Yorkshire
BUILDING SOCIETY
With you one hundred percent

Pillar 3 Disclosures

for the year ending 31 December 2008

Contents

Contact
Tanya Jackson, Corporate Affairs Manager
Tel: 01274 472005
Mobile: 07881 501098
Fax: 01274 735571
Email: tjjackson@ybs.co.uk

1 Overview

1.1 Background

The European Union Capital Requirements Directive came into effect on 1 January 2008. Implementation of the Directive in the UK was by way of rules introduced by the Financial Services Authority ("the FSA").

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

Yorkshire Building Society ("YBS") adopted the Pillar 1 standardised approach to credit risk and operational risk from 1 January 2008. It also became subject to Pillars 2 and 3 from that date.

1.2 Basis and frequency of disclosures

This disclosure document has been prepared by YBS in accordance with the requirements of Pillar 3.

No quantitative disclosures have been made in this document as the last externally audited accounts were dated 31 December 2007, which was prior to the adoption of Basel II requirements. Future Pillar 3 disclosures will provide supporting quantitative analysis and will be published as soon as practicable after the publication the Group's Annual Report and Accounts.

1.3 Scope

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

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

- Yorksafe Insurance company Limited (Yorksafe), which is the Group's captive insurance company for the provision of mortgage indemnity guarantees, is, due to the nature of its activity, outside of the scope of the Basel II framework to be included for capital purposes. Yorkshire Key Services Ltd (YKS) is classified as a commercial undertaking and is also outside the scope of consolidation for capital purposes. These entities are both fully consolidated in the statutory accounts in the Annual Report and Accounts.
- Some definitions of assets and capital differ between the regulated capital adequacy rules and the statutory accounting balance sheet standards.

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

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

The principal subsidiaries included under solo consolidation are:

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

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

1.4 Location and verification

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

2 Risk Management Objectives and Policies

2.1 Risk management objectives

The activities of financial institutions inevitably involve a degree of risk. The Group's risk management framework and governance structure aims to provide appropriate and comprehensive monitoring, control and ongoing management of its major risks to ensure the security of its members' funds. The Group's ability to properly identify, measure, monitor and report risk is critical to its soundness and its ability to provide value to its membership.

2.2 Risk appetite

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

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

The Group's overall statement of risk appetite is:

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

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

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

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

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

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

2.3 Risk management framework

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

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

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

2.4 Risk identification, measurement and control

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

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

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

2.5 Risk oversight

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

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

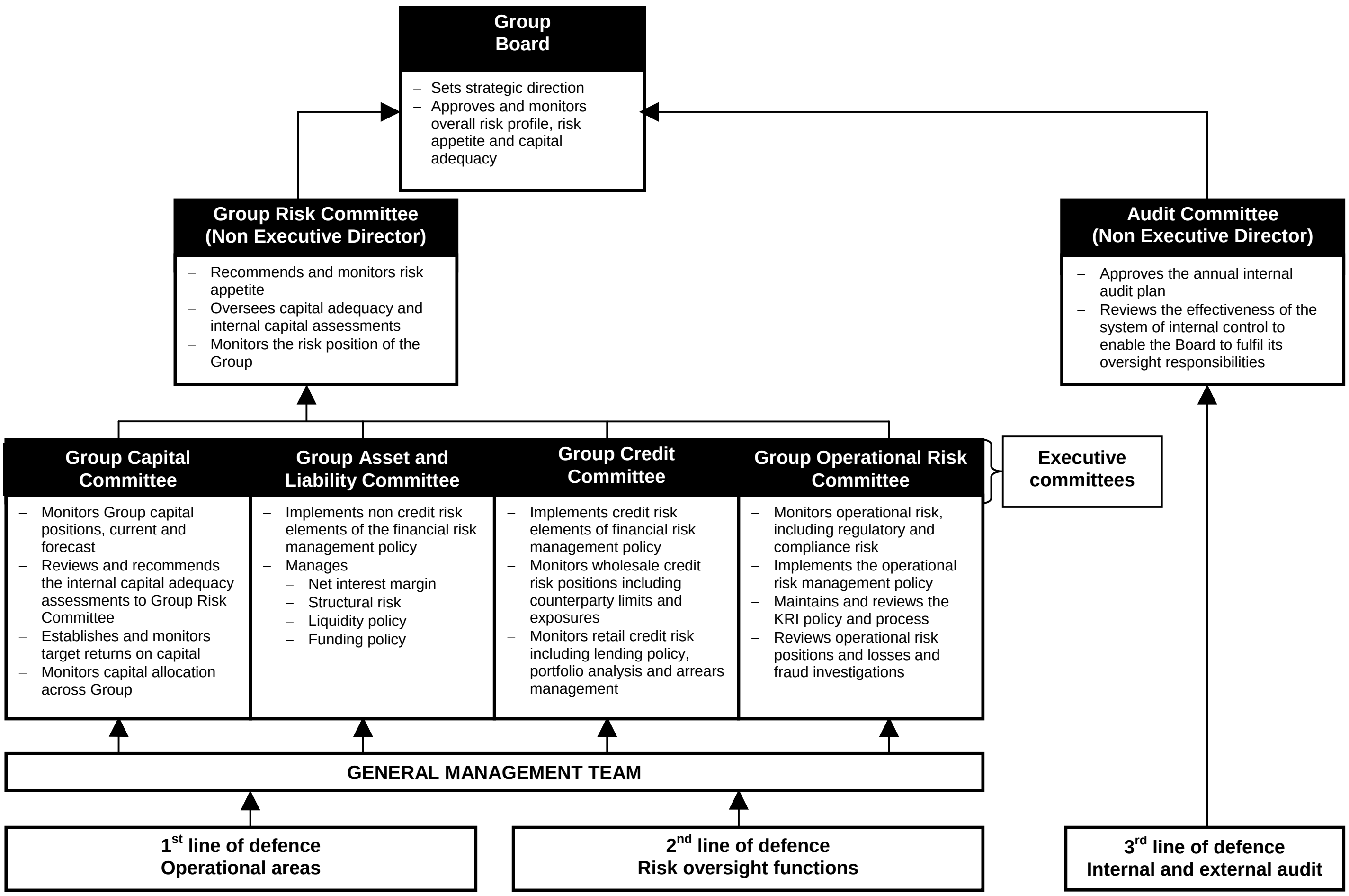
The Group Risk Committee has put in place a risk management policy which documents the Group’s approach to risk management across its major risk categories, the governance structure it has put in place, responsibilities of individual risk committees and functions within the risk framework and a comprehensive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

The Group’s risk management policy provides a “three lines of defence” model for risk management, as follows:

- The first line of defence is operational management, who manage risk by maintaining appropriate controls on a daily basis.
- The second line of defence comprises oversight functions including advisory functions that set and maintain policy, and Group Risk. These functions cover all significant risk areas, such as credit risk, interest rate risk, operational risk and liquidity risk. Their role is described more fully under “Risk monitoring and reporting” below.

- The third line of defence is independent assurance and challenge, which includes Group Internal Audit and the external auditors. Via the Audit Committee, Group Internal Audit assists the Board in fulfilling its oversight responsibilities.

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



2.6 Risk monitoring and reporting

The Group maintains an independent risk management function (Group Risk) that is responsible for ensuring that appropriate risk management techniques and measures are deployed, and that they reflect leading practice and remain commensurate with the Group's strategic aims and its appetite for risk. The Group Risk function provides periodic independent reports on positions against key risk limits and triggers as specified in the Group Risk Management Policy and risk management activities for consideration by General Management, the Group Risk Committee, its sub-committees and the Board. The General Manager Risk and Planning provides a formal update to each board meeting covering all areas of risk management, including both routine reporting and ad hoc issues.

3 Capital Resources

3.1 Total available capital

For details of total capital resources at 31 December 2007 please see note 30 to the Annual Report and Accounts.

3.2 Tier 1 capital

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

- PIBS are unsecured deferred shares and rank behind the claims of all subordinated noteholders, depositors, creditors and investing members of YBS. Further details about PIBS are provided in note 28 to the Annual Report and Accounts.

- An adjustment is made to tier 1 capital in respect of the Group's pension obligations. For accounting purposes, the present value of obligations less the fair value of plan assets in respect of the YBS pension fund ("the fund") is included as an asset or liability as appropriate and hence is included in the general reserve. For capital purposes this amount is reversed out of the Group's capital and a deduction is made for the additional funding that is expected to be paid to the fund over the next 5 years.

- An adjustment is also made in respect of intangible assets. For accounting purposes software development costs are capitalised as intangible fixed assets where they meet certain accounting criteria. However, because intangibles do not qualify as capital for regulatory purposes, intangible assets are reversed out of capital.

3.3 Tier 2 capital

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

- Subordinated notes are unsecured and rank behind the claims of all depositors, creditors and investing members (other than holders of PIBS) of YBS. More details of the subordinated liabilities are included in note 27 to the Annual Report and Accounts.

- To the extent that collective provisions for impairment have been recognised in the income and expenditure account these may be added back to tier 2 capital.

4 Capital Adequacy

4.1 Capital management

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

- The maintenance of sufficient regulatory capital to meet solvency requirements. This relates to both current and projected capital (i.e. the levels of capital in the light of the Group's strategy and corporate plans, current capital and risk weighted assets combined with future balance sheet movements and profitability, and with the potential for raising external capital)
- The maintenance of what, in the Board's view, is a comfortable margin over the regulatory minimum
- The maintenance of sufficient capital strength within the balance sheet to provide comfort to interested third parties, and to generate a degree of funding cost benefit in the retail and wholesale markets, in particular with regard to retail savings customers and external credit rating agencies, and
- The efficient and effective allocation of capital across the Group's operations. Again, this needs to be commensurate with its status as a deposit taker and a mutual organisation.

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

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

Regulatory capital covers the following risks across the capital Group:

- Pillar 1 risks (i.e. credit risk and operational risk). The minimum capital requirement is calculated using regulatory-prescribed risk weightings laid out in the FSA's rulebooks. The Group has adopted the standardised approach to both credit and operational risk since 1 January 2008 in order to calculate the Pillar 1 minimum capital requirement.
- Pillar 2 risks (i.e. all other material risks for the Group which does not require the provision of regulatory capital under Pillar 1). Each material risk that the Group has identified outside the scope of Pillar 1 (e.g. pension obligation risk, interest rate risk, concentration risk) has undergone considered and vigorous stress testing to calculate an economic value for each of the material risks across the Group.

4.2 Internal Capital Adequacy Assessment Process

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

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

This process includes:

- Identification by senior managers of the relevant risk categories for the Group;
- Establishment, under the sponsorship of individual General Managers, of separate work streams to consider each risk category in detail
- Analysis of the risks within each work stream, involving relevant personnel from across the business, and documented in individual risk assessment documents
- Consideration of whether capital is an appropriate mitigant to the risk. Where this is deemed to be the case, capital requirements are calculated and stress tested for each risk category over a four-year horizon, consistent with the Group's current strategic planning horizon. Where capital is not deemed as being able to mitigate a particular risk, alternative management actions are identified and described within the risk assessment

- Approval of individual risk assessment documents by the relevant sponsor, the General Manager Risk and Planning and Group Capital Committee
- Documentation of the overall process and assessment, which is presented to Group Capital Committee before being presented to Group Risk Committee and the Board (with whom ultimate responsibility lies) for challenge and approval.

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

The FSA is currently assessing our internal capital assessment and, to date, no Individual Capital Guidance (ICG) for the Group has been set. The Group is therefore required to hold capital at the “Interim” ICG level until the FSA have approved a YBS specific ICG.

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

5 Significant risk categories - Credit Risk

5.1 Credit risk overview

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

For the purposes of Pillar 3 disclosure, credit risk is sub-divided into retail (residential mortgages) credit risk and wholesale (treasury) credit risk.

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

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

Exposures
Details on exposure amounts at 31 December 2007 can be found in the 2007 Annual Report and Accounts.

5.2 Retail credit risk

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

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

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

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

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

In assessing willingness and ability to service the loan, the Group uses credit scoring systems that factor in the profile of the borrower, the nature of the loan, evidence that the prospective borrower can service other debt obligations satisfactorily and environmental conditions. These scoring systems, and the way they are used within the initial lending process, are varied to suit the different risks and profiles of the Group's underlying mortgage portfolios. The score decision is combined with a number of other factors such as lending criteria, value of the collateral to be taken as security and affordability of loan repayments to determine whether a loan should be made. The maximum percentage of the value of a property (loan-to-value, LTV) that an applicant may borrow is calculated in relation to the credit score and lending criteria. This is based on the market value of the property. No lending is undertaken based solely upon security provided by the value of the underlying assets, and the decision to lend rests with the Lending Risk function in Lending Quality Department. Once a mortgage application is made, the sales force has no bearing on the final decision. All mortgages are secured by way of a first legal charge against the property.

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

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

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

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

5.3 Wholesale credit risk

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

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

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

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

- Overall wholesale credit exposures, split between core liquidity and structured credit, analysed by internal credit rating band and showing exposures, expected losses and capital requirements
- Overall distribution of internal and external credit ratings through wholesale portfolio
- High risk exposures (i.e. low rated investments) and Large exposures (i.e. highest £ amounts)

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

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

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

5.4 Impairment provisions

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

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

Where there is objective evidence of impairment or that trigger events exist at the balance sheet date, then the impairment loss is calculated as the difference between the assets' carrying value and the present value of the estimated cash flows from those assets. In assessing these cash flows a number of factors are taken into account, including the Group's historic default experience, historic and current loss emergence periods, the effect of changes in house prices and adjustments to allow for ultimate forced sales discounts.

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

Further details on impairment charges and provisions for 2007 are contained in note 9 to the Annual Report and Accounts.

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

- significant financial difficulties of the issuer or obligor;
- any breach of contract or covenants;
- the granting of any concession or rearrangement of terms;
- the disappearance of an active market;
- any significant downgrade of ratings; and
- any significant reduction in market value.

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

Where the Group determines that there is objective evidence of impairment or that trigger events exist at the balance sheet date, then the cumulative loss that had been recognised directly in reserves is removed from reserves and recognised in the income statement.

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

Further details on impairment charges and provisions for 2007 are contained in note 9 to the Annual Report and Accounts.

5.5 Credit risk concentrations

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

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

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

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

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

5.6 Credit risk mitigation

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

Retail

Residential property is the Group's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolios. All current mortgage lending activities are supported by an appropriate form of valuation using either an independent firm of valuers (except historic low LTV re-mortgage cases valued without independent valuation) or indexed valuation for further advances.

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

In addition all the residential lending portfolios have mortgage indemnity insurance coverage with another Group company, Yorksafe. This coverage is either funded by the borrower on loan inception or directly by the YBS group company advancing the loan. The premium is paid to Yorksafe, which in turn provides a coverage amount related to that specific loan in the event of a loss being incurred if the property is sold from possession.

Wholesale

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

Guarantees, from national governments or connected legal entities may be available for some treasury counterparty debt. Where available, these guarantees may enhance the credit profile of the exposure and provide security in the event of default. Such exposures will then qualify for a lower risk weighting.

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

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

5.7 Securitisation

The Group has not, to date, securitised assets that we have originated.

5.8 Counterparty credit risk

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

As described in section 5.6, risk is mitigated by offsetting the amounts due to the same counterparties (‘Netting benefits”) and by cash deposited by certain of the counterparties (‘Collateral held’).

Further details on derivative financial instruments held by the Group are contained in note 33 to the Annual Report and Accounts.

6 Significant risk categories - Operational Risk

6.1 Operational risk overview

YBS has adopted the standardised approach to operational risk and has defined operational risk as: "the risk of loss arising from inadequate or failed internal processes, people and systems or from external events, including legal risk".

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

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

6.2 Operational risk framework

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

6.3 Operational risk oversight and governance

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

6.4 Operational risk monitoring and reporting

In support of the enterprise-wide risk map, the Group has in place a risk dashboard supporting each key risk. These risk dashboard summarise the status of the risk, identifying:

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

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

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

- Operational risk profile (map of operational risks featured on the group risk map)
- Loss information
- Hits and near misses
- Operational risk activity report
- Business continuity update
- Information security and data protection update
- TCF (treating customers fairly)
- Regulatory risk and financial crime update
- Update on internal audit actions

7 Other significant risks - Pillar 2

7.1 Pillar 2 overview

As noted in section 4.2, the Group has undergone an Internal Capital Adequacy Assessment Process (ICAAP) in line with Basel II Pillar 2 requirements. The outcome of the ICAAP is presented within an Internal Capital Assessment document (ICA).

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

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

The ICA is prepared at a Group level, and at 31 December 2007 identified the following key risk categories

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

** - These risks are Pillar 1 risks that are considered in detail within Sections 5 and 6 of this document.*
^ - The Group deemed this risk as material but capital requirement against this risk was not deemed an appropriate action.

The risks that have been identified, after severe stress testing, as material and that are not Pillar 1 risks have resulted in an additional capital charge (with the exception of liquidity risk). These risk categories are further considered below.

7.2 Interest rate risk in the banking book

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

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

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

Value at Risk
Value at Risk ("VaR") evaluates the potential losses that may be incurred as a result of movements in market conditions over a specified holding period and to a given level of confidence. The model used is based on a 10-day holding period and a 99% confidence level. The VaR model calculates potential movements in market prices by reference to market data from the last 90 days, and incorporates underlying risk factors based on historic interest rate volatilities and correlations.

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

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

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

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

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

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

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

YBS has stressed asset/liability positions by way of a 200 basis point shock (interest rates going up and down) as required by BIPRU rules to assess the quantity of Pillar 2 capital requirement for interest rate risk.

7.3 Pension obligation risk

The Group has a low risk appetite for this category of risk, but some degree of unavoidable risk already exists relating to the Group's obligations to existing members of the defined benefit scheme.

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

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

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

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

7.4 Other risks

The Group has also reviewed the full range of risks to which it is exposed and performed significant stress testing across several scenarios. No other risks were considered material from a capital perspective.