# Nottingham Building Society

# Pillar 3 Disclosures at 31 December 2014

# Contents

# 1. Overview

### 1.1 Background

The Basel Committee on Banking Supervision introduced the Basel II framework (Basel II) which was implemented in the EU at the beginning of 2007.

On 1st January 2014, the Basel Committee replaced the Basel II framework with the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD), commonly known as the Capital Requirements Directive IV (CRD IV), introducing a revised definition of capital resources and included additional capital and disclosure requirements. The rules are enforced in the UK by the Prudential Regulatory Authority (PRA).

The Basel framework consists of regulatory requirements that fall within 3 pillars:

**Pillar 1** – Sets out the regulatory minimum capital requirements for credit, operational and market risk.

**Pillar 2** – Supervisory review process which assesses whether additional capital should be held for those risks not captured under Pillar 1.

**Pillar 3 –** Sets out the disclosure requirements for firms to publish key information about their underlying risks, capital and risk management. These are aimed at promoting market discipline and complement Pillar 1 and Pillar 2.
The disclosure in this document meet the Society's obligation under Pillar 3 and are based on the new CRD IV rules.

### 1.2 Basis and Frequency of Disclosures

This document details the Nottingham's Pillar 3 disclosures as at 31 December 2014, with comparative figures for 31 December 2013 where relevant, and has been prepared to meet the disclosure requirements of CRD IV.

The Pillar 3 report is based upon the Society's Annual Report and Accounts for the year ended 31 December 2014, unless otherwise stated. Pillar 3 disclosures will be issued on an annual basis in conjunction with the publication of the year end annual accounts.

The introduction of CRD IV means that our 2014 capital position is presented on a different basis to that reported in 2013. Where appropriate we have disclosed 31 December 2013 comparatives on a CRD IV basis to aid comparability.

### 1.3 Location and Verification

These disclosures and the Annual Report and Accounts are published on the Nottingham's website (www.thenottingham.com).

These disclosures have been reviewed and approved by the Board. The disclosures are not subject to external audit; however, some of the information within the disclosures also appears in the Society's audited 2014 Annual Report and Accounts.

### 1.4 Scope of Application

The disclosure requirements in this document apply to Nottingham Building Society ("the Society") only. For prudential purposes the Society is shown on an unconsolidated basis.

PRA number: 200785

The principal office of the Society is Nottingham House, 3 Fulforth Street
Nottingham NG1 3DL.

The trading subsidiaries of the Society (consolidated for financial statement purposes only) are:

| Name of Subsidiary | Ownership | Nature of business |
|---|---|---|
| Harrison Murray Ltd | 100% | Estate Agency |
| HM Lettings Ltd | 100% | Lettings |
| Nottingham Mortgage Services Ltd | 100% | Mortgage Broker |
| Nottingham Property Services Ltd | 100% | Estate Agency |
| The Mortgage Advice Centre (East Midlands) Limited | 100% | Mortgage Broker |

There are no current or foreseen material, practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities among Nottingham Building Society and its subsidiaries.

## 2. Risk Management Objectives and Policies

### 2.1 Introduction

The Nottingham recognises risk as a natural consequence of its business environment, as with any organisation. Through prudent management it aims to manage risk in a manner that supports the achievement of its strategic objectives, whilst protecting members' interests and its financial resources.

### 2.2 Risk Management Framework

The Board is responsible for ensuring that an effective framework is in place to promote and embed an effective risk-aware culture that identifies, appropriately mitigates and manages the risks which the Group and Society face in the course of delivering its strategic objectives.

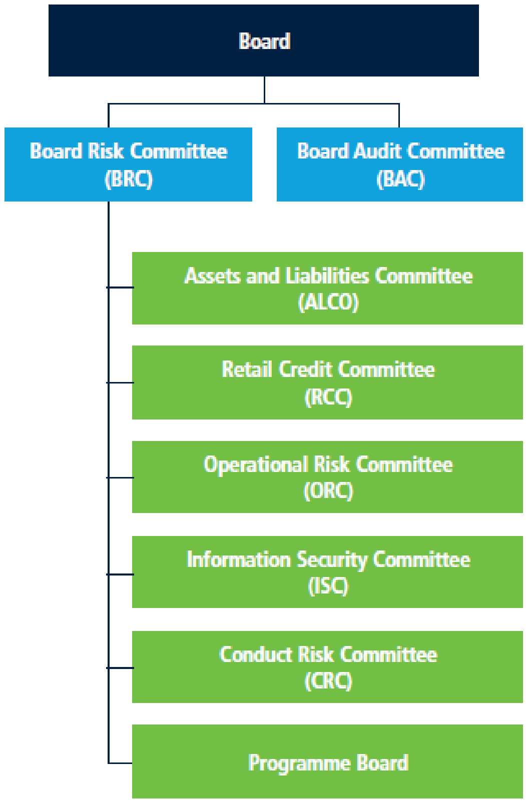
This includes both current risks and those associated with the implementation of future strategy. The Board annually reviews and approves a risk appetite statement. In pursuing its strategy the Board ensures there are appropriate capabilities and resources available, along with sufficient capital strength to succeed. This includes focusing on risk and reward to ensure it is at an acceptable level.

The Nottingham operates a 'three lines of defence' approach to the allocation of responsibilities for risk identification and management. This is illustrated in the following diagram:

| 3 Lines of Defence | Focus | Summary of core responsibilities |
|---|---|---|
| 1st line of defence:<br>Front Line Function | Control | • Day to day management and control of risk |
| 2nd line of defence:<br>Risk Management | Oversight | • Oversight and challenge of 1st Line of defence |
| 3rd Line of defence:<br>Internal Audit | Assurance | • Independent assurance of the first two lines of defence. |

## 2.3 Organisation and Structure of Risk Management

The Nottingham's risk committee structure has been designed to support a wide ranging approach to the identification and management of risk. In so doing each of the six 'management level' risk committees report to the Board Risk Committee, whose responsibility it is to take a Society wide view of The Nottingham's overall exposure to risk.




The table below illustrates how The Nottingham's committees fit into the three lines of defence framework:

| Key Risks | First Line | Second Line | Third Line |
|---|---|---|---|
| Credit Risk | | | |
| Retail Credit Risk (Residential and Buy to Let Mortgages) | Retail Lending | Retail Credit Committee | |
| Secured business lending Credit Risk (Commercial Mortgages) | Secured business lending | Retail Credit Committee | |
| Treasury Credit Risk | Treasury Risk | ALCO | |
| Liquidity & Funding Risk | Treasury Risk | ALCO | Board Risk Committee and Board Audit Committee |
| Market Risk | Treasury Risk | ALCO | |
| Operational Risk (including Financial Crime and Project Risk) | All business areas | Operational Risk Committee | |
| Information Security Risk and Data Protection | All business areas | ISC | |
| Conduct Risk | All business areas | Conduct Risk Committee | |
| Programme Board | Programme office | Programme Board | |

Detailed below are the board and management level risk committees along with a summary of their respective remits:

| Board Risk Committee (BRC) | |
|---|---|
| *Committee members* | All Board members |
| *Summary terms of reference* | The BRC is responsible for overseeing the management of risk by ensuring:<br><br>a. Key risks are identified and steps taken to mitigate them.<br>b. Due consideration is given to all significant matters relating to governance, control, regulatory and compliance issues.<br>c. Risks and controls are monitored adequately.<br><br>It also oversees, at a high level, the operation of the Internal Capital Adequacy Assessment Process (ICAAP) and Individual Liquidity Adequacy Assessment (ILAA).<br><br>In addition the BRC monitors The Nottingham's overall capital and liquidity adequacy and exposure to risk. |
| *Frequency* | Quarterly |

| Board Audit Committee (BAC) | |
|---|---|
| *Committee members* | 5 Non-executive Directors |
| *Summary terms of reference* | The BAC considers all audit matters relating to The Nottingham, including systems of internal control, financial reporting, accounting policies and judgemental accounting issues.<br><br>The BAC oversees the work of Internal Audit. This includes considering the findings from audit reports and reviewing the progress of management in implementing identified actions.<br><br>The BAC considers the scope and planning of external audit activities and recommends to the Board any decisions on the engagement of external auditors for non-audit services. |
| *Frequency* | Quarterly with an additional meeting to deal with the Annual Report and Accounts. |

| Management Assets and Liabilities Committee (ALCO) | |
|---|---|
| *Committee members* | Chief Executive, Deputy Chief Executive & Finance Director, Head of Treasury Risk, Treasurer, Head of Finance and Head of Risk. |
| *Summary terms of reference* | The ALCO assists the Board and Executive in the prudent management of The Nottingham's Treasury function. It is responsible for developing and defining the treasury risk appetite of The Nottingham and for ensuring that the activities of the Treasury function support the corporate plan whilst remaining compliant with all applicable regulatory requirements.<br><br>It fulfils this role by ensuring that appropriate policies, strategies and processes exist for the management of The Nottingham's Treasury function. It receives regular reports on the activities and performance of The Nottingham's treasury function. |
| *Frequency* | Monthly |

| Management Retail Credit Committee (RCC) | |
|---|---|
| *Committee members* | Deputy Chief Executive & Finance Director, Chief Operating Officer, Head of Risk, Head of Central Sales & Service and Senior Credit Risk Manager. |
| *Summary terms of reference* | The RCC assists the Board and Executive in the identification and prudent management of the credit risks that are associated with The Nottingham's mortgage lending portfolios. |
| *Frequency* | Minimum 5 meetings per annum |

| Operational Risk Committee (ORC) | |
|---|---|
| *Committee members* | Chief Operating Officer, Head of Risk, Head of HR, Head of IT and Change, Head of Branch Network, Head of Central Sales & Service, Head of Marketing, , And Operational Risk Manager. |
| *Summary terms of reference* | The ORC oversees the identification and management of system, project and operational risk (including the risks associated with fraud and financial crime) and related compliance issues across The Nottingham. |
| *Frequency* | Quarterly |

| Information Security Committee (ISC) | |
|---|---|
| *Committee members* | Chief Executive, Information Security Manager, Head of IT and Change, Head of Risk, Computer Services Manager, Technical Architect, Data Protection Officer and Senior IT Security Analyst. |
| *Summary terms of reference* | The ISC supports the board in ensuring the security of the Society's information is managed effectively. It performs this role through the approval of appropriate frameworks and policy and oversight of policy implementation. |
| *Frequency* | Minimum 6 meetings per annum |

| Conduct Risk Committee (CRC) | |
|---|---|
| *Committee members* | Chief Operating Officer, Head of Marketing, Head of Branch Network, Head of Central Sales & Service, Head of HR, Head of Risk, Senior Manager Conduct Risk and Group Secretary. |
| *Summary terms of reference* | The CRC has responsibility for overseeing the manner in which The Nottingham conducts business ensuring it is conducted in a clear, transparent and fair manner and is compliant with conduct rules set by the Regulator. |
| *Frequency* | Minimum 4 meetings per annum |
| Programme Board (PB) | |
| *Committee members* | Chief Executive, Deputy Chief Executive & Finance Director, Chief Operating Officer, Head of Risk, Head of IT & Change, Head of Business Development, Head of Finance, Head of HR |
| *Summary terms of reference* | The Programme Board supports the Executive in ensuring the optimum use of the Society's resources when applied to managing the Building Society's strategic programme of projects. It performs this role through the approval and prioritisation of all requests to initiate or materially change a project and ensures their ongoing monitoring of status at a corporate level. |
| *Frequency* | Minimum quarterly |

## 2.4 Risk strategy

The Nottingham's risk strategy reflects its committee structure. As such the Board approves the Board Risk Appetite Statement which contains both quantitative and qualitative risk measures. These statements are supported by a suite of risk metrics, limits and triggers designed to ensure The Nottingham stays within risk appetite.

Secondary, more granular, risk policies are approved by the relevant management level risk committee. These risk policies set out the key risks, how they are managed and incorporate further limits and triggers which are monitored by the individual management level risk committees.

In addition the third line of defence review the operation of controls during their assessments to provide assurance to the Board Risk Committee that controls are operating as expecting or where weaknesses are identified to assist the strengthening of the risk management framework.

During 2014, the information received and considered by the risk committees provided reasonable assurance that during the year there were no material breaches of control or regulatory standards and that The Nottingham maintained an adequate system of internal control.

## 2.5 Stress testing and planning

The Nottingham uses stress testing and scenario planning to help inform management of the impact from high impact stress events. Stress testing forms an integral part of the corporate planning process to ensure The Nottingham remains with risk appetite and has sufficient capital and liquid resources to carry out its strategic objectives.

## 3. Capital Resources

From the 1 January 2014, the Basel III, regulations more commonly known as CRD IV, has become part of European law. One of the objectives of the new regulation is to improve the banking sector's ability to absorb shocks arising from financial and/or economic stress. This is to be achieved through increasing both the quality and quantity of regulatory capital firms will be required to hold.

This document reflects the Basel III position as at 31 December 2014, with the prior year as at 31 December 2013, disclosed on both a CRD IV and Basel III basis.

The Nottingham's capital resources are broken down as follows:

| | 2014 CRD IV (£m) | 2013 CRD IV (£m) | 2013 Basel II (£m) |
|---|---|---|---|
| **Common Equity Tier 1 Capital** | | | |
| General Reserves | 178.0 | 166.0 | 166.0 |
| Available for sale reserve (AFS) | 0.4 | (0.2) | - |
| Intangible assets | (3.7) | (5.4) | (6.1) |
| Deductible deferred tax assets | (2.5) | (1.7) | - |
| | **172.2** | **158.7** | **159.9** |
| **Additional Tier 1 Capital** | | | |
| Permanent interest bearing shares (PIBS) | 19.1 | 23.9 | 23.9 |
| **Total Tier 1 Capital** | **191.3** | **182.6** | **183.8** |
| **Tier 2 Capital** | | | |
| Collective provision | 1.7 | 1.6 | 1.6 |
| **Total Tier 1 and Tier 2 Capital** | **193.0** | **184.2** | **185.4** |
| Deductions from Tiers 1 and 2 capital | - | - | (9.1) |
| **Total Capital** | **193.0** | **184.2** | **176.3** |

**Common Equity Tier 1 capital**
The Available for Sale reserve is included in regulatory capital under CRD IV.

Intangible assets do not qualify as capital for regulatory purposes and are deducted from capital.

Under the rules of CRD IV deferred tax assets that rely on future profitability and arise from temporary differences are deducted from capital.

**Additional Tier 1 capital**
Under the CRD IV rules PIBS no longer contribute towards Tier 1 capital due to their lack of loss absorbency features. They are subject to the transitional rules of CRD IV which allow the instrument to be grandfathered until December 2021.

**Tier 2 capital**
Tier 2 capital includes collective impairment provisions.

Deductions from Tiers 1 and 2 capital in 2013 relate to investments in subsidiary companies which are risk weighted under CRD IV rules.

### 3.1 Reconciliation of Regulatory Capital

| | 2014 CRD IV Transitional (£m) | 2014 CRD IV Final (£m) |
|---|---|---|
| **Total equity attributable to members per the Statement of Financial Position** | **178.4** | **178.4** |
| Adjustments for items not eligible for inclusion in Common Equity Tier 1 capital: | | |
| Intangible fixed assets | (3.7) | (3.7) |
| Deductible deferred tax assets | (2.5) | (2.5) |
| **Total adjustments to Common Equity Tier 1 Capital** | **(6.2)** | **(6.2)** |
| Adjustments to Additional Tier 1 capital: Amortisation of PIBS under transitional rules | 19.1 | - |
| **Adjustments to Tier 2 capital: Add back: Collective impairment** | 1.7 | 1.7 |
| **Regulatory Capital** | **193.0** | **173.9** |

# 4. Capital Adequacy

### 4.1 Capital Management

The Nottingham's policy is to maintain a strong capital base to maintain member, creditor and market confidence and to sustain the future development of the business. The Board manages The Nottingham's capital and risk exposures to maintain capital in line with regulatory requirements. This is subject to regular stress tests to ensure The Nottingham maintains sufficient capital for future possible events.

As a mutual, The Nottingham has no outside shareholders to whom it needs to pay dividends. As such The Nottingham does not have to maximise profitability so long as it maintains an adequate capital position.

The Nottingham's capital requirements are also monitored by the Prudential Regulatory Authority (PRA).

The Board monitors The Nottingham's capital position with the aid of its Internal Capital Adequacy Assessment Process (ICAAP). This requires The Nottingham to assess its capital adequacy over a 3 year period and determine the level of capital it requires to support both current and future potential risks.

The Nottingham adopted the Standardised Approach to calculate its credit risk weightings from 1 January 2008. Internally The Nottingham operates a similar standard to the Internal Ratings Based (IRB) approach for its retail mortgages, the benefit of which is an enhanced risk management capability.

Under the Standardised Approach the level of capital required against a given level of exposure to credit risk is calculated as:

Credit risk capital requirement = Exposure value x Risk weighting* x 8%.

* The risk weighting applied will vary depending on whether the asset is retail or wholesale. For retail assets, variables such as loan to value and security will impact the risk weighting. Wholesale assets are dependent on counterparty, duration and credit rating.

The primary source for obtaining information on counterparties' creditworthiness is External Credit Assessment Institutions (ECAIs). Unrated counterparties may be approved by the Assets and Liabilities Committee (ALCO).

Credit ratings are reviewed regularly and a list of relevant changes provided to the monthly ALCO meeting. Consideration will be given to selling holdings where ratings fall below the minimum criteria for a counterparty. In addition to credit ratings The Nottingham reviews the capital adequacy, assesses the financial performance, non-performing loans and any other risks associated with financial institutions.

### 4.2 Capital Requirements Summary

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

The following table shows the Society's overall minimum capital requirement as at 31 December 2014:

| Capital requirements | 31 December 2014 (£m) | 31 December 2013 (£m) |
|---|---|---|
| Credit Risk | | |
| - Loans and advances to customers | 79.5 | 75.1 |
| - Wholesale lending | 2.1 | 2.9 |
| - Other | 3.3 | 1.3 |
| Operational Risk | 6.4 | 5.4 |
| **Minimum capital requirement** | **91.3** | **84.7** |
| Capital resources (section 3) | 193.0 | 184.2 |
| **Excess of own funds over minimum Pillar 1 capital requirement** | **101.7** | **99.5** |

### 4.3 Leverage Ratio

The CRD IV framework requires firms to calculate a simple, transparent, non-risk based leverage ratio that is supplementary measure to the risk-based capital requirements.

The ratio is defined as the Capital Measure divided by the Exposure Measure, with this ratio expressed as a percentage. The basis of calculation is the average of the three month-end leverage ratios over a quarter.

The capital measure for the leverage ratio is Tier 1 capital from the risk-based capital framework as defined in paragraphs 49 to 96 of the Basel III framework (see table in Section 3), taking account of the transitional arrangements.

The Exposure measure is the total on and off balance sheet exposures less the deductions applied to Tier 1 capital as per Basel III December 2010 requirements. In January 2014 the Basel Committee on Banking Supervision (BCBS) published a revised definition for calculating the leverage ratio which requires off-balance sheet items e.g. commitments, to be converted into credit exposure equivalents through the use of credit conversion factors (CCFs) resulting in reduced exposure measure. Therefore, the table below also shows Nottingham's leverage ratio according to this revised BCBS definition.

| Leverage – Transitional rules | 2014<br>£m | 2013<br>£m |
|---|---|---|
| Total Tier 1 capital | 191.3 | 182.6 |
| Exposure: | | |
| Balance sheet exposure | 3,266.9 | 3,016.3 |
| Netted Derivative adjustment | 6.3 | 5.1 |
| Mortgage Pipeline | 28.2 | 49.4 |
| Other committed facilities | 223.4 | 154.0 |
| Leverage ratio exposure | 3,524.8 | 3,224.8 |
| Leverage ratio | 5.4% | 5.7% |

| Leverage – Final rules | 2014<br>£m | 2013<br>£m |
|---|---|---|
| Total Tier 1 capital | 172.2 | 158.7 |
| Exposure: | | |
| Balance sheet exposure | 3,266.9 | 3,016.3 |
| Netted Derivative adjustment | 6.3 | 5.1 |
| Mortgage Pipeline | 28.2 | 49.4 |
| Other committed facilities | 223.4 | 154.0 |
| Leverage ratio exposure | 3,524.8 | 3,224.8 |
| Leverage ratio | 4.9% | 4.9% |

The BCBS will continue to test for a minimum requirement of 3% for the leverage ratio during the parallel run period (i.e. from 1 January 2013 to 1 January 2017).

At the 31 December the leverage ratio of The Nottingham was well above the 3% regulatory minimum at 5.4% based on the transitional rules. Upon full implementation of the CRD IV rules this will reduce to 4.9%, but still well above the 3% regulatory minimum.

The Nottingham will continue to operate at a level considerably in excess of the regulatory minimum.

# 5. <u>Measurement of Risk</u>

### 5.1 Overview

The Nottingham aims to manage all the risks that arise from its operations. The main categories of risk in our business are credit, liquidity, market, conduct of business, operational, business, strategic, regulatory, concentration and pension scheme obligation risk.

### 5.2 Credit Risk

Credit risk is the risk that a financial loss arises from the failure of a customer or counterparty to meet their contractual obligations. The Nottingham manages the level of credit risk it undertakes by applying various control disciplines, the objectives of which are to maintain asset quality in line with the stated risk appetite.

As a building society this is most likely to arise through the inability of borrowers to repay their mortgage commitments (retail credit risk) or through the failure of a treasury counterparty or country (wholesale credit risk).

a) Lending and Business Decisions

The Nottingham uses application scorecards to help it assess whether mortgage applications fit within its appetite for credit risk. Once loan funds have been advanced, behavioural scorecards are used to review the ongoing risk profile of both the portfolios and individual customers. In addition, for residential and buy-to-let mortgages property values are updated on a quarterly basis.

Through the use of scorecards, The Nottingham is able to estimate the likely level of default, mortgage arrears, impairment charges and capital allocation.

b) Pricing

Pricing models are utilised for all mortgage product launches. The models include expected loss estimates and capital utilisation enabling the calculation of a risk adjusted return on capital.

c) Concentration Risk

The design of retail products takes into account the overall mix of products to ensure that The Nottingham's exposure to market risk remains within permitted parameters.

### 5.2.1 Credit Risk: Loans and advances to customers

a) Retail Credit Risk

Exposure to retail credit risk is limited to the provision of loans secured on property within the UK. All mortgage loan applications are reviewed by an individual underwriter supported by the use of application scorecards and are assessed with reference to The Nottingham's retail credit risk appetite statement which is approved by the Board Risk Committee. Exposure to retail credit risk is carefully monitored by the Retail Credit Committee which reports to the Board Risk Committee. Responsibility for day to day management is delegated to the Head of Risk.

b) Secured Business Lending Credit Risk

The Nottingham's secured business lending policy is used to manage the level of credit risk. Primarily, secured business lending loans are made available to Small and Medium sized Enterprises (SME market) for either owner occupied or investment property purposes. Loans are only granted against the 'bricks and mortar' value (i.e. loans are only provided for the purchase/remortgaging of a property and not for working capital or machinery, etc.)

Secured business lending credit risk is monitored by the Retail Credit Committee with day to day management delegated to the Head of Risk.

The table below details the minimum credit risk capital requirement by standardised exposure class at 31 December 2014 broken down by exposure value.

| | 31 Dec 2014 (£m) | | 31 Dec 2013 (£m) | |
|---|---|---|---|---|
| Standardised exposure classes | Exposure Value | Capital Requirement | Exposure Value | Capital Requirement |
| Retail | 19.4 | 1.2 | 37.3 | 2.2 |
| Secured by Mortgages on Residential Property | 2,605.5 | 73.0 | 2,350.6 | 65.8 |
| Secured by Mortgages on Commercial Real Estate | 73.3 | 4.5 | 78.1 | 6.2 |
| Past Due Items | 8.3 | 0.7 | 8.6 | 0.7 |
| Other Items | 1.7 | 0.1 | 1.9 | 0.2 |
| **Total Loans and advances to customers** | **2,708.2** | **79.5** | **2,476.5** | **75.1** |

The following table shows the residual maturities of all Loans and Advances exposures as at 31 December 2014.

| 31 Dec 2014 | < 3 months (£m) | > 3 months but < 1 year (£m) | > 1 year but < 5 years (£m) | > 5 years (£m) | **Total (£m)** |
|---|---|---|---|---|---|
| Retail | - | - | 0.3 | 19.1 | **19.4** |
| Secured by Mortgages on Residential Property | 2.3 | 7.5 | 86.2 | 2,509.5 | **2,605.5** |
| Secured by Mortgages on Commercial Real Estate | 0.2 | 0.1 | 3.6 | 69.4 | **73.3** |
| Past Due Items | 0.2 | 0.6 | 0.4 | 7.1 | **8.3** |
| Other Items | 0.2 | - | 0.1 | 1.4 | **1.7** |
| **Total Loans and advances to customers** | **2.9** | **8.2** | **90.6** | **2,606.5** | **2,708.2** |

| 31 Dec 2013 | < 3 months (£m) | > 3 months but < 1 year (£m) | > 1 year but < 5 years (£m) | > 5 years (£m) | **Total (£m)** |
|---|---|---|---|---|---|
| Retail | - | - | 1.0 | 36.3 | **37.3** |
| Secured by Mortgages on Residential Property | 2.7 | 7.2 | 89.5 | 2,251.2 | **2,350.6** |
| Secured by Mortgages on Commercial Real Estate | 0.4 | 0.3 | 3.1 | 74.3 | **78.1** |
| Past Due Items | 0.2 | - | 0.5 | 7.9 | **8.6** |
| Other Items | 0.2 | - | 0.1 | 1.6 | **1.9** |
| **Total Loans and advances to customers** | **3.5** | **7.5** | **94.2** | **2,371.3** | **2,476.5** |

Credit risk exposures can be further sub-divided. The table below shows the geographical analysis of these exposures at 31 December 2014:

| 31 Dec 2014 Region (All UK) | Retail (£m) | Secured by Mortgages on Residential Property (£m) | Secured by Mortgages on Commercial Real Estate (£m) | Past Due Items (£m) | Other Items (£m) | **Total (£m)** |
|---|---|---|---|---|---|---|
| Eastern | 0.7 | 286.2 | 4.0 | - | - | **290.9** |
| East Midlands | 5.1 | 549.3 | 21.8 | 4.3 | 1.2 | **581.7** |
| London | 0.3 | 295.9 | 4.5 | 0.4 | - | **301.1** |
| North East | 2.2 | 82.6 | 0.8 | - | - | **85.6** |
| North West | 2.2 | 214.2 | 12.3 | 0.9 | - | **229.6** |
| South East | 1.0 | 398.2 | 6.1 | 0.9 | 0.1 | **406.3** |
| South West | 0.9 | 203.5 | 4.7 | 0.1 | 0.1 | **209.3** |
| Wales | 0.7 | 60.0 | 3.7 | 0.1 | - | **64.5** |
| West Midlands | 3.3 | 229.3 | 6.4 | 0.6 | - | **239.6** |
| Yorkshire and Humberside | 2.7 | 278.3 | 7.2 | 1.0 | 0.1 | **289.3** |
| Other | 0.3 | 8.0 | 1.8 | - | 0.2 | **10.3** |
| **Total** | **19.4** | **2,605.5** | **73.3** | **8.3** | **1.7** | **2,708.2** |

| 31 Dec 2013 Region (All UK) | Retail (£m) | Secured by Mortgages on Residential Property (£m) | Secured by Mortgages on Commercial Real Estate (£m) | Past Due Items (£m) | Other Items (£m) | **Total (£m)** |
|---|---|---|---|---|---|---|
| Eastern | 5.0 | 246.7 | 4.7 | 0.5 | - | **256.9** |
| East Midlands | 16.7 | 518.0 | 22.6 | 3.5 | 1.3 | **562.1** |
| London | 0.6 | 269.5 | 5.2 | 0.2 | - | **275.5** |
| North East | 1.1 | 73.8 | 0.6 | 0.1 | - | **75.6** |
| North West | 2.0 | 188.0 | 13.5 | 1.4 | - | **204.9** |
| South East | 1.5 | 356.6 | 6.5 | 0.2 | 0.1 | **364.9** |
| South West | 1.3 | 187.7 | 4.9 | 0.4 | 0.1 | **194.4** |
| Wales | 0.8 | 55.6 | 4.0 | 0.1 | - | **60.5** |
| West Midlands | 2.7 | 194.1 | 6.6 | 0.7 | 0.1 | **204.2** |
| Yorkshire and Humberside | 5.3 | 253.9 | 7.8 | 1.5 | 0.1 | **268.6** |
| Other | 0.3 | 6.7 | 1.7 | - | 0.2 | **8.9** |
| **Total** | **37.3** | **2,350.6** | **78.1** | **8.6** | **1.9** | **2,476.5** |

### 5.2.2 Credit Risk: Wholesale Lending

A Board approved policy statement restricts the level of risk by placing limits on the amount of exposure that can be taken in relation to one counterparty or group of counterparties, and to industry sectors. This is reported by the Assets and Liabilities Committee to the Board Risk Committee.

The Nottingham's treasury policy only permits sterling denominated lending to UK and other central governments, UK local authorities, UK and overseas banks and building societies. During the year lending has been permitted to selected European based Multilateral Development Banks in instances where it qualifies as Liquidity Asset Buffer (LAB) eligible assets, The Nottingham has not permitted any lending directly to sovereign states, other than the UK. In addition, every bank must have a minimum 'A' rating from an external credit assessment institution and meet The Nottingham's thresholds on capital and non-performing loan measures.

The table below details the exposure value and minimum credit risk capital requirement by standardised exposure class at 31 December 2014.

| | 31 Dec 2014 (£m) | | 31 Dec 2013 (£m) | |
|---|---|---|---|---|
| Standardised exposure class | Exposure Value | Capital Requirement | Exposure Value | Capital Requirement |
| Central Government or Central Banks | 352.4 | - | 339.4 | - |
| Multilateral Development Banks | 26.4 | - | 20.7 | - |
| Institutions | 111.5 | 2.1 | 156.2 | 2.9 |
| Corporates | 16.2 | - | - | - |
| **Total Wholesale lending** | **506.5** | **2.1** | **516.3** | **2.9** |

The following table shows the residual maturities of all Wholesale Credit exposures as at 31 December 2014.

| 31 Dec 2014 | < 3 months (£m) | > 3 months but < 1 year (£m) | > 1 year but < 5 years (£m) | > 5 years (£m) | **Total (£m)** |
|---|---|---|---|---|---|
| Central Government or Central Banks | 331.5 | - | 20.9 | - | **352.4** |
| Multilateral Development Banks | - | - | 26.4 | - | **26.4** |
| Institutions | 42.8 | 44.4 | 24.3 | - | **111.5** |
| Corporates | 3.3 | 3.3 | 6.6 | 3.0 | **16.2** |
| **Total Wholesale lending** | **377.6** | **47.7** | **78.2** | **3.0** | **506.5** |

| 31 Dec 2013 | < 3 months (£m) | > 3 months but < 1 year (£m) | > 1 year but < 5 years (£m) | > 5 years (£m) | **Total (£m)** |
|---|---|---|---|---|---|
| Central Government or Central Banks | 318.6 | - | 20.8 | - | **339.4** |
| Multilateral Development Banks | - | - | 20.7 | - | **20.7** |
| Institutions | 52.2 | 51.6 | 50.0 | 2.4 | **156.2** |
| **Total Wholesale lending** | **370.8** | **51.6** | **91.5** | **2.4** | **516.3** |

The geographical split and credit rating of The Nottingham's treasury exposures at 31 December 2014 are detailed in the table below.

| 31 Dec 2014<br>Credit Rating | | UK<br>(£m) | Eurozone<br>(£m) | North America<br>(£m) | Asia<br>(£m) | **Total**<br>**(£m)** |
|---|---|---|---|---|---|---|
| Moody's | Fitch | | | | | |
| Aaa | AAA | - | 26.4 | - | - | **26.4** |
| Aa1 | AA+ | 352.3 | - | - | - | **352.3** |
| Aa2 | AA | - | - | 6.5 | - | **6.5** |
| Aa3 | AA- | 26.4 | - | 7.5 | 28.8 | **62.7** |
| A1 | A+ | - | - | - | - | **-** |
| A2 | A | 35.2 | - | - | - | **35.2** |
| A3 | A- | - | - | 7.3 | - | **7.3** |
| Baa1 | BBB+ | 8.1 | - | - | - | **8.1** |
| Unrated | | 8.0 | - | - | - | **8.0** |
| **Total** | | **430.0** | **26.4** | **21.3** | **28.8** | **506.5** |

| 31 Dec 2013<br>Credit Rating | | UK<br>(£m) | Eurozone<br>(£m) | North America<br>(£m) | Asia<br>(£m) | **Total**<br>**(£m)** |
|---|---|---|---|---|---|---|
| Moody's | Fitch | | | | | |
| Aaa | AAA | - | 20.7 | - | - | **20.7** |
| Aa1 | AA+ | 339.4 | - | 5.0 | - | **344.4** |
| Aa2 | AA | - | - | - | - | **-** |
| Aa3 | AA- | 25.3 | - | - | 31.3 | **56.6** |
| A1 | A+ | - | - | | - | **-** |
| A2 | A | 62.4 | - | - | - | **62.4** |
| A3 | A- | | - | - | 17.2 | **17.2** |
| Baa1 | BBB+ | | - | - | - | **-** |
| Unrated | | 15.0 | - | - | - | **15.0** |
| **Total** | | **442.1** | **20.7** | **5.0** | **48.5** | **516.3** |

The credit ratings of the external credit assessment institutions correspond to the following credit quality steps:

| Credit Quality Step | Moody's | Fitch |
|---|---|---|
| 1 | Aaa to Aa3 | AAA to AA- |
| 2 | A1 to A3 | A+ to A- |
| 3 | Baa1 to Baa3 | BBB+ to BBB- |
| 4 | Ba1 to Ba3 | BB+ to BB- |
| 5 | B1 to B3 | B+ to B- |
| 6 | Caa1 and below | CCC+ and below |

### 5.3 Impairment Provisions

a) Impairment of Loans and advances to customers

Throughout the year, and at each year-end, individual assessments are made of all loans and advances against properties that are in possession or in arrears by two months or more and/or are subject to forbearance activities. Individual impairment provision is made against those loans and advances where there is objective evidence of impairment.

Objective evidence may include:

- Significant financial difficulty of the borrower/issuer;
- deterioration in payment status;
- renegotiation of the terms of an asset due to financial difficulty of the borrower or issuer, including granting a concession/forbearance to the borrower or issuer;
- becoming probable that the borrower or issuer will enter bankruptcy or other financial reorganisation; and
- any other information discovered during annual review suggesting that a loss is likely in the short to medium term.

If there is objective evidence of impairment, the amount of loss is measured as the difference between the assets carrying amount and the present value of estimated future cash flows discounted at the financial asset’s original effective interest rate. In considering expected future cash flows, account is taken of any discount that may be needed against the value of the property at the balance sheet date thought necessary to achieve a sale and amounts recoverable under mortgage indemnity policies and anticipated realisation costs.

In addition, The Nottingham assesses quarterly whether there is objective evidence to suggest that a financial asset or group of financial assets is likely to be impaired. Where a collective assessment is made, each category or class of financial assets is split into groups of assets with similar credit risk characteristics. The Nottingham measures the amount of impairment loss by applying expected loss factors based on The Nottingham’s experience of default, loss emergence periods, the effect of movements in house prices and any adjustment for the expected forced sales value.

The resultant impairment charge is deducted from the appropriate asset values in the balance sheet.

Details of past due loans and provisions for impaired exposure at 31 December 2014 are shown in the table below.

| 31 Dec 2014 | Loans fully secured on residential property (£m) | Loans fully secured on land (£m) | Total (£m) |
|---|---|---|---|
| Not impaired | | | |
| Neither past due or impaired | 2,610.3 | 68.3 | 2,678.6 |
| Past due up to 3 months but not impaired | 13.6 | 1.1 | 14.7 |
| Past due over 3 months but not impaired | 4.5 | 0.4 | 4.9 |
| Possessions | - | 0.4 | 0.4 |
| Impaired | - | - | - |
| Not past due | 0.6 | 3.3 | 3.9 |
| Up to 3 months | 1.9 | 0.9 | 2.8 |
| 3 to 6 months | 0.6 | 0.3 | 0.9 |
| 6 to 12 months | 0.4 | - | 0.4 |
| Over 12 months | 0.2 | - | 0.2 |
| Possessions | 0.1 | 1.3 | 1.4 |
| **Total Exposure** | **2,632.2** | **76.0** | **2,708.2** |
| Provision | 0.9 | 3.9 | **4.8** |
| Charge for the year | (0.1) | 1.7 | **1.6** |

| 31 Dec 2013 | Loans fully secured on residential property (£m) | Loans fully secured on land (£m) | Total (£m) |
|---|---|---|---|
| Not impaired | | | |
| Neither past due or impaired | 2,370.2 | 73.4 | 2,443.6 |
| Past due up to 3 months but not impaired | 16.3 | 1.1 | 17.4 |
| Past due over 3 months but not impaired | 2.4 | 0.4 | 2.8 |
| Possessions | 0.2 | - | 0.2 |
| Impaired | | | |
| Not past due | 1.0 | 1.4 | 2.4 |
| Up to 3 months | 2.4 | 1.8 | 4.2 |
| 3 to 6 months | 2.1 | 0.8 | 2.9 |
| 6 to 12 months | 0.9 | - | 0.9 |
| Over 12 months | 0.3 | - | 0.3 |
| Possessions | 1.2 | 0.6 | 1.8 |
| **Total Exposure** | **2,397.0** | **79.5** | **2,476.5** |
| Provision | 1.4 | 2.5 | **3.9** |
| Charge for the year | 0.3 | 0.6 | **0.9** |

The values shown in the table relate to the full value of the loan, not just the amount past due. All past due and impaired loans are UK based.

The table below details the movement of impairment provisions during the year:

| 2014 | Loans fully secured on residential property (£m) | Loans fully secured on land (£m) | Total (£m) |
|---|---|---|---|
| Individual provision | | | |
| At 1 January 2014 | 0.8 | 1.5 | **2.3** |
| Provision for loan impairment | (0.1) | 1.6 | **1.5** |
| Provision utilised | (0.4) | (0.3) | **(0.7)** |
| **At 31 December 2014** | **0.3** | **2.8** | **3.1** |
| Collective provision | | | |
| At 1 January 2014 | 0.6 | 1.0 | **1.6** |
| Provision for loan impairment | - | 0.1 | **0.1** |
| **At 31 December 2014** | **0.6** | **1.1** | **1.7** |

| 2013 | Loans fully secured on residential property (£m) | Loans fully secured on land (£m) | Total (£m) |
|---|---|---|---|
| Individual provision | | | |
| At 1 January 2013 | 1.1 | 1.6 | **2.7** |
| Provision for loan impairment | 0.2 | 0.3 | **0.5** |
| Provision utilised | (0.5) | (0.4) | **(0.9)** |
| **At 31 December 2013** | **0.8** | **1.5** | **2.3** |
| Collective provision | | | |
| At 1 January 2013 | 0.5 | 0.7 | **1.2** |
| Provision for loan impairment | 0.1 | 0.3 | **0.4** |
| **At 31 December 2013** | **0.6** | **1.0** | **1.6** |

b) Impairment of Treasury Assets

The Nottingham assesses at each balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired. Available for sale assets are impaired and impairment losses are incurred if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a ‘loss event’), and that loss event has an impact on the estimated future cash flows of those assets. Loss events may include default of a counterparty or disappearance of an active market for the assets.

The amount of the impairment loss is recognised in the statement of comprehensive income. Any loss previously recognised through other comprehensive income is reversed out and charged to the statement of comprehensive income as part of the impairment cost.

During the year The Nottingham incurred no impairment charges on its treasury available for sale assets.

### 5.4 Credit risk mitigation

The Nottingham employs a range of techniques and strategies to reduce the credit risks of its retail and wholesale lending.

a) Loans and advances to customers

All mortgage loan applications are assessed with reference to the Nottingham's retail credit risk appetite statement and lending policy, which includes assessing applicants for potential fraud risk, and which is approved by the board.

For new customers the first element of the retail credit control framework is achieved via credit scoring, which assesses the credit quality of potential customers prior to making loan offers. The customers' credit score combines demographic and financial information. A second element is lending policy rules which are applied to new applications to ensure that they meet the risk appetite of the Nottingham. All mortgage applications are overseen by the Lending Services team who ensure that any additional lending criteria are applied and that all information submitted within the application is validated.

For existing customers who have been added to the lending portfolio, management use behavioural scorecards to review the ongoing creditworthiness of customers by determining the likelihood of them defaulting over a rolling 12 month period together with the amount of loss if they do default.

In the event of a default, the ultimate source of collateral remains the borrower's property. The Nottingham takes a first charge on all residential lending. The collateral is supported by an appropriate form of valuation using either an independent firm of valuers or an Automated Valuation Model (ALM).

The Nottingham insures its residential mortgage book against losses using Mortgage Indemnity Guarantee (MIG) Insurance. MIG Insurance is taken on all purchases where the loan to value (LTV) exceeds 80%. However, for prudence, no credit risk mitigation benefits have been taken from this purchase when assessing its Pillar 1 capital requirements.

The Nottingham does not have any exposure to the sub-prime market.

b) Treasury Assets

In addition to retail credit risks, the Society is also exposed through its treasury function. This arises from counterparties who may be unable to repay loans and other financial instruments that the treasury team holds as part of its liquidity portfolio.

A regular assessment of investment quality is undertaken by the Treasury Risk team which is reported monthly to the Assets and Liabilities Committee (ALCO).

Instruments used for risk management purposes include derivative financial instruments (derivatives), which are contracts whose value is derived from one or more underlying price, rate or index inherent in the contract or agreement, such as interest rates, exchange rates or stock market indices.

The objective of the Society in using derivatives is in accordance with the Building Societies Act 1986 and is to limit the extent to which the Society will be affected by changes in interest rates. Derivatives are not used in trading activity or for speculative purposes.

The derivative instruments used by the Society in managing its statement of financial position risk exposures are interest rate swaps. These are used to protect the Society from exposures arising principally from fixed rate mortgage lending, fixed rate savings products and fixed rate wholesale funding. An interest rate swap is a contract to exchange one set of interest rate cash flows for another. Such swaps result in the economic exchange of interest rates. No exchange of principal takes place. Instead interest payments are based on notional principal amounts agreed at inception of the swap. The duration of the interest rate swap is generally short to medium term and their maturity profile reflects the nature of the exposures arising from the underlying business activities.

The Society applies fair value hedging techniques to reduce its exposure to interest rate risk as follows:

| Activity | Risk | Fair value interest rate hedge |
|---|---|---|
| Fixed rate mortgage | Increase in interest rates | Society pays fixed, receives variable |
| Fixed rate savings bond | Decrease in interest rates | Society receives fixed, pays variable |
| Fixed rate funding | Decrease in interest rates | Society receives fixed, pays variable |

Under the new European Securities & Market Authority (ESMA) regulations it will become mandatory for all eligible derivate instrument transactions to be centrally cleared. Although not yet required The Nottingham has decided to centrally clear all eligible derivatives. As such all The Nottingham's derivatives are fully collateralised with a central clearing member.

The table below shows the derivative contracts held using the Mark to Market (MTM) method:

| | Replacement Cost £m | Credit Exposure £m | Total Exposure £m |
|---|---|---|---|
| 31 December 2014 | 10.0 | 6.2 | 16.2 |
| 31 December 2013 | 18.9 | 6.3 | 25.2 |

**5.5 Liquidity Risk**

Liquidity risk is the risk that The Nottingham will not have sufficient financial resources available to meet its obligations as they fall due, under either normal business conditions or a stressed environment.

It is The Nottingham's policy that a significant amount of its total assets are carried in the form of cash and other readily realisable assets in order to:

- Meet day-to-day business needs;
- Meet any unexpected cash needs;
- Maintain public confidence; and
- Ensure maturity mismatches are provided for.

Monitoring of liquidity and funding policies, in line with The Nottingham's prudent framework, is performed daily as set out by a Board approved policy statement. Compliance with these policies is reported, to the Assets and Liability Committee monthly and to the Board Risk Committee.

## 5.6 Market Risk

Market risk is the risk of changes to The Nottingham's financial condition caused by market variables in particular interest rates and property prices. Differing interest rate characteristics between assets and liabilities, and in particular fixed rate products, expose The Nottingham to the risk of either a reduction in interest income or an increase in interest expense relative to variable rate interest flows.

The instruments that are used for market risk management purposes include derivative financial instruments (derivatives). The objective of The Nottingham in using derivatives is in accordance with the Building Societies Act 1986 and is to limit the extent to which The Nottingham will be affected by changes in interest rates.

The treasury risk team is responsible for the day to day management of market risks. The balance sheet is subjected to a stress test of a 2% rise in interest rates on a weekly basis and the results are reported monthly to the Assets and Liabilities Committee. In addition management review interest rate basis risk, the risk that different market interest rates move by different amounts, to assess the possible impact on profit. Both sets of results are measured against risk appetite for market risk which is currently set at a maximum of 2.5% of capital.
The Nottingham's sensitivity to this measurement (in terms of economic value) was:

| | 2% shift in interest rates (£m) | 2.5% of capital (£m) |
|---|---|---|
| 31 December 2014 | 1.3 | 4.8 |

A Board approved policy statement defines the maximum acceptable level of market risk as well as the steps that may be taken to reduce it. The Assets and Liabilities Committee is responsible for reviewing treasury activity, performance and compliance with approved policy statements. It reports to the Board Risk Committee.

## 5.7 Business Conduct Risk

Business conduct risk is the risk that The Nottingham does not conduct its business activities in a clear, transparent and fair manner. The Nottingham must ensure it complies with the FCA's Principles of Business (PRIN).

Each business area is responsible for ensuring compliance with all regulatory and legal obligations with regard to conduct of business that affect its area of operations.

The Conduct Risk Committee, which comprises an executive director and senior managers, supports the Board Risk Committee by overseeing the manner in which The Nottingham conducts business with its members and customers.

It achieves this by ensuring effective governance and control frameworks are in place, maintained and monitored. In addition the committee will identify and drive actions to address priorities for improvement that will enable The Nottingham to deliver and sustain self-imposed targets in customer satisfaction and ensuring good customer outcomes.

## 5.8 Business Risk

Business risk is the risk of unexpected changes in the external environment that have the potential to affect The Nottingham's business model either through the level of demand for The Nottingham's products and services and or its ability to meet it.

The Nottingham looks to mitigate its exposure to business risk by having a diverse range of products and services so that its income source is not reliant on one product or one area of its business.

The Board monitors The Nottingham’s exposure to business risk. In so doing it receives a range of Management Information on a monthly basis from both the Deputy Chief Executive & Finance Director and Chief Operating Officer.

### 5.9 Strategic Risk

Strategic risk is the risk that the Nottingham pursues an inappropriate strategy or that risks associated with its implementation are not fully recognised. When discussing strategy the Board takes care to ensure that risks such as system changes, long term funding approach and acquisitions are evaluated and that management has plans to mitigate them.

The board risk committee oversees the detailed evaluation of these risks.

### 5.10 Regulatory and Compliance Risk

These risks are the risk of loss from failure to comply with statutory and regulatory requirements. The Nottingham, being a retailer of mortgage, savings and insurance products, is regulated by the Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA) and as such must comply with relevant policies.

The Nottingham must also comply with the relevant sections of the Building Society Act 1986 and other legal requirements.

Each business area is responsible for ensuring compliance with all regulatory and legal requirements that affect its area of operations. Oversight of the business is undertaken by the Compliance function supported by the Society’s Secretary.

### 5.11 Concentration Risk

As a regional building society The Nottingham is exposed to concentration risk. This includes the potential for geographical and product concentrations in terms of both its mortgage book and wholesale funding activities.

a) Retail Credit Risk

The Nottingham receives its mortgage business via two main sources: its branch network and intermediaries. Over 75% of its business is introduced by intermediaries, which are spread throughout England and Wales.

The Nottingham has geographic concentration risk as it is regionally based in the East Midlands and domiciled in the UK, acquiring all of its current business from England and Wales.

Geographic concentration risk is monitored by observing the spread of The Nottingham's exposure by region and the impact of house price changes during various economic scenarios. The risk is monitored on an ongoing basis.

b) Wholesale Credit Risk

The Nottingham carries out wholesale lending predominantly in the London money markets. This creates a potential source of concentration risk if, for example, there is a general tightening of credit conditions.

Stress testing has been carried out to consider a systematic downgrading of all current non-UK government counterparties by one credit notch. This scenario is designed to mimic a general deterioration in the credit conditions in the UK money markets and recognises that there is concentration risk inherent within the wholesale lending function.

Funding concentration risk is mitigated by limiting the amount of exposure to each specific risk. Treasury monitors large exposures on a daily basis and reports any exceptions to policy to the ALCO on both a weekly and monthly basis. Limits are monitored on an ongoing basis and are formally reviewed twice a year as a minimum as part of the overall review of treasury policy.

### 5.12 Pension Scheme Obligation Risk

Pension liability risk is the risk that there may be a shortfall with respect to meeting the benefits that are due within a defined benefit pension scheme.

The Nottingham operates a contributory defined benefit pension scheme. The scheme closed to new members in 1997 and closed to future service accrual from 31 January 2009. The membership consists of pensioners, those with deferred benefits and current members.

The Nottingham is exposed to the risk that it will need to make further unexpected future contributions to the scheme. The risk may arise from a number of factors including:

- A fall in the discount rate increasing the present value of scheme liabilities.
- An increase in life expectancy increasing the present value of scheme liabilities.
- A fall in equity prices reducing the fair value of scheme assets.

The Nottingham uses independent actuarial advice to advise on the risks that may lead to an increase in the deficit. This is reviewed by the Board.

# 6. Measurement of Operational Risk Capital

### 6.1 Operational Risk

Operational risk is the risk of loss arising from inadequate or failed internal processes, the actions of people, The Nottingham's systems or from external physical events such as wars, terrorism or an 'Act of God'.

All of The Nottingham's teams and functions are required to identify, assess, monitor and control their operational risks via an agreed framework and methodology. As part of the risk management framework all business areas are required to complete an Objectives, Risks and Control Assessment (ORCA) and review it on an annual basis. In addition line management are held directly responsible for the assessment and management of the operational risks and associated controls that fall within their area of responsibility.

The Operational Risk Committee, which comprises two executive directors and senior managers, oversees the management of operational risk. In so doing it monitors a range of management information and other reports on The Nottingham's operational risk exposures. It also reviews the results of the operational risk scenario analysis that is performed for the purposes of The Nottingham's Internal Capital Adequacy Assessment Process.

The Operational Risk Committee reports regularly to the Board Risk Committee that in turn reports to the Board.

### 6.2 Minimum Capital Requirements for Operational Risk

The Nottingham calculates its operational risk capital requirement using the Basic Indicator Approach. This is determined in relation to the Society's net income averaged over the previous 3 years.

The Nottingham's minimum (Pillar 1) capital requirement for operational risk at 31 December 2014 is:

| | 2014 Operational risk capital requirement (£m) | 2013 Operational risk capital requirement (£m) |
|---|---|---|
| Basic Indicator approach | 6.4 | 5.4 |

# 7. Remuneration Committee and Policy

The primary objective of the Committee is to make recommendations to the Board on the general remuneration policy of the Society and specifically on the remuneration of Executive Directors. The Committee also has oversight of the remuneration of the senior management team.

From the 1st January 2011 the Society came within the scope of the Regulator's Remuneration Code (then the FSA). As a result those individuals who comprise Remuneration Code staff also fall within the remit of the Remuneration Committee.

The Committee comprises three non-executive directors (one of which acts as Chairman of the Committee) and the Chief Executive, the Head of HR and the Group Secretary attend.

Further details regarding the remuneration policy are set out in the Directors Remuneration Report in the 2014 Annual Report and Accounts which are published on the Society's website www.thenottingham.com.

**Code Staff:**

Code staff are defined by the Regulator as 'staff whose activities have a material impact on the firms risk profile, this includes staff that perform significant influence functions, senior managers and risk takers'.

The table below sets out the aggregate quantitative remuneration for code staff in relation to their services for The Nottingham for the year ended 31st December 2014.

| | Total remuneration (£) | Deferred variable remuneration (£) |
|---|---|---|
| Senior Management | 1,769,705 | Nil |
| Other code staff | 128,592 | Nil |
| Non-Executive Directors | 227,278 | Nil |

**Remuneration structure:**

1. Basic salary = Band, market benchmarking and performance driven. Band is determined via the HAY evaluation process and salaries for roles are determined by using functional external market benchmark data.
2. Variable pay = all code staff participate in one (Executive Directors participate in two) discretionary bonus schemes. The bonus schemes are based upon a modular scorecard approach derived from the Society's strategic goals which include effective risk management. As a mutual the Society does not issue shares on the Stock Exchange. For this reason the annual performance pay cannot be based upon Share Option Schemes or Share Incentive plans. The Society is a level three firm (as assets are less than £15bn) and is therefore not subject to the rules on retained shares and other instruments and deferral of variable pay.
3. Pensions = the Society contributes up to a maximum of 16% of salary (dependent upon age of joining and period of time in the scheme) for members of the Group Personal Pension Plan. The pension benefits relating to the Executive Directors are outlined in the 2014 Annual Report and Accounts.
4. Benefits = include the provision of a car allowance, private medical insurance and death in service benefits.

## 8. Glossary

| | |
|---|---|
| **Arrears** | A customer is in arrears when they are behind in meeting their contractual obligations with the result that an outstanding loan payment is overdue. The value of the arrears is the value of any payments that have been missed. |
| **Additional Tier 1 capital (AT1)** | Capital that meets certain rules under CRD IV and which comprises the Society's PIBS but only under the transitional provisions. |
| **Basel II** | Basel II is the second of the Basel Accords, issued by the Basel Committee on Banking Supervision, which defines the methods by which firms should calculate their regulatory capital requirements to retain sufficient capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive, and was implemented in the UK via the PRA/FCA Handbook. |
| **Basel III** | Basel III entered into force on 1 January 2014 and introduces more onerous capital requirements for credit institutions and amends the existing standards of Basel I and II. |
| **BIPRU** | The prudential sourcebook for banks, building societies and investment firms which sets out the FSA's capital requirements. |
| **Capital Requirements Regulation and Capital Requirements Directive IV (CRD IV)** | CRD IV is the European legislation which came into force from 1 January 2014 to implement Basel III. It has revised the capital requirements framework and introduced liquidity requirements, which regulators use when supervising firms. |
| **Common Equity Tier 1 capital (CET1)** | CET1 capital consists of general reserves and other reserves less intangible assets and other regulatory deductions. |
| **Counterparty credit risk** | Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. |
| **Credit Quality Steps** | A credit quality assessment scale as set out in BIPRU 3.4 (Risk weights under the Standardised Approach to credit risk). |
| **Credit risk** | This is the risk that a customer or counterparty fails to meet their contractual obligations. |
| **External Credit Assessment Institution (ECAI)** | An ECAI (e.g. Moody's, Standard and Poor's, Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves. |
| **Financial Conduct Authority (FCA)** | The statutory body responsible for conduct of business regulation and supervision of UK authorised firms from 1 April 2013. |
| **Internal Capital Adequacy Assessment Process (ICAAP)** | The Society's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements for risks it faces under a business as usual scenario including stress events. |
| **Individual liquidity adequacy assessment (ILLA)** | The Society's own assessment of the liquidity resources it requires in order to remain within the risk tolerances it has set. This will include an evaluation of potential stresses based on multiple market environments. |
| **Institutions** | Treasury assets with financial institutions such as banks and building societies. |

| | |
|---|---|
| **Leverage Ratio** | Leverage ratio is defined as Tier 1 capital divided by the total exposures which includes on and off balance sheet items, with this ratio expressed as a percentage. |
| **Loan to value (LTV)** | LTV expresses the amount of a mortgage as a percentage of the value of the property. |
| **Market risk** | The risk that movements in market risk factors, including foreign exchange rates, interest rates, credit spreads and customer-driven factors will create potential losses or decrease the value of the Society balance sheet. |
| **Minimum capital requirement** | The minimum amount of regulatory capital that a financial institution must hold to meet the Basel II Pillar 1 requirements for credit, market and operational risk. |
| **Multilateral Development Banks** | Treasury assets with Multilateral Development banks. |
| **Operational risk** | The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events. |
| **Other items** | Other assets not included in other definitions. |
| **Past due items** | Loans which are 90 days or more in arrears. |
| **Permanent interest bearing shares (PIBS)** | Unsecured, deferred shares of the Society that are a form of Tier 1 capital. PIBS rank behind the claims of all depositors, payables and investing members of the Society. PIBS are also known as subscribed capital. |
| **Provisions** | Amounts set aside to cover incurred losses associated with credit risks. |
| **Prudential Regulation Authority (PRA)** | The statutory body responsible for the prudential supervision of banks, building societies, insurers and small number of significant investment firms in the UK from the 1 April 2013. The PRA replaced the FSA (Financial Services Authority). |
| **Retail** | Residential mortgages where LTV is greater than 80%. |
| **Risk appetite** | The level of risk that the Society is willing to accept (or not accept) in order to safeguard the interests of the Society's members whilst achieving business objectives. |
| **RWA** | Risk Weighted Assets. The value of an on or off-balance sheet exposure adjusted under Pillar 1 rules to reflect the degree of risk it presents. |
| **Secured by Mortgages on Residential Property** | Residential mortgages where LTV is less than or equal to 80%. |
| **Secured by Mortgages on Commercial Real Estate** | Secured business lending. |
| **Tier 1 capital** | A component of regulatory capital, it comprises CET1 and AT1. |
| **Tier 2 capital** | Comprises the collective impairment allowance (for exposures treated on a Basel II Standardised basis), less certain regulatory deductions. |