivatives, and sundry debtors	521.6	38.7
Total other	**521.6**	**38.7**
Total	**12,937.3**	**407.9**

6.1.1 Credit risk: loans and advances to customers

The Group currently lends in the prime residential UK mortgage market, including buy-to-let, through the Society and via Skipton International in the Channel Islands.

The Group's lending is always within – and aligned to – the Board's defined Credit Risk Appetite. The Board's Credit Risk Appetite cascades from Board level to operational level and drives action in relation to management of the business and management of capital. We have established comprehensive risk management processes in accordance with the Board's Credit Risk Appetite which defines a number of limits and statements regarding customer and collateral credit quality to which all lending activity must adhere. The Group always lends responsibly, taking into account the best interests of customers at all times. All new mortgage lending is secured by first legal charge on residential property in the UK and Channel Islands, and there is no current appetite for any new lending on a commercial or unsecured basis. The Group's risk appetite for new lending continues to be cautious whilst current economic conditions remain.

The credit decision process is achieved by automated credit scoring and policy rules within lending policy criteria supporting manual underwriting. All aspects of the credit decision process are subject to regular independent review and development ensuring they support decisions in line with the Board's risk appetite. The Group also has credit exposures through Amber and NYM which comprise residential UK mortgages, including buy-to-let, across prime and sub-prime lending markets. In light of the deteriorating economic conditions in early 2008, we ceased new lending in these portfolios in March 2008.

The Group's collections and recoveries functions aim to provide a responsive and effective operation for the arrears management process. We seek to engage in early communication with borrowers experiencing difficulty in meeting their repayments, to obtain their commitment to maintaining or re-establishing a regular payment plan. We consider forbearance options on a case by case basis in line with industry guidance and best practice. Such options include capitalisation of arrears, interest only concessions, payment holidays and term extensions where these are in the best interests of the borrower and the Group. The impact of any such forbearance is recognised within our provisioning policy. RCC provides oversight to the effectiveness of retail credit risk management across the Group.

The table below sets out the gross credit risk arising from loans and advances to customers.

	Full group 10 / 11 average £m	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Total residential mortgages	9,312.6	9,532.5	9,535.5	8,997.9
Commercial loans	484.1	467.1	467.1	467.1
Other lending:				
Debt factoring loans	40.8	42.0	42.0	-
Other loans	56.6	58.4	57.0	24.4
Gross balances	**9,894.1**	**10,100.0**	**10,101.6**	**9,489.4**
Impairment provisions	(83.7)	(88.1)	(88.1)	(87.5)
Fair value adjustment	223.4	240.9	240.9	237.2
Total	**10,033.8**	**10,252.8**	**10,254.4**	**9,639.1**

Commercial lending

The Society retains a commercial loan portfolio which is UK based and, following a reduction in the Group's risk appetite, was closed to new lending in November 2008. We have retained an appropriately skilled team of staff to ensure these loans are managed appropriately and their credit performance is actively monitored. We consider forbearance options on a case by case basis in line with industry guidance and best practice. Such options, in relation to the existing portfolio, include capitalisation of arrears and interest only concessions, only with customer consent. The impact of any such forbearance is recognised within our provisioning policy. The table below sets out the Skipton Group's commercial loan exposure by industry type. The commercial loan exposures are held by the Society.

	£m
Leisure and hotel	44.5
Retail	16.5
Nursing / residential homes	25.4
Offices	15.6
Commercial investment and industrial units	341.5
Miscellaneous	23.6
Total	**467.1**

Credit exposures are well diversified geographically at a regional level, controlled via risk appetite limits and subject to regular review. Controls and monitoring are in place to minimise geographic concentrations at more granular levels i.e. postcode areas, industry type etc.

6.1.2 Credit risk: wholesale lending

The Group's wholesale credit risk arises principally from assets held for liquidity purposes. The risk is that counterparties with whom the Group invests fail to repay those investments and interest when they fall due. Credit risk within our treasury portfolio arises from the investments held by the Group in order to meet its liquidity requirements and for general business purposes. This element of credit risk is managed by the Treasury function within the strict limits set by ALCO, with a regular review of credit policies and exposures through the Group Wholesale Credit Committee (a sub-committee of ALCO). Netting and collateralisation agreements are used to reduce credit exposure, which are discussed further under section 6.1.7. The table below sets out the liquidity book by industry sector / asset class.

	Full group 10/11 average £m	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Cash in hand and balances with the Bank of England	723.4	782.3	782.2	782.2
Cash with banks and building societies	327.8	361.0	364.3	324.6
Gilts	194.1	187.3	187.3	187.3
Treasury bills	394.9	40.4	40.4	40.4
Certificates of deposit	310.0	414.6	414.6	379.5
Local authority investments	0.3	-	-	-
Fixed rate bonds	424.4	396.3	396.3	396.3
Floating rate notes	537.3	543.8	543.8	529.8
Residential mortgage backed securities	244.9	256.6	256.6	256.6
Commercial mortgage backed securities	43.0	38.3	38.3	38.3
Total	**3,200.1**	**3,020.6**	**3,023.8**	**2,935.0**

This table clearly shows that the Group has a suitably varied liquidity portfolio and does not have significant exposures concentrated to one specific asset class. The table below sets out the maturity of the liquidity book.

	Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Loans and advances to credit institutions			
Repayable on demand	98.8	102.1	62.3
In not more than three months	244.4	244.4	244.4
In more than three months but not more than one year	0.6	0.6	0.6
In more than one year	17.2	17.2	17.2
	361.0	**364.3**	**324.5**
Debt securities			
In not more than one year	945.9	945.9	896.9
In more than one year	931.4	931.4	931.4
	1,877.3	**1,877.3**	**1,828.3**
Cash in hand and balances with the Bank of England			
Repayable on demand	782.3	782.2	782.2
	782.3	**782.2**	**782.2**
Total	**3,020.6**	**3,023.8**	**2,935.0**

The table below sets out the capital held for the liquidity book by credit rating.

	Full consolidation group		UK consolidation group		Solo consolidation group	
Rating	**Exposure[4] £m**	**Capital £m**	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**
Aaa	2,073.8	4.6	2,073.7	4.6	2,061.2	4.4
Aa1	74.1	1.2	74.1	1.2	74.1	1.2
Aa2	278.9	4.4	278.5	4.4	256.7	4.0
Aa3	144.6	2.2	150.1	2.2	144.2	2.2
A1	126.4	2.5	126.2	2.5	123.1	2.5
A2	226.0	4.6	224.5	4.6	190.8	3.7
A3	33.6	1.1	33.6	1.1	33.6	1.1
Baa1	1.9	0.1	1.9	0.1	1.9	0.1
Baa2	4.5	0.3	4.5	0.3	4.5	0.3
Baa3	2.5	0.2	2.5	0.2	2.5	0.2
Ba1	1.3	0.1	1.3	0.1	1.3	0.1
Ba2	22.7	2.8	22.7	2.8	15.0	1.8
Caa1	7.4	7.4	7.4	7.4	7.4	7.4
Caa2	14.3	1.8	14.3	1.8	10.0	1.2
Total	**3,012.0**	**33.3**	**3,015.3**	**33.3**	**2,926.3**	**30.2**

The Group's treasury investments are held to provide actual liquidity and 98% of these investments are rated A3 or better (as shown above).

The Group's policy is that initial investments in treasury assets must be investment grade or above.

Within the treasury investments portfolio, the Group has no direct sovereign exposure to Greece, Ireland, Italy, Portugal and Spain (GIIPS) as at 31 December 2011. As at 31 December 2011, the Group had £38m of senior debt exposure to financial institutions based in Ireland (see section 8.0). However, whilst the economic environment in Ireland remains very challenging, we do not currently expect any impairment to be required.

The table below sets out the capital held for the liquidity book by geographical region.

	Full consolidation group		UK consolidation group		Solo consolidation group	
Geographical region	**Exposure[4] £m**	**Capital £m**	**Exposure £m**	**Capital £m**	**Exposure £m**	**Capital £m**
UK	2,182.1	22.2	2,188.2	22.3	2,133.7	21.1
Rest of Europe	725.1	9.3	725.1	9.3	700.6	7.5
Far East	3.8	0.2	3.8	0.2	3.8	0.2
North America	84.1	1.3	84.0	1.3	84.0	1.3
Australasia	16.9	0.3	14.2	0.2	4.2	0.1
Total	**3,012.0**	**33.3**	**3,015.3**	**33.3**	**2,926.3**	**30.2**

To obtain the risk weights and hence calculate the minimum credit risk capital requirement for wholesale lending exposures, Skipton uses Moody's, Fitch and Standard & Poor's as External Credit Assessment Institutions (ECAIs).

The Group's preference is to use the long-term rating; however, the short-term rating is used if this is unavailable. For asset-backed securities, the issue rating is used. This process is documented within the Treasury Policy and is supported by Treasury credit procedures.

[4] The exposures in the above tables do not include balances relating to the fair value of hedged liquid assets as these are classed as 'other assets' for capital purposes as set out in the tables on pages 13 and 14. This accounts for the differences between the above exposures and those as set out on page 16.

The table below sets out exposure values and risk weightings associated with each credit quality step under the standardised approach.

Central Governments and Central Banks				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	0%	Aaa	**1,416.7**

Multilateral Development Banks				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	0%	Aaa	**346.4**

Financial Institutions				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	536.8
2	Residual / original maturity < 3 months	20%	A1 to A3	278.4
2	Original maturity > 3 months	50%	A1 to A3	99.1
3	Original maturity > 3 months	50%	Baa1 to Baa3	0.7
4	-	100%	Ba1 to Ba3	24.0
6	-	150%	Caa1 to Caa3	14.3
				953.3

Residential Mortgage Backed Securities				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	246.4
2	-	50%	A1 to A3	8.5
				254.9

Commercial Mortgage Backed Securities				
Credit quality step	**Maturity**	**Risk weighting**	**Moody's ratings**	**Exposure values £m**
1	-	20%	Aaa to Aa3	25.1
3	-	100%	Baa1 to Baa3	8.2
5	-	1250%	B1 and below	7.4
				40.7

Full group total	**3,012.0**

6.1.3 Concentration risk

Concentration risk is the risk that the Group suffers losses from being over-exposed to sectoral, geographic, product type or other portfolio concentrations.

Both retail mortgage and commercial lending concentration risk is managed within the risk appetite set by the Board, including specific sectoral, geographic and product type limits. RCC monitors and reports on concentration risk monthly. Exposure limits are monitored and controlled within the operational underwriting area via system driven limits and strong mandate controls. These are subject to assurance activity and independent review by the Credit Risk Policy team.

Credit exposures are well diversified geographically at a regional level, are controlled via risk appetite limits and are subject to regular review.

ALCO sets policy limits to manage Treasury credit risk concentrations. Compliance with these limits is monitored daily and formally reported to the Group Wholesale Credit Committee and ALCO monthly.

6.1.4 Impairment

Impairment of loans and advances to customers
The Group assesses monthly the trends of balances of those financial assets or groups of financial assets that are impaired, with RCC and the Board receiving trend and emergence analysis relating to each sector of the secured lending portfolio in respect of residential and commercial assets. At each balance sheet date RCC considers the level of provisions and takes into account the effect of expected macroeconomic factors, such as unemployment, interest rates and house prices. In turn these impact on the performing portfolios for the calculation of collective impairment, and the quantum assessed to meet any losses which may arise as a result of ultimate foreclosure. The BAC also considers the adequacy of loan impairment provisions at each balance sheet date.

Individual assessments are made of all mortgage loans where objective evidence indicates losses are likely or the property is in possession or where fraud or negligence has been identified. Objective evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficulty, default or delinquency in interest or principal payments, or the debt being renegotiated to reduce the burden on the borrower. Based upon these assessments an individual impairment reduction of these assets is made.

For the purposes of the information set out in this document ‘past due’ is defined as one day over the date of which a monthly contractual instalment is due, unless otherwise stated.

Where appropriate for customers’ needs, the Society applies a policy of forbearance and may grant a concession to borrowers. This may be applied where actual or apparent financial stress of the customer is deemed short term with a potential to be recovered. A concession may involve arrears capitalisation, a reduction in the monthly payment, a conversion to interest only or a mortgage term extension. These strategies are undertaken in order to achieve reduced long term arrears and allow the best outcome for both the customer and the business by dealing with arrears at an early stage. The customer accounts are monitored to ensure that these strategies remain appropriate.

Capitalisation is only offered where all other forbearance options (transfer to interest only, reduced payment, mortgage extension) have been exhausted and it is the right option for the customer. The Group policy, after obtaining the customers consent, is to capitalise arrears once the customer has made at least six consecutive contractual monthly mortgage repayments following the instance of non-payment.

The table on the following page provides further information on the residential loans by types of account renegotiations applied to our customers since January 2010. This includes renegotiations regardless of whether or not our customer is experiencing financial difficulty in repaying their loan with the Group. For clarity, this table illustrates all balances which have had their terms renegotiated in the last two years, regardless of whether the renegotiation is still in place or whether the loan has reverted to its original terms.

Residential (Group)	**Balance £m**	**Arrears Capitali -sation £m**	**Reduced payment £m**	**Transfer to interest only £m**	**Term extension £m**	**Total renego-tiations £m**
Neither past due nor individually impaired	8,981.6	138.4	94.1	183.6	99.8	**515.9**
Past due but not individually impaired:						
Up to 3 months	74.2	5.6	9.8	8.3	4.2	**27.9**
3 to 6 months	12.2	1.1	1.0	1.8	0.9	**4.8**
6 to 9 months	5.0	0.5	1.1	0.6	0.3	**2.5**
9 to 12 months	2.3	-	0.1	0.5	-	**0.6**
Over 12 months	3.3	-	0.3	1.1	-	**1.4**
	9,078.6	**145.6**	**106.4**	**195.9**	**105.2**	**553.1**
Individually impaired	420.8	68.2	47.8	38.2	4.6	**158.8**
Possessions	33.1	3.4	2.7	2.3	0.4	**8.8**
	9,532.5	**217.2**	**156.9**	**236.4**	**110.2**	**720.7**
Collective impairment	(13.3)	(2.9)	(1.0)	(0.5)	-	**(4.4)**
Individual impairment	(46.3)	(3.9)	(4.4)	(3.6)	(0.2)	**(12.1)**
	9,472.9	**210.4**	**151.5**	**232.3**	**110.0**	**704.2**

The Society applies a similar policy for its commercial loan book and the table below provides further information on the commercial loans by types of account renegotiations applied to our customers since January 2010. This includes renegotiations regardless of whether or not our customer is experiencing financial difficulty in repaying their loan with the Society. For clarity, this table illustrates all balances which have had their terms renegotiated in the last two years, regardless of whether the renegotiation is still in place or whether the loan has reverted to its original terms.

Commercial (Group)	**Balance £m**	**Arrears Capitalisation £m**	**Transfer to interest only £m**	**Total renegotiations £m**
Neither past due nor individually impaired	441.0	17.8	11.9	**29.7**
Past due but not individually impaired:				
Up to 3 months	12.4	-	0.4	**0.4**
3 to 6 months	0.1	-	-	**-**
6 to 9 months	0.5	-	-	**-**
9 to 12 months	0.1	-	-	**-**
Over 12 months	1.1	-	-	**-**
	455.2	**17.8**	**12.3**	**30.1**
Individually impaired	**11.9**	**-**	**11.8**	**11.8**
	467.1	**17.8**	**24.1**	**41.9**
Collective impairment	(1.5)	(0.1)	(0.1)	**(0.2)**
Individual impairment	(5.2)	(0.2)	(1.2)	**(1.4)**
	460.4	**17.5**	**22.8**	**40.3**

Where forbearance has been applied this is assessed to determine whether it is a potential indicator of impairment. This is then taken account of within the loan impairment models utilised by the Group.

The table below provides further information on residential loans and advances by payment due status across each level of consolidation.

	2011 Full consolidation group £m	UK consolidation group £m	Solo consolidation group £m
Neither past due nor individually impaired	8,981.6	8,984.5	8,452.8
Past due but not individually impaired:			
Up to 3 months	74.2	74.2	70.5
3 to 6 months	12.2	12.2	11.1
6 to 9 months	5.0	5.0	5.0
9 to 12 months	2.3	2.3	2.3
Over 12 months	3.3	3.3	3.3
Total	**9,078.6**	**9,081.5**	**8,544.0**
Individually impaired	420.8	420.8	420.8
Possessions	33.1	33.1	33.1
Total	**9,532.5**	**9,535.4**	**8,997.9**

The overall exposure is greater at a UK consolidation group level than a full group level due to consolidation adjustments made at a full group level for Connells' procuration fees. Connells 'sits' outside the UK consolidation group.

The table below provides further information on commercial loans and advances by payment due status.

Full consolidation group, UK consolidation and Solo group	**2011 £m**
Neither past due nor individually impaired	441.0
Past due but not individually impaired:	
Up to 3 months	12.4
3 to 6 months	0.1
6 to 9 months	0.5
9 to 12 months	0.1
Over 12 months	1.1
Total	**455.2**
Individually impaired	11.9
Possessions	-
Total	**467.1**

The table below sets out the impairment losses on loans and advances for the full group and UK consolidation group for the year ended 31 December 2011.

Full group and UK consolidation group	**Loans fully secured on residential property**	**Loans fully secured on land**	**Other loans**	**Total**
	£m	**£m**	**£m**	**£m**
At 1 January 2011				
Individual impairment	43.1	2.2	12.9	58.2
Collective impairment	19.2	2.0	-	21.2
	62.3	**4.2**	**12.9**	**79.4**
Amounts written off during the year				
Individual impairment	(20.3)	(0.3)	(0.7)	(21.3)
	(20.3)	**(0.3)**	**(0.7)**	**(21.3)**
Income Statement				
Impairment losses on loans and advances				
Individual impairment	24.1	3.3	9.4	36.8
Collective impairment	(5.9)	(0.5)	-	(6.4)
	18.2	**2.8**	**9.4**	**30.4**
Adjustment to impairment losses on loans and advances resulting from recoveries during the year				
Individual impairment	(0.6)	-	0.2	(0.4)
Charge for the year	**17.6**	**2.8**	**9.6**	**30.0**
At 31 December 2011				
Individual impairment	**46.3**	**5.2**	**21.8**	**73.3**
Collective impairment	**13.3**	**1.5**	**-**	**14.8**
	59.6	**6.7**	**21.8**	**88.1**

The Group's impairment charge on loans and advances increased year-on-year to £30.0m (2010: £14.8m) and is broken down as follows:

	2011	**2010**
	£m	**£m**
Residential (Society)	3.3	5.3
Residential (Amber and NYM)	14.3	1.8
Commercial and other loans	12.4	7.7
Total	**30.0**	**14.8**

The performance of the Society prime residential mortgage book remains excellent and the continuing low emergence of arrears results in another low impairment charge for the year. Within our specialist portfolios in Amber and NYM, arrears levels have increased during 2011 which, coupled with a prudent approach to provisioning, has led to a higher loan impairment charge for the year. The impairment charge for commercial and other loans reflects legacy business written prior to 2009.

The loan books in our Guernsey based subsidiary, Skipton International, and our debt factoring business, Skipton Business Finance, remain of high quality and the charge for impairment losses on these loans remains negligible at £0.5m (2010: £0.4m) for the year. Skipton International and Skipton Business Finance are the only lending entities that sit outside the Solo consolidation Group. The overall impairment at a Solo consolidation level for the year ended 31 December 2011 was therefore only £0.5m lower than the full group and UK consolidation group which are set out above.

Impairment of treasury assets
The table below sets out the Treasury asset loan impairment position for the Skipton Group for the year ended 31 December 2011 which is the same for all levels of consolidation.

Full consolidation group, UK consolidation and Solo group	**£m**
At 1 January 2011	
Individual impairment	0.8
Amounts written off during the year	
Individual impairment	-
Income Statement	
Impairment losses on treasury assets	
Individual impairment	-
Adjustment to impairment losses on loans and advances resulting from recoveries during the year	
Individual impairment	-
Charge for the year	-
At 31 December 2011	
Individual impairment	0.8
	0.8

6.1.5 Credit risk mitigation

The Group has available to it a variety of methods and techniques to reduce the credit risk of its lending predicated on a principle of forbearance where borrowers are experiencing periods of difficulties in servicing their loans. The Group employs staff with considerable experience in individually assessing borrowers' financial capability and to assist borrowers accordingly where it is practical and within a Treating Customers Fairly framework. This may include advising them of interim arrangements open to them to assist in periods of difficulty or recommending external resources that could be accessed including relevant debt counselling services.

Residential mortgages
Residential lending secured against a property is only permitted if the property is insured for normal property damage perils. Borrowers may also seek to protect against loss of earnings as a result of sickness and unemployment by purchasing an optional mortgage payment protection policy.

The ultimate source of collateral and final recourse for credit risk mitigation remains the borrower's property in the event of a borrower defaulting on their loan. The extent of mitigation is predetermined by the original and current loan-to-value (LTV) assessed by either a valuation conducted by a suitably qualified professional firm or, in instances of lower LTV lending, by employing an Automatic Valuation Model which is subject to conditions and key assumptions agreed ultimately by RCC and set within the lending criteria.

Commercial mortgages
The commercial property is the primary source of collateral utilised for credit risk mitigation and in all instances will be secured by way of first legal charge over the freehold or long leasehold property. The primary security may be supplemented, depending on the nature and amount of the loan and the security offered, by other forms of security deemed appropriate and considered on a case by case basis. The forms of additional security could comprise legal undertakings, mortgage debentures, equitable charges and personal guarantees or as sanctioned by the Commercial Underwriting team who are suitably experienced to make these determinations. The Group ceased originations of new commercial lending during 2008 but will consider alterations to present commercial borrowings on a case by case basis.

For all commercial securities valuations were undertaken prior to inception of the loan by suitably qualified professionals with relevant expertise in commercial properties. The Group may seek subsequent valuations as it is deemed appropriate. The legal documentation is performed by reference to selected solicitors acting for the Group and appointed to ensure that the covenants are robust and enforceable in addition to the validity of any additional security afforded or required as a condition of our loan.

For a commercial security the requirement for insurance is considered. Such insurance must be taken out and maintained for the duration of the loan in relation to normal property damage perils and must protect against insurable events. Other specialist insurance risk coverage may be requested at the discretion of the Group on a case by case basis.

6.1.6 Wholesale counterparty credit risk mitigation

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

For repurchase agreements, the Global Master Repurchase Agreement (GMRA) document is utilised to mitigate credit risk. Valuations are agreed with the relevant counterparties and collateral is then exchanged in order to bring the credit exposure within agreed tolerances. The fair value of collateral held by the Group under reverse repurchase agreements at 31 December 2011 was £6.1m.

Derivative counterparty credit risk mitigation is discussed under the following section.

6.1.7 Derivative counterparty credit risk mitigation

The Group uses derivative instruments (interest rate, foreign currency and equity) to hedge its exposure to market risk. Derivatives are only used to limit the extent to which the Group will be affected by changes in interest rates, foreign exchange rates or other indices which affect fair values or cash flows. Derivatives are therefore used exclusively by the Group in accordance with the Building Societies Act 1986 to hedge risk exposures only and are not used for trading or speculative purposes. The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, interest rate options and foreign exchange contracts.

A credit exposure could arise in respect of derivative contracts entered into by the Group if the counterparty was unable to fulfil its contractual obligations. The Group addresses this risk by using legal documentation for counterparty derivative transactions that grants legal rights of set-off for those transactions. Accordingly the credit risk associated with such contracts is reduced to the extent that negative mark to market valuations on derivatives will offset positive mark to market values on derivatives, subject to an absolute exposure of zero.

International Swaps and Derivatives Association (ISDA) documentation confers the ability to use designated cash collateral to set against derivative credit exposures in the event of counterparty default. Frequent (at least weekly) rebalancing of the collateral reduces the potential increase in future credit exposure. For such collateralised exposures, the posting of collateral reduces the impact of the current market value to the difference between the market value of the sensitivities and the value of the collateral. The difference is limited by the operational use of ‘thresholds’ and ‘minimum transfer amounts’ which set criteria to avoid the movement of small amounts of collateral.

The Group measures derivative counterparty credit exposure values using the counterparty credit risk mark to market method. This exposure value is derived by adding the net market value of the contract (replacement cost) to the contract’s potential credit exposure, which is calculated by applying a multiple based on the contract’s residual maturity to the notional value of the contract.

The exposure value on derivative counterparty credit risk exposures at 31 December 2011 was:

Exposure to derivative counterparty credit risk	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Interest rate contracts	326.9	326.9	329.9
Foreign exchange contracts	6.9	6.9	6.9
Other contracts	13.1	13.1	13.1
Gross positive fair value of contracts	**346.9**	**346.9**	**349.9**
Netting benefits	(333.0)	(333.0)	(336.0)
Netted current credit exposure	**13.9**	**13.9**	**13.9**
Collateral held	(13.9)	(13.9)	(13.9)
Net derivative credit exposure	**-**	**-**	**-**

As at 31 December 2011, the external counterparties with whom the Group held derivative instruments had Moody's or equivalent credit ratings ranging from Aaa to A2.

If the Society were to be downgraded, there would be no material impact on the collateral required. Wrong-way risk may occur when an exposure to a counterparty is adversely correlated with the credit quality of the counterparty. The Society has no exposure.

The Group does not currently use credit derivatives for risk mitigation.

6.1.8 Securitisation

The Group has securitised certain residential mortgage loans by the transfer of the loans to a special purpose vehicle (SPV) named Darrowby No. 1 plc. The securitisation enables a subsequent issuance of debt by the SPV, to investors who gain the security of the underlying assets as collateral. The SPV is fully consolidated into the Group's 2011 Annual Report and Accounts.

The Group also has exposure to Mortgage Backed Securities (see section 6.1.2).

6.2 Operational risk

Operational risk is the risk of financial loss or reputational damage arising from inadequate or failed internal processes or systems, human error or external events. The Group maintains a system of internal controls commensurate with the characteristics of the business, the markets in which it operates and regulatory considerations.

With its diverse business model and an ever more competitive operating environment, the Board acknowledges that the Group is exposed to increased levels of operational risk, for example in terms of systems capability and staff competencies. The financial services sector also faces growing levels of fraud and financial crime, particularly in relation to e-distribution channels, which require increasingly sophisticated controls.

The Society has adopted the standardised approach to operational risk, compliant with the requirements of BIPRU 6, and has defined operational risk as "the risk of loss arising from inadequate or failed internal processes, people or systems or from external events". This definition includes legal, financial (the risk of loss arising from poor financial control) and reputational risk.

The role of the Group's operational risk management function is to ensure appropriate strategies are in place to manage, control and mitigate the risks that could impact the ability of the Group to meet its business objectives whilst protecting its reputation, operating within the Board approved operational risk appetite.

Through the operational risk management framework, the Board ensures the management and oversight of the key risk exposures facing the Group in the following risk categories:

- Business Continuity
- Change
- Customer / Client Experience
- Financial Management & Management Information
- Fraud
- Information Security
- Information Technology
- Legal & Regulatory
- People
- Premises
- Process
- Third Party Relationships

The Group's operational risk management framework sets out the strategy for identifying, assessing and managing operational risk. Senior management are responsible for understanding the nature and extent of the impact on each business area and for embedding appropriate controls to mitigate those risks. The framework is updated periodically to take account of changes in business profile, new product development, and the external operating environment. The GORC provides oversight and assesses the Group's exposure to operational risks based on both quantitative and qualitative considerations. The crystallisation of operational risks is captured through the recording and analysis of operational losses (and near misses) which is used to identify any potential systemic weaknesses in operational processes.

Given the nature of the regulated sectors in which the Group operates one of the key operational risks is the potential failure to maintain ongoing compliance with relevant external regulation across the Group. Each of the regulated businesses has an established Compliance team which both monitors compliance with existing legislation and considers the impact of new requirements. Oversight is provided by a central Group Compliance function which ensures best practice is adhered to and shared across the Group as appropriate.

The FSA initiated a market-wide review of the sale of Mortgage Payment Protection and Payment Protection Policies during 2010. Four businesses within the Group have sold such policies and while initial review suggests that appropriate sales practices have been employed, the FSA's proposed approach to reviewing such sales is rigorous and could see unexpected compensation payments, however these are not expected to materially impact the Group's performance.

6.2.1 Minimum capital resources requirement for operational risk (Pillar 1)

Through its adoption of the standardised approach to operational risk management, the Society calculates its Pillar 1 capital requirement for operational risk, based upon the sum of the average of three years' net income, segmented by business line and multiplied by the published regulatory 'beta factors'.

As at 31 December 2011 this approach resulted in the Pillar 1 minimum capital requirements as follows:

Pillar 1	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Operational risk capital requirement	**54.0**	**23.3**	**4.2**

6.3 Market risk

Market risk is the risk that the value of, or income arising from, the Group's assets and liabilities changes as a result of changes in market prices, the principal elements being interest rate risk; foreign currency risk; and equity risk. The Society is not impacted by commodity price risk. Market risk arises only in the banking book (apart from the Group's defined benefit pension schemes which is managed by the Trustees of the schemes – see section 7.5) as the Group does not have a trading book.

The Society's Treasury function is responsible for managing the Group's exposure to all aspects of market risk in the banking book within the operational limits set out in the Group's treasury policies. ALCO approves the Group's treasury policies and receives regular information on all relevant aspects of market risk exposure, including the continuing effectiveness of hedges. Currency risk is included in the Society's Pillar 1 capital requirement calculations; other market risks are considered under Pillar 2 capital requirements.

6.3.1 Currency risk

Currency risk is the risk of loss because of changes in foreign exchange rates.

Throughout the year, the Group had no material direct exposure to foreign currency exchange fluctuations. The Group's currency risk appetite is low and any issuance denominated in foreign currency is immediately swapped into Sterling.

The Group's exposure to foreign exchange risk is calculated in accordance with BIPRU 7.5, representing 8% of the net sterling equivalent of the foreign currency assets and liabilities. As at 31 December 2011, the foreign currency risk capital requirement was as follows:

Pillar 1	**Full consolidation group £m**	**UK consolidation group £m**	**Solo consolidation group £m**
Foreign exchange risk capital requirement	**0.6**	-	-

7.0 Other risks faced by the business

This section sets out the other risks faced by the business above and beyond the Pillar 1 risks set out in section 6 above.

7.1 Business risk

Business risk is the risk of changes in the environment in which the Group operates or the occurrence of events which damage the franchise or operating economics of the Group's businesses. The Group addresses these risks within its corporate plan which is approved by the Board and the Board is regularly provided with updates on the Group's key strategies and plans to ensure progress is consistent with the Group's risk appetite.

If the Group does not deliver its plans as anticipated, its earnings could grow more slowly or decline. In addition, potential sources of business risk include revenue volatility due to factors such as macroeconomic conditions, inflexible cost structures, uncompetitive products or pricing and structural inefficiencies.

7.2 Liquidity risk

Liquidity risk is the risk that the Group is unable to meet its current and future financial obligations as they fall due, or is only able to do so at excessive cost. The Group has, therefore, developed comprehensive funding and liquidity policies to ensure that it maintains sufficient liquid assets to be able to meet all financial obligations and maintain public confidence.

The Society's Treasury function is responsible for the day to day management of the Group's liquidity and wholesale funding. The Board sets limits over the level, composition and maturity of liquidity and deposit funding balances, reviewing these at least annually. Compliance with these limits is monitored daily by Finance and Market & Liquidity Risk personnel (i.e. independent of Treasury) and additionally, a series of liquidity stress tests are performed weekly by Market & Liquidity Risk and formally reported to ALCO and the Board monthly to ensure that the Group maintains adequate liquidity for business purposes even under stressed conditions.

The Group's liquidity and funding policies have been fundamentally reviewed and enhanced in line with the FSA's liquidity regime *FSA Policy Statement 09/16 "Strengthening Liquidity Standards"* and, since June 2010, the Group has reported its liquidity position against Individual Liquidity Guidance ('ILG') provided by the FSA for regulatory purposes. The Group continues to exceed both the ILG requirement and satisfy its own internal liquidity risk appetite.

The Group continued to actively manage its funding profile during 2011 and raised over £1bn of secured long term funding during the year, through RMBS bonds issued by its securitisation vehicle Darrowby No 1 plc and similar private transactions. The longer term unsecured wholesale markets remain largely unavailable to the Society. The Group's main source of funding is retail deposits which accounted for 80% (2010: 82%) of our total funding.

We have also increased the quality of the Group's liquidity portfolio by focussing on high quality UK Government issued debt and, as at 31 December 2011, the proportion of our liquidity rated A3 or above was 98%. We continue to maintain a close watching brief on the money markets and hold prudent levels of liquidity.

7.3 Interest rate risk

Interest rate risk is the risk of loss arising from adverse movements in market interest rates. Interest rate risk arises from the mortgage, savings and other financial products that the Group offers. This risk is managed through the use of appropriate financial instruments, including derivatives, with established risk limits, reporting lines, mandates and other control procedures.

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, for example, LIBOR and Bank of England Base Rate) are also monitored closely and regularly reported to

ALCO. This risk is managed where appropriate, through the use of derivatives, with established risk limits and other control procedures.

Derivatives are only used to limit the extent to which the Group will be affected by changes in interest rates, foreign exchange rates or other indices which affect fair values or cash flows. Derivatives are therefore used exclusively to hedge risk exposures. The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, interest rate options and foreign exchange contracts.

The Group's forecasts and plans take account of the risk of interest rate changes and are prepared and stressed accordingly, in line with FSA guidance.

The Group uses a number of different metrics to monitor interest rate risk and details of these are set out below.

Repricing Gap Analysis
To assess the Pillar 2 capital requirement for interest rate risk, the Group determines the effect on the Group's asset and liability gap positions of a 2% parallel shift in interest rates for all maturities. Results are compared to Board and Operational limits weekly and formally reported to ALCO and the Board monthly.

An analysis of repricing dates is performed to ensure that excessive net assets or liabilities repricing within a given time period is avoided. Key assumptions used in the repricing gap analysis include that net free Reserves are assumed to re-price proportionately across repricing bands (up to six years); that small amounts of mortgage loan prepayments will occur; and that fixed assets and other liabilities are classified as having 'non-specific' repricing.

Earnings-at-Risk and Market Value Sensitivity
Other interest rate risk metrics employed by the Group incorporate earnings-at-risk and market value methodologies, which calculate interest rate risk exposure positions, based on 250 historical data observations going back over approximately the last seven years. All of these approaches employ 95% confidence intervals and are multi-currency. These advanced interest rate risk measurement exposures, which are compared to Board and Operational limits weekly and formally reported to ALCO and the Board monthly, are used to guide interest rate risk management decisions.

Although these measures provide valuable insights to the market risk to which the Group is exposed, they need to be viewed in the context of the following limitations:

- Historical data is not necessarily a good guide to future events;
- The use of 95% confidence levels, by definition, does not take account of changes that may occur beyond this level of confidence and therefore may not fully take into account extreme events;
- Exposures are calculated on static Statement of Financial Position positions and therefore future changes in the structure of the Statement of Financial Position are ignored.

Balance Sheet Structure Analysis
Further 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, for example, LIBOR and Bank of England Base Rate) are also monitored closely and regularly reported to ALCO. This risk is managed where appropriate, through the use of derivatives, with established risk limits and other control procedures.

The interest rate exposures during 2011 were as follows:

	As at 31 December £m	Average £m	High £m	Low £m
Static Earnings-at-risk	2.9	2.6	3.6	1.9
Historical Value-at-risk	2.8	1.5	2.9	0.2
2% Parallel interest rate shift	-*	8.9	20.1	-*

* As at 31 December 2011, a 2% parallel interest rate shift up or down would result in a small profit for the Group therefore the net loss exposure is nil.

7.4 Equity risk

This is the risk of loss due to movements in equity markets. The Group offers savings products where the return to the customer is linked to the performance of equity markets and hedges this risk through the use of derivative contracts.

As at 31 December 2011, the Group had £237.6m of equity related savings balances which were appropriately hedged. Therefore, the Group's exposure to equity risk, net of hedging, is immaterial.

7.5 Pension obligation risk

The Group has funding obligations for five defined benefit schemes which are all now closed to new entrants and to future accrual of benefit. Pension risk is the risk that the value of the schemes' assets, together with ongoing contributions, will be insufficient to cover their obligations over time. The return on assets, which includes equities and bonds, will vary with movements in equity prices and interest rates. The projection of the schemes' obligations includes estimates of mortality, inflation and future salary increases, the actual outturn of which may differ from the estimates. The schemes are also exposed to possible changes in pensions legislation.

The following controls are in place to limit the Group's exposure to pension obligation risk:

- Senior management and the scheme trustees receive professional advice from separate actuarial advisers regarding the management of the pension scheme obligations on a regular basis.
- The pension trustees meet every quarter to monitor and make, in consultation with the principal employer, investment decisions with regard to the assets within the five schemes.
- The pension obligation position is updated every quarter and reported to the Board and the pension scheme trustees.

The Group also performs stress testing on the pension scheme liabilities and assets as part of its capital planning methodologies articulated in the ICAAP.

During 2011, the Group completed an enhanced transfer value (ETV) exercise to reduce the Group's pension risk profile.

7.6 Reputational risk

Reputational risk is the risk to earnings, liquidity or capital arising from negative market or public opinion. Management has considered how this might arise and what the impact could be. The consequences would adversely impact the future prospects of the Group and could expose the Group to litigation and financial loss. Reputational risk is inherent across the Group. Senior Management manage this risk in the following ways:

- Management of the Society's reputation through marketing and external communications
- By ensuring compliance with all regulatory requirements.
- Through the risk management framework which has reputation risk as a key consideration.

7.7 Insurance risk

Insurance risk is the risk that the Group's insurers will be unable to pay in the event of a legitimate claim being made. This risk is controlled by ensuring that all the Group's insurers have a suitable credit rating as assessed and recommended by our professional advisers.

Insurance risk also relates to the risk that insurance contracts written by a firm are not adequately covered. The Group is not exposed to this risk as it does not write insurance contracts. Any risk relating to mis-selling of a third party's insurance contracts e.g. general insurance or life sales, is captured under operational risk.

7.8 Investment risk

Investment risk is the risk that a fall in the carrying value of the Group's businesses may result in the Society losing the capital that it has invested in the subsidiary companies.

Investment risk is monitored and managed by the Skipton Group via a series of controls, including:

- Monthly review of subsidiary performance by the Board;
- Senior Group Executives act as non-executive directors of subsidiary companies and therefore attend Divisional / Operational Board of each business Division;
- The bi-annual assessment of the carrying value of subsidiary investments is reported to the Board; and
- Initial and future investment in subsidiary companies must be approved by the Executive Committee and / or the Board in accordance with documented mandates.

7.9 Taxation risk

Taxation risk is the risk associated with changes in tax law or in the interpretation of tax law. It also includes the risk of changes in tax rates and the risk of failure to comply with procedures required by tax authorities. Failure to manage tax risks could lead to an additional tax charge. It could also lead to reputational damage or financial penalties. The Group has effective, well-documented and controlled processes in place to ensure compliance with tax disclosure and filing obligations and employs its own tax professionals who take appropriate advice from reputable professional firms when necessary.

The Group takes a responsible approach to the management, governance and oversight of its tax affairs which is documented in a Tax Policy approved by the Board which requires tax risks to be reviewed and assessed as part of the Group's formal governance processes. The Group has adopted the Code of Practice on Taxation for Banks, which requires banks to have proper governance around tax, integrated into business decision making, to establish an appropriate working relationship with HMRC and to undertake tax planning only to support business operations and not to achieve unintended tax advantages. The Group will continue to be co-operative and transparent in its dealings with the tax authorities and has embedded the terms of the Code into its Tax Policy.

7.10 Regulatory risk

Regulatory risk is the risk that the Group does not adhere to the fast changing regulatory environment in which it operates. Key changes on the horizon include the Government's response to the Independent Commission on Banking reforms, Resolution and Recovery Planning, the replacement of Basel II by CRD IV (Basel III) and the impact upon our capital, the Retail Distribution Review and the Mortgage Market Review. The Group has allocated resource to ensure continued compliance in these areas and we believe we are well placed to meet these requirements.

Importantly, the FSA moving to a 'twin peaks' regulatory approach will see greater focus on both conduct matters alongside prudential risk. The Financial Conduct Authority (FCA) is expected to ensure firms are subject to greater scrutiny with regard to the fair treatment of customers.

7.11 Credit rating downgrade

A further decline in the Society's credit rating could result in it becoming more difficult to secure wholesale funding and at a higher cost. In addition, in the short term the Group would also have to increase its level of retail funding. Whilst the Group's strong retail franchise would enable this, such funding would be expected to come at a higher cost to the Group. The impact that a credit rating downgrade would have on liquidity is included in the weekly stress testing carried out by Market Risk and is reported to ALCO and the Board on a monthly basis.

8.0 Post balance sheet events

Irish Exposures
The Group had £38m of senior debt exposure to financial institutions based in Ireland as at 31 December 2011. Subsequent to the year end £23m of this total exposure has been recovered in full. The remaining £15m is also expected to be recovered in full later in the year.