



Pillar 3 Disclosures 2008

18 July 2008

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1 Overview

1.1 Background

The European Union Capital Requirements Directive came into effect on 1 January 2007. It introduced consistent capital adequacy standards and an associated supervisory framework in the EU based on the Basel II rules agreed by the G-10.

Implementation of the Directive in the UK was by way of rules introduced by the Financial Services Authority (“the FSA”).¹ Among them are disclosure requirements applicable to banks and building societies, which are known as Pillar 3. These are designed to promote market discipline by providing market participants with key information on a firm’s risk exposures and risk management processes. Pillar 3 also aims to complement the minimum capital requirements described under Pillar 1 of Basel II, as well as the supervisory review processes of Pillar 2.

Nationwide Building Society (“Nationwide”) 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. The disclosures in this document are on a standardised basis.

On 20 May 2008, the FSA granted Nationwide permission to use an Internal Ratings Based (“IRB”) approach to credit risk and capital management. This will allow Nationwide to use its own estimates of risk, rather than values prescribed by the FSA, after certain conditions have been satisfied. The IRB approach will further enhance our risk management processes. Pillar 3 Disclosures are expected to be on this basis in 2009.

1.2 Basis and Frequency of Disclosures

This disclosure document has been prepared by Nationwide in accordance with the requirements of Pillar 3. Unless otherwise stated, all figures are as at 4 April 2008, our financial year-end.

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

1.3 Scope

Nationwide is an EEA parent institution that is regulated by the FSA. The Basel II Framework therefore applies to Nationwide and its subsidiary undertakings (together “the Group”).

There is a requirement to calculate and maintain regulatory capital ratios on both a Group basis and on a “solo consolidation” basis. However, there are no differences between the basis of consolidation of the Group for accounting and prudential purposes. The principal subsidiaries included under solo consolidation are:

- UCB Home Loans Corporation Limited
- Nationwide Syndications Limited
- Nationwide Trust Limited
- The Mortgage Works (UK) plc

All of the Group’s subsidiaries are included in the Pillar 3 disclosures. Nationwide International Limited is regulated by the Isle of Man Financial Supervision Commission and has its own regulatory capital requirements. With that exception, the Group does not foresee any practical or legal impediments to the transfer of capital resources or the repayment of liabilities within the Group. Full details of the principal subsidiary undertakings are included in Note 23 to the Annual Report and Accounts.

1.4 Location and Verification

These disclosures have been reviewed by the Group’s Audit Committee and are published on the Group’s corporate website (www.nationwide.co.uk). The disclosures are not subject to audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Group’s Annual Report and Accounts.

¹ *FSA Handbook – General Prudential sourcebook (“GENPRU”), and Prudential sourcebook for Banks, Building Societies and Investment Firms (“BIPRU”).*

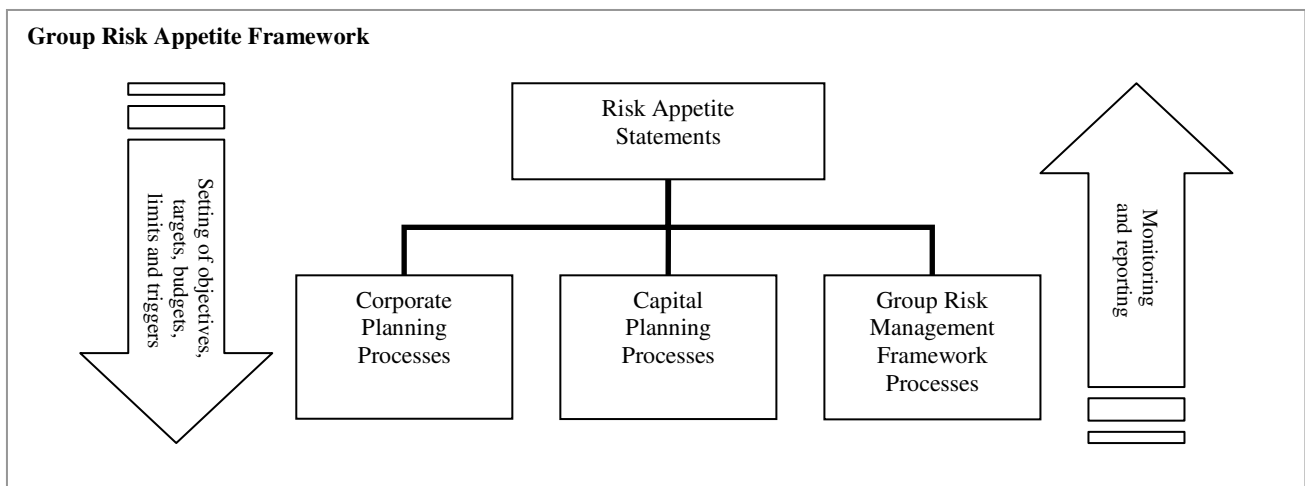
2 Risk Management Objectives and Policies

2.1 Strategies and Processes to Manage Risks - Risk Appetite

Nationwide is the custodian of its members' long-term financial interests. As a mutual organisation with no shareholders, the Board is prudent when deciding upon its appetite for risk relative to its banking peers, in order to take a long-term view of value creation. As such, the Board has agreed to adopt an overall low Risk Appetite, expressed in terms of the following seven categories:

- Profitability
- External Rating
- Solvency
- Economic Capital
- Return on Capital
- Liquidity
- Funding

Risk Appetite is integrated into the business through three process streams: Corporate Planning; Capital Planning; and the Group Risk Management Framework. These enable the Board to set the overarching parameters within which it wishes the business to operate and to monitor performance thereon. The process streams are all subject to documented governance processes and are illustrated below:



2.2 Group Risk Management Framework

Under the third Risk Appetite process stream (Group Risk Management Framework), Nationwide has adopted a “Three Lines of Defence” model to manage its risks. Primary responsibility for the identification, control, monitoring and mitigation of risk lies with the operational areas (first line of defence). Oversight and governance is provided through specialist risk support functions and dedicated Risk Committees (second line of defence). Finally, independent assurance is provided by Group Internal Audit and the Audit Committee (third line of defence).

This model is applied to all risks which could have a significant negative impact on the Group if they were to materialise. Such material risks represent the Group’s “Risk Profile” and are reviewed and reassessed at least annually as a part of the Internal Capital Adequacy Assessment Process (ICAAP) (see section 4.2). The Board has assessed that the Group’s most significant risk categories are credit risk, market risk, liquidity and funding risk, and operational risk. For each risk, the following risk management practices have been adopted in line with the Group Risk Management Framework:

- Risk policy
- Risk measurement
- Risk control
- Risk mitigation
- Risk monitoring and reporting

Risk policy

For all material risks within Nationwide's Risk Profile the Board's approach to risk management is documented within a set of detailed risk management policies which are owned and approved by the relevant mandated Risk Committee, and are supported by comprehensive limits, triggers, and processes.

Risk measurement

Robust and discriminatory internal ratings systems and models are used to measure the Group's credit risk exposures. These have been developed and validated according to documented and approved model development policies and procedures. Similarly, appropriate quantitative and qualitative methodologies have been developed to measure the Group's other material risk exposures, in line with industry best practice.

Risk control

Control of the Group's current and future exposure to risk is managed by the imposition of increasingly granular limits, triggers and mandates, which are embedded within Risk Policy and set by the relevant policy-owning Committee. This provides a clear hierarchical structure for identifying and managing risk against Risk Appetite.

Risk mitigation

All credit risk exposures, whether fully performing or otherwise, are reviewed at least annually. Behavioural scoring techniques are used to measure retail exposures while for commercial and treasury exposures a comprehensive health check on the financial standing of the borrower or counterparty is carried out. Both methods enable the Group to assess whether the level of credit given to the borrower remains acceptable.

Business Streams responsible for all of the material risks within Nationwide's Risk Profile ensure that appropriate mitigation techniques are undertaken to minimise the Group's exposure to each risk type. Additionally, they are responsible for minimising losses arising from the materialisation of a risk. Credit risk mitigation is described in more detail in section 5.7.

Risk monitoring and reporting

Specialist risk support functions are responsible for measuring and reporting performance against capital targets, as well as the limits, triggers and mandates contained within the relevant Group Risk Policy Statements. Management information is provided to the Risk Committees and to Group Risk Committee every month. Summary information is prepared for consideration by the Board quarterly.

At all levels of reporting, if past or future forecast business performance appears to have moved, or is likely to move, outside of agreed parameters, or there is a breach or near-breach of policy limits, the relevant committee will ensure that the most appropriate course of action is implemented. Thereafter, if the situation persists the matter will be escalated, ultimately to the Nationwide Board.

2.3 Structure and Organisation of Risk Management**Group governance structure**

Responsibility for risk management (first line of the "Three Lines of Defence" model) lies with operational areas. Responsibility for risk governance and oversight (the second line) lies with the specialist risk support functions in Risk Management Division (RMD) and delegated powers through the Group Risk Committee to specialist Risk Committees. Responsibilities for the Group's main risks have been allocated as follows:

Key Risks	FIRST LINE	SECOND LINE	
	Risk Management	Risk Oversight (RMD)	Risk Governance*
Credit Risk			
• Retail credit risk	Retail Lending	Retail Credit Risk	Retail Credit Committee
• Commercial credit risk	Commercial Lending	Commercial & Treasury Credit Risk	Commercial & Treasury Credit Committee
• Treasury credit risk	Treasury Division	Commercial & Treasury Credit Risk	Commercial & Treasury Credit Committee
Market Risk	Treasury Division	Market Risk	ALCO
Operational Risk	All business areas	Operational Risk Unit	Operational Risk Committee
Liquidity and Funding Risk	Treasury Division	Market Risk	ALCO

* Oversight of all risk governance committees is provided by the Group Risk Committee.

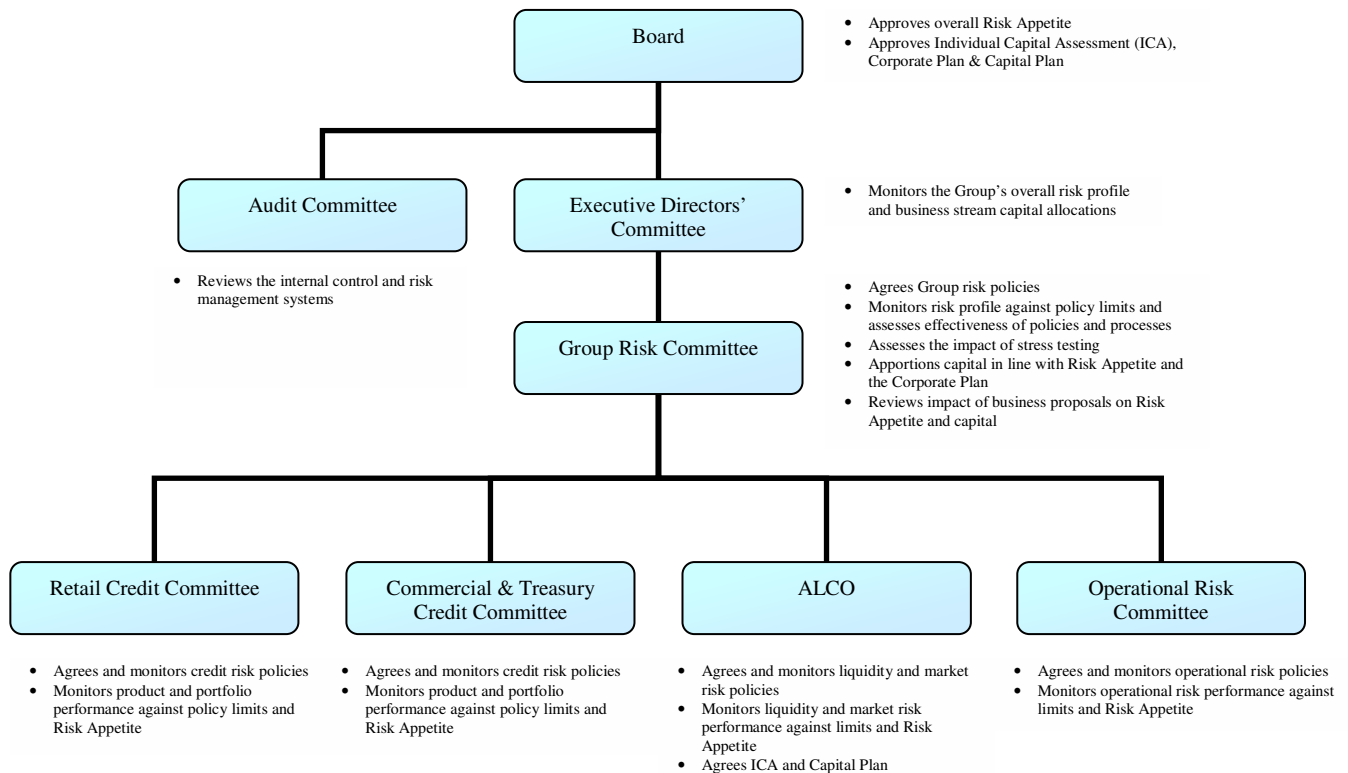
First line of defence: senior management responsibilities

All Business Stream managers are responsible for managing business performance in line with the Group’s overall Risk Appetite (per the Group Risk Management Framework described above). This requires them to manage their areas in line with operational performance targets and objectives cascaded from the Group’s Corporate Plan, regulatory and economic capital limits set within its Capital Plan, in addition to risk exposure limits set within Group Risk Policies.

Second line of defence: Board-Committee responsibilities

All Risk Committees have Board-mandated responsibility to: monitor business performance against Risk Appetite; to set, monitor and report on risk policy and methodology; and to challenge the risk management approach undertaken for their specific risks.

The Group’s Risk Committee structure is summarised as follows:



Delegated committees are responsible for satisfying themselves that no material changes in risk levels and profiles have occurred or are planned. Where appropriate, they will prepare policy and strategy papers for agreement by the Group Risk Committee and/or the Nationwide Board. These papers will propose the appropriate scale, portfolio mix and/or desired return to fit with the Group's overall Risk Appetite.

Second line of defence: specialist risk support function responsibilities

Specialist risk functions within Risk Management Division support the Board-mandated Risk Committees to fulfil their delegated responsibilities in respect of risk governance. These functions cover each of the significant categories of risk, namely retail, commercial and treasury credit risk, market risk, liquidity and funding risk, and operational risk, and play a major role in supporting the operational areas to manage their risks effectively on a day-to-day basis.

In addition, a Group Risk function sits alongside the specialist risk support functions and is responsible for developing and maintaining the risk and capital management frameworks within which the entire Group operates.

All of the functions within Risk Management Division are mandated to carry out their responsibilities by the Board through the Group Risk Committee.

Third line of defence: Internal Audit responsibilities

Group Internal Audit is responsible for carrying out a risk-based programme of work designed to provide assurance that assets are being safeguarded. This involves ensuring that controls are in place and working effectively in accordance with Group policies and procedures as well as with laws and regulations, and that Group records and reports are accurate and reliable. The work carried out by Group Internal Audit includes providing assurance on the effectiveness of the second line of defence functions as well as that of controls operated by Business Streams. The Audit Committee approves the Annual Audit Plan and also receives regular reports of the results of audit work.

Coverage of risks

Pillar 3 disclosures in this document cover credit risks (section 5), market risks (section 6), and operational risks (section 7).

There is additional information regarding credit risks in the 2008 Annual Report and Accounts (pages 91-97); other information regarding liquidity and funding risks is also included (pages 97 - 99).

3 Capital Resources

3.1 Total Available Capital

At 4 April 2008 and throughout the year, the Group complied with the capital requirements that were in force as set out by the FSA. The following table shows the breakdown of the total available capital for the Nationwide Group as at 4 April 2008:

	Group £m	Solo £m
Tier 1		
General reserve	6,303	6,097
Permanent Interest Bearing Shares (PIBS)	1,245	1,245
Pension fund deficit adjustment	19	19
Intangible assets	(137)	(137)
Agreed FSA deductions	(6)	(6)
Investments in non-solo consolidated subsidiaries*	-	(209)
Total Tier 1 Capital	7,424	7,009
Tier 2		
Revaluation reserve	121	121
Subordinated debt	1,743	1,743
Collective provisions for impairment	192	192
Agreed FSA deductions	(6)	(6)
Investments in non-solo consolidated subsidiaries*	-	(209)
Total Tier 2 Capital	2,050	1,841
Total capital available (own funds)	9,474	8,850

* Under solo consolidation, investments are not included in capital and are consequently deducted 50% from Tier 1 and 50% from Tier 2

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. The general reserve represents the Group's accumulated accounting profits as well as adjustments for pension obligations and property disposals.

Nationwide currently has no innovative Tier 1 instruments. PIBS are unsecured deferred shares and rank behind the claims of all subordinated noteholders, depositors, creditors and investing members of Nationwide. Further details about PIBS are provided in note 39 to the 2008 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 Nationwide Pension Fund ("the Fund") is included as a liability and hence is deducted from the general reserve. For capital purposes this amount is added back to the Group's capital and, instead, a deduction is made for the additional funding that is expected to be paid to the Fund over the next 5 years. At 4 April 2008, £19m had been added back to capital in this regard.

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 criteria. In addition, £12m of goodwill is held as part of intangible assets. However, because intangibles do not qualify as capital for regulatory purposes, intangible assets are deducted from capital. At 4 April 2008, £137m had been deducted from capital in respect of intangible assets.

3.3 Tier 2 Capital

Tier 2 capital comprises the Group's property revaluation reserve, qualifying subordinated notes, the collective impairment allowance, and adjustments for items treated separately for capital adequacy purposes.

Under FSA rules, qualifying subordinated notes cannot exceed 50% of the total of Tier 1 capital, and Tier 2 capital cannot exceed Tier 1 capital.

Subordinated notes are unsecured and rank behind the claims of all depositors, creditors and investing members (other than holders of PIBS) of the Society. More details of the subordinated notes are included in note 38 to the 2008 Annual Report and Accounts.

4 Capital Adequacy

4.1 Capital Management

The Group has adopted the standardised approach to both credit and operational risk since 1 January 2008 in order to calculate the Basel II Pillar 1 minimum capital requirement.

Nationwide manages its capital supply and demand by balancing capital efficiency and prudence. The Board believes that this approach fits in with the Group's approach towards capital adequacy, preserves the Group's competitive position in relation to capital requirements, and maintains and enhances the Group's reputation in the financial services industry.

Capital is measured on both a regulatory and an economic basis. Regulatory capital covers all Pillar 1 risks (i.e. credit risk, operational risk and foreign exchange risk) for all significant portfolios. Nationwide determines its minimum Capital Resource Requirement (CRR) using a regulatory capital calculator which is compliant with the BIPRU rules. Economic capital includes all other material risks for the Group which do not require the provision of regulatory capital (known as Pillar 2 risks) in addition to Pillar 1 risks. An internally-driven economic capital model has been developed to calculate an economic value for the whole range of material risks across the Group.

Regulatory capital is reported in the monthly Board Performance Pack. Economic capital is reported monthly to the Group Risk Committee. The Capital Management Working Group (CMWG), a sub-committee of ALCO, receives detailed reports of both regulatory and economic capital on a monthly basis. Business stream-specific reports of economic capital are also included in the monthly packs of the appropriate Risk Committees.

4.2 Internal Capital Adequacy Assessment Process

The Group undertakes an Internal Capital Adequacy Assessment Process (ICAAP) which is an internal assessment of its capital needs. This internal assessment makes use of the regulatory capital calculator and the economic capital model. The ICAAP is performed annually or more frequently should the need arise.

The outcome of the ICAAP is presented in an Internal Capital Assessment (ICA) document covering the Group and its subsidiaries. The ICA covers all material risks to determine the capital requirement over a three-year horizon, and includes stressed scenarios to satisfy the regulatory requirements. Where capital is deemed as not being able to mitigate a particular risk, alternative management actions are identified and described within the ICA.

The ICA is presented to CMWG before being presented to ALCO and the Board (with whom ultimate responsibility lies) for challenge and approval. The FSA has assessed our ICA and set Individual Capital Guidance (ICG) for the Group which came into effect from 1 January 2008.

4.3 Minimum Capital Requirement: Credit Risk

The following table shows Nationwide's overall minimum capital requirement for credit risk under the standardised approach (expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes) at 4 April 2008:

Minimum Capital Requirement 8%	Group £m	Solo £m
Retail exposure classes		
Secured on real estate property	3,474	3,185
Unsecured lending	149	149
Past due items	41	41
	3,664	3,375
Other exposure classes		
Commercial real estate	1,260	1,260
Central governments & central banks	1	1
Regional governments & local authorities	3	3
Financial institutions	429	429
Corporate	158	168
Securitisation positions	139	139
Covered bonds	7	7
Past due items	14	14
	2,011	2,021
Other		
Fixed and other assets	136	469
Credit risk minimum capital requirement	5,811	5,865

4.4 Minimum Capital Requirement: Pillar 1

Nationwide's overall minimum capital resource requirement under Pillar 1 is calculated by adding the credit risk charge described in section 4.3 to that required for operational risk using the standardised approach, and the foreign exchange Position Risk Requirement (FX PRR) element of Market Risk. The FX PRR charge is the amount of regulatory capital required to cover the risk of losses on open foreign currency positions arising from movements in the foreign exchange rate and is calculated in accordance with the FSA Handbook.

The following table shows both the Group's overall minimum capital requirement and capital adequacy position under Pillar 1 at 4 April 2008:

Total minimum capital requirement	Group £m	Solo £m
Credit Risk (Standardised)	5,811	5,865
Market Risk (FX PRR)	3	3
Operational Risk (Standardised)	317	317
	6,131	6,185
Total own funds (per section 3.1)	9,474	8,850
Excess of own funds over minimum capital requirement under Pillar 1	3,343	2,665

Given the total minimum capital requirements are not materially different on a Group or solo basis, the disclosures in the remainder of this document are on a Group basis.

5 Credit Risk Measurement, Mitigation and Reporting

5.1 Credit Risk Overview

Introduction

Credit risk is defined as the risk that a borrower or counterparty fails to pay the interest or to repay the capital on a loan. For the purposes of Pillar 3 disclosure, credit risk is sub-divided into residential mortgages, other unsecured lending, commercial lending, and treasury credit risks.

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent across most of the Group's activities. Adverse changes in the credit quality of borrowers or a general deterioration in UK economic conditions could affect the recoverability and value of the Group's assets and therefore its financial performance. Comprehensive risk management methods and processes have been established as part of its overall governance framework to measure, mitigate and manage credit risk within the Group's Risk Appetite.

Exposures

The gross credit risk exposure (based on the definitions for regulatory capital purposes, before credit risk mitigation) and the average for the year is summarised as follows:

	Average 2007/08 £m	4 April 2008 £m
Residential mortgages	108,736	121,128
Unsecured lending	2,558	2,429
Commercial loans	21,133	22,202
	132,427	145,759
Treasury:		
• Sovereign	1,696	3,348
• Financial institutions	18,116	23,710
• Asset-backed securities	6,627	7,863
• Corporate	454	585
	26,893	35,506
	159,320	181,265

The geographical distribution of these exposures at 4 April 2008 is as follows:

	UK £m	Other European Countries £m	North America £m	Rest of the World £m	Total £m
Residential mortgages	121,128	-	-	-	121,128
Unsecured lending	2,429	-	-	-	2,429
Commercial loans	21,100	1,102	-	-	22,202
	144,657	1,102	-	-	145,759
Treasury:					
• Sovereign	3,322	26	-	-	3,348
• Financial institutions	9,904	10,959	1,520	1,327	23,710
• Asset-backed securities	2,781	2,997	1,826	259	7,863
• Corporate	192	347	46	-	585
	16,199	14,329	3,392	1,586	35,506
	160,856	15,431	3,392	1,586	181,265

The following table shows the residual maturity of the exposures at 4 April 2008:

	Up to 12 months £m	1-5 years £m	5-10 years £m	More than 10 years £m	Total £m
Residential mortgages	2,171	3,286	10,985	104,686	121,128
Unsecured lending	1,584	691	154	-	2,429
Commercial loans	599	5,614	3,258	12,731	22,202
	4,354	9,591	14,397	117,417	145,759
Treasury:					
• Sovereign	762	1,884	702	-	3,348
• Financial institutions	15,070	6,367	1,724	549	23,710
• Asset-backed securities	24	483	1,327	6,029	7,863
• Corporate	17	231	300	37	585
	15,873	8,965	4,053	6,615	35,506
	20,227	18,556	18,450	124,032	181,265

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

The Group is firmly committed to the management of credit risk in both its lending and Treasury market activities. For all its lending business the Group employs sophisticated credit scoring, underwriting and fraud detection techniques that support sound credit decision making and work to minimise losses. A proactive approach to the identification and control of loan impairment is maintained, with challenge and oversight provided by the Retail Credit Committee and the Commercial & Treasury Credit Committee with further oversight by the Group Risk Committee.

5.2 Retail Credit Risk

Retail lending activity is split between secured (prime and specialist lending) and unsecured products (personal loans, credit cards and overdrawn current accounts).

Retail credit risks are managed in accordance with limits set out within the policy approved by Retail Credit Committee (and ratified by the Board). The policy sets out where specialist underwriting may be needed.

For residential mortgages, a combination of lending policy criteria, credit scoring (including behavioural scoring), policy rules and underwriting are used to make a decision on applications for credit. The primary factors considered are affordability, residential status, residential history, credit history, employment history, nature of income and loan-to-value (LTV). In addition, confirmation of borrower identity is obtained and an assessment of the value of the security being taken as collateral is carried out prior to granting a credit facility. When considering applications the primary focus is placed on the willingness and ability to repay.

Credit scoring is used to support the customer account management process in the following ways:

- To set customer maximum lending limits
- To pre-determine lending limits for selected further advances
- To determine account specific recommended limits and product types
- To set shadow limits to manage unauthorised borrowing
- To prioritise collections activity

The maximum mortgage loan is calculated and expressed as a percentage of the vacant possession price or open market value, whichever is the lower; for re-mortgages the LTV is determined by the open market

value. A range of LTV limits apply with the maximum limit currently being 95% and limits are set for concentrations of LTV bands.

No lending is undertaken based solely upon security provided by the value of the underlying assets, and the decision to lend rests with the Retail Credit Risk function in Risk Management Division. 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.

For unsecured products, similar lending policy criteria are used. Each of the unsecured portfolios has its own credit scoring models (including behavioural scoring), policy and underwriting rules to make decisions on applications for credit and to manage accounts. The factors used are attuned to the portfolio in question although affordability and credit history are considered in all areas. Accounts are subject to behavioural re-scoring every month.

Ongoing monitoring of all retail credit portfolios is undertaken by the Retail Credit Risk function in Risk Management Division. Reports are sent to the Retail Credit Committee and Group Risk Committee on a monthly basis. In the event that particular exposures show adverse features such as arrears, specialist lending teams will work with borrowers to resolve the situation.

5.3 Commercial Credit Risk

Nationwide's commercial lending activity is split between lending to private sector landlords and property investors, registered (and unregistered) social landlords, and funding projects originated under Private Finance Initiatives and Public Private Partnerships.

The following table provides an analysis of commercial lending exposure by industry sector at 4 April 2008:

	£m
Registered Social Landlords	7,434
Private Finance Initiative (PFI)	1,172
Private Sector Landlords & Property Investors:	
• Residential investments	1,979
• Retail outlets	3,829
• Offices and industrial	5,338
• Leisure	1,190
• Other	1,260
	22,202

Commercial credit risks are managed in accordance with limits and asset quality measures which are set out in the policy approved by the Commercial & Treasury Credit Committee (and ratified by the Board). The policy places limits on business volumes as well as the sector, geography, size and seniority of exposures. Reports are sent to the Commercial & Treasury Credit Committee and the Group Risk Committee on a monthly basis.

Lending decisions are based upon independent credit risk analysis supplemented by the use of expert judgement models which assess the obligor's likelihood of default. The output of these models is a borrower grade which maps to a long-run average, one-year probability of default. Borrower grades are reviewed at least annually, allowing identification of adverse individual and sector trends.

The Commercial & Treasury Credit Risk function in Risk Management Division has a level of delegated sanctioning authority and underwrites certain credit risks based upon an evaluation of both the 'objective' model outputs and a detailed 'subjective' assessment of the borrower's experience, track record, financial strength, ability to repay, transaction structure and security characteristics. Large or high risk exposures are subject to further approval by the Commercial & Treasury Credit Committee and/or the Group Risk Committee.

Consideration is also given to risk mitigation measures which will provide the Group with protection, such as third-party guarantees, supporting collateral and security, robust legal documentation, financial covenants and hedging.

To ensure that risks are appropriately priced, transactions are further assessed using an internal pricing model which takes into account capital utilisation and return on economic capital, as measured against a series of limits/targets disseminated from the Capital Plan.

Commercial portfolio asset quality monitoring is based upon a number of measures, including, economic capital, financial covenant monitoring, pricing movements and external input from rating agencies and other organisations. In the event that particular exposures begin to show adverse features such as payment arrears, covenant breaches or business trading losses, a full risk reappraisal is undertaken.

Where appropriate, a specialist recovery team will work with the borrower to resolve the situation. If this proves unsuccessful, the case will be subject to intensive monitoring and management procedures designed to maximise debt recovery.

5.4 Treasury Credit Risk

Treasury credit risks are managed in accordance with limits, asset quality measures and criteria set out within the policy approved by the Commercial & Treasury Credit Committee (and ratified by the Board). 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.

Lending and investment decisions are made by applying a qualitative overlay adjustment to the outputs of a quantitative financial strength rating model, in order to reflect material changes in internal and external operating conditions that may not yet be reflected in the financials. The output from this process provides Nationwide with a long-term unsecured debt rating, comparable to Moody's. Once on book, all individual exposures are reviewed at least annually.

Treasury uses a number of risk mitigation techniques including netting and collateralisation agreements. Other methods (such as margining, credit breaks, compounding, termination and credit derivatives) are used periodically to mitigate the credit risk associated with particular transactions or group of transactions.

Ongoing asset quality monitoring is undertaken by Treasury and the Commercial & Treasury Credit Risk function in Risk Management Division. Reports are sent to the Commercial & Treasury Credit Committee and the Group Risk Committee on a monthly basis. Where necessary, exception reporting also takes place against a range of asset quality triggers including economic capital analysis.

For its exposure to treasury credit risk, Nationwide uses Standard and Poor's (S&P), and Moody's as External Credit Assessment Institutions (ECAIs). S&P is used for Sovereign, Financial Institutions, Asset-backed Securities, Covered Bonds and Corporates. Moody's is used for Sovereign, Financial Institutions, Covered Bonds and Asset-backed Securities.

With regard to Financial Institutions and Corporates the Group's preference for a long-term rating is the senior unsecured rating. However, it will use counterparty ratings and deposit ratings if these are unavailable, recording the short-term rating or the commercial paper rating. For Asset-backed Securities the issue rating is used.

The issuer and issue credit assessments provided by ECAIs are one of a number of considerations that form part of the credit assessment process. This process is documented within policy and is supported by comprehensive Treasury Credit procedures.

The following tables show the exposure values associated with each credit quality step for treasury exposures under the standardised approach (asset-backed securities can be found in section 5.9):

Central Banks and Sovereigns

Credit Quality Step	Risk weight	S & P ratings	Moody's ratings	Exposure Values £m	Exposure Values after mitigation £m
1	0%	AAA to AA-	Aaa to Aa3	4,837	4,837
2	20%	A+ to A-	A1 to A3	55	55
				4,892	4,892

Corporates

Credit Quality Step	Risk weight	S & P ratings	Moody's ratings	Exposure Values £m	Exposure Values after mitigation £m
1	20%	AAA to AA-	Aaa to Aa3	31	31
2	50%	A+ to A-	A1 to A3	34	34
3	100%	BBB+ to BBB-	Baa1 to Baa3	63	63
4	100%	BB+ to BB-	Ba1 to Ba3	56	56
5	150%	B+ to B-	B1 to B3	15	15
				199	199

Financial Institutions

Credit Quality Step	Risk weight	S & P ratings	Moody's ratings	Exposure Values £m	Exposure Values after mitigation* £m
1	20%	AAA to AA-	Aaa to Aa3	14,887	13,801
2	50%	A+ to A-	A1 to A3	6,542	6,517
3	50%	BBB+ to BBB-	Baa1 to Baa3	148	148
				21,577	20,466

* Mitigation includes the benefit of netting and collateral held against derivatives – see section 5.7 Credit Risk Mitigation: Treasury

Covered Bonds

Credit Quality Step	Risk weight	S & P ratings	Moody's ratings	Exposure Values £m	Exposure Values after mitigation £m
1	20%	AAA to AA-	Aaa to Aa3	883	883
				883	883

5.5 Impairment Provisions

Assets held at amortised cost

The Group assesses at each balance sheet date whether, as a result of one or more events that occurred after initial recognition, there is objective evidence that a financial asset or group of financial assets are impaired. Evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficulty, default or delinquency in interest or principal payments or the debt being restructured to reduce the burden on the borrower.

The Group first assesses whether objective evidence of impairment exists either individually for assets that are separately significant or individually or collectively for assets that are not separately significant. If there is no objective evidence of impairment for an individually assessed asset it is included in a group of assets with similar credit risk characteristics and collectively assessed for impairment.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the carrying amount of the asset and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The resultant provisions have been deducted from the appropriate asset values in the balance sheets.

The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised the provision is adjusted and the amount of the reversal is recognised in the income statement.

Where a loan is not recoverable, it is written off against the related provision for loan impairment once all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement.

Loans subject to collective impairment assessment and whose terms have been renegotiated are no longer considered to be past due or impaired but are treated as new loans after the minimum required number of payments under the new arrangements have been received. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

The following table shows the past due loans and provisions for impaired exposures (equivalent to value adjustments) and charges to the income statement for the year-ended 4 April 2008:

	Residential £m	Unsecured £m	Commercial £m	Total £m
Neither past due nor impaired	118,518	2,204	21,918	142,640
Past due:				
Up to 3 months	2,133	63	246	2,442
3 to 6 months	297	61	20	378
6 to 12 months	111	71	9	191
Over 12 months	42	30	9	81
Possessions	27	-	-	27
	2,610	225	284	3,119
Total Exposures	121,128	2,429	22,202	145,759
Provisions	38	144	30	212
Charge/(credit) for the year	(12)	122	(4)	106

For the purposes of this table, past due is defined as one day or over. The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due.

Past due loans, impaired loans and provisions are all UK-based.

The following table summarises the movement during the year in impairment provisions. Further information on the charge to the income statement for provisions and more detailed analysis is included in note 13 in the Annual Report and Accounts:

	Individual Provisions £m	Collective Provisions £m	Total £m
Balance at 5 April 2007	10	194	204
Transfer from Portman Building Society	-	22	22
Charge for the year	1	105	106
Write-offs	(4)	(129)	(133)
Recoveries	5	14	19
Unwind of discount	-	(6)	(6)
Balance at 4 April 2008	12	200	212

Available for sale assets

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets are impaired. If any such evidence exists for available for sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that asset previously recognised – is recognised in the income statement.

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

As at 4 April 2008, 99.9% (2007: 100.0%) of the treasury portfolio exposure was neither past due nor impaired. There are no assets that would otherwise be past due or impaired whose terms have been renegotiated. In assessing impairment, the Group evaluates among other factors, the normal volatility in valuation, evidence of deterioration in the financial health of the investee, industry and sector performance and operational and financing cash flows.

During the year, the Group incurred an impairment charge of £102.2 million on treasury investments relating to Structured Investment Vehicles (SIVs). The net fair value of the remaining SIV capital notes, excluding restructured notes of £11.2 million, totalled £1.7 million at 4 April 2008. Further details are given in page 16 of the Group's Annual Report and Accounts.

5.6 Credit Risk Concentrations

For residential mortgages, LTV concentration limits are set within policy. Geographic concentration of risk is also monitored, but no specific parameters are deemed necessary for domestic lending. The Group operates across the whole of the UK with a bias towards the South-East of England reflecting a concentration of branches in that region and historically higher asset value growth trends. As at 4 April 2008 approximately 36% of residential exposures by account and 45% by value was concentrated in the South-East of England.

By their nature, our residential mortgages and unsecured lending comprise a large number of intrinsically highly diversified small loans and have a low volatility of credit risk outcomes.

For commercial lending, exposure to each of the principal lending categories is monitored and total portfolio exposure constrained via a self-imposed cap set at 20% of Nationwide's total business assets. Limits are also set restricting the size of aggregate exposure to any single counterparty or group of closely connected counterparties. Concentration of risk within the portfolio is monitored using indicators such as maturity, industry sector and geography, though specific limits are not normally imposed for UK-domiciled lending.

In terms of counterparty concentration, the largest single commercial customer including undrawn commitments represents only 2% of the commercial book.

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

5.7 Credit Risk Mitigation

The Group uses a wide range of techniques to reduce credit risk of its 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.

Residential mortgages

Residential property is the Group's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolios. All 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), indexed valuation (further advances) or Automatic Valuation Model subject to business rules and confidence levels.

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.

Commercial

Commercial property is the Group's main source of collateral and means of mitigating credit risk inherent in its commercial portfolios. Collateral for the majority of commercial loans comprises first legal charges over freehold or long leasehold property (including Companies House registration where appropriate) but the following may also be taken as security:

- Life policies
- Shares
- Debentures
- Credit balances
- Guarantees
- Chattel mortgages
- Assignments
- Equitable charges
- Solicitor undertakings

For property-based lending, supporting information such as professional valuations are an important tool to help determine the suitability of the property offered as security and, in the case of investment lending, generating the cash to cover interest and repay the advance. All valuations are undertaken by members of an internally approved panel of valuers that is controlled by a dedicated team within Commercial Division.

Nationwide's standard documentation states that it has the power to have the security re-valued at the customer's expense every two years (or upon an act of default) and while a revaluation is not automatically obtained, the merits of obtaining a revaluation are considered at each facility review.

All standard documentation is subject to independent legal review and sign off in order to ensure that Nationwide's legal documentation is robust and enforceable. Documentation for large advances is tailor-made, specifically prepared by independent solicitors, and is co-ordinated by a specialised loans documentation team to oversee all documentation issues.

A syndication strategy may be adopted to avoid large concentrations of risk and hedging strategies are considered as part of the appraisal process where borrowers have chosen fixed rates.

Insurance requirements are always fully considered as part of the application process and Nationwide ensures that appropriate insurance is taken out to protect the property e.g. building or terrorism cover, and to cover an important party or to protect against an insurable event.

Treasury

Collateral held as security for treasury 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.

The International Swaps and Derivatives Association (ISDA) Master Agreement is the Group's preferred method of documenting derivative activity. It is common in such cases for a Credit Support Annex to be executed in conjunction with the ISDA Master Agreement in order to mitigate credit risk on the derivatives portfolio. Under these agreements the Group values its portfolio in-house using discounted cashflow and options pricing models as appropriate. Any such valuations are agreed with the relevant counterparties, and collateral is then exchanged in order to bring the credit exposure within agreed tolerances. At 4 April 2008, £320m was held as collateral against derivative exposures.

The Group's legal documentation with its counterparties for derivative transactions grants legal rights of set-off 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.

Guarantees, from connected legal entities or Monoline insurers, 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. Any concentration of exposures in this respect is actively monitored. As at 4 April 2008, £123m of Treasury exposures were covered by AAA rated Monoline insurers.

5.8 Credit Derivatives

The purchase of a credit derivative (credit default swap) is treated as credit substitution and enables the credit exposure to be transferred to the credit protection seller (for the future performance of contractual commitments) from the reference asset (to which exposure only arises in the joint event that the asset and the credit protection seller both default).

Currently, exposure is recorded against both the credit protection seller and the reference asset according to their relative rating. A reduction in credit exposure is recorded against the issuing counterparty. However, the total exposure remains unchanged, as part of the exposure is transferred to the credit protection seller.

The Group has credit derivatives in place to cover the credit risk of £183m of assets within the treasury corporate portfolio. The credit derivatives are with an AA rated European financial institution.

5.9 Securitisation

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

The Group's main exposure to purchased securitisation positions relates to mortgage-backed securities, accounting for £5,053m of a total exposure of £7,063m.

The following tables show the Group's aggregate exposure to purchased securitisations, split by their associated credit quality steps:

Credit Quality Step	Risk weight	S & P ratings	Moody's ratings	Exposure Values £m	Exposure Values after mitigation £m
1	20%	AAA to AA-	Aaa to Aa3	6,885	6,885
2	50%	A+ to A-	A1 to A3	137	137
3	100%	BBB+ to BBB-	Baa1 to Baa3	41	41
				7,063	7,063

5.10 Counterparty Credit Risk

The Group uses derivative instruments to hedge its exposure to market risk, for example, interest rate and foreign exchange risk. Counterparty credit risk is the risk that a counterparty to a derivative instrument we hold could default. The 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').

The following table shows the exposures to counterparty credit risk for derivative contracts at 4 April 2008:

	Total £m
Interest rate contracts	1,038
Foreign exchange contracts	1,366
Other contracts	3
Gross positive fair value of contracts	2,407
Netting benefits	(948)
Netted current credit exposure	1,459
Collateral held	(320)
Net derivatives credit exposure	1,139

The net derivatives credit exposure represents the credit exposure to derivative transactions after taking account of legally enforceable netting agreements and collateral arrangements.

The net exposure value of derivatives at 4 April 2008 was £2,110m which includes future credit exposure.

The Group has credit derivatives in place with a notional value of £206m. This covers the credit risk on £183m of assets within the treasury corporate portfolio. All of the Group's credit derivatives are credit default swaps. All credit derivatives are purchased. The Group does not sell credit derivatives.

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.

Collateralisation of derivatives introduces two substantive changes in the incidence of credit exposure:

- 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.
- The commitment to post collateral also shortens the timescale within which future changes in interest rates and foreign exchange rates may occur. If the counterparty fails to post additional collateral required, a default can be enforced within a very short timetable. On the assumption that operational procedures are followed, a substantial reduction in the calculation of future increases in credit exposure is permitted.

6 Market Risks

6.1 Market Risk Overview

Market risk is defined as the potential reduction in net income, or decrease in value of the Group balance sheet, arising from adverse market movements. Specific types of market risk are listed below:

- Interest rate risk
- Foreign exchange risk
- Basis risk
- Attrition risk
- Prepayment risk
- Access risk

Interest rate risk arises from mortgages, savings and other financial services products offered by the Group where net interest income and market value of the Group's assets is exposed to movements in interest rates. This risk only arises in the banking book as the Group does not run a trading book, and therefore does not have the type of higher risk exposure run by many banking institutions.

Foreign exchange risk arises from assets and liabilities that are denominated in a foreign currency where the Sterling value or net income changes as a consequence of variations in foreign exchange rates. Basis risk arises from changes in the relationship between interest indices, such as base rate and LIBOR. Attrition risk arises from customer take-up of fixed-rate mortgages which is different from that anticipated. Prepayment risk arises from customer repayment of fixed-rate mortgages which is different from that anticipated. Access risk arises from customer withdrawal of fixed-rate savings which is different from that anticipated.

Market risk exposures are generally calculated and monitored independently of each other. All market risks are monitored closely and regularly reported to the Assets and Liabilities Committee (ALCO).

6.2 Interest Rate Risk

The primary market risk faced by the Group is interest rate risk. The varying interest rate features and maturities on products, together with the use of retail and wholesale funds to support these products, create interest rate risk exposures due to the imperfect matching of interest rates between different financial instruments and the timing differences on the re-pricing of assets and liabilities. Given our policy of hedging fixed-rate assets and liabilities back to floating rate, this risk arises mainly from the Board's decision to invest the Group's reserves according to a specified fixed-rate maturity profile. The level of risk can deviate from this (subject to limits) in particular as a result of decisions made by the Group's Treasury department to temporarily deviate from the specified fixed-rate maturity profile in the light of market conditions.

The Group manages this risk through the use of appropriate financial instruments, including derivative instruments and cash instruments such as loans, deposits and bonds, and through consideration of product features. The Group uses three metrics to monitor interest rate risk and details of these are set out below. The limits around these three metrics have been set to reflect the Group's low risk appetite.

Value at Risk (VaR)

This technique estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence based on historic experience. In its day-to-day monitoring Nationwide uses a 10-day horizon and a 99% confidence level.

The VaR model used by Nationwide incorporates underlying risk factors based on interest rate volatilities and correlations. Potential movements in market prices are calculated by reference to daily market data from the last two years equally weighted. Exposures against limits are reviewed daily by management. Actual outcomes are monitored periodically to test the validity of the assumptions and parameters/factors used in the VaR calculation.

Although a valuable guide to risk, VaR needs to be viewed in the context of the following limitations:

- Historic data is not necessarily a reliable guide to future events.
- The use of a 99% confidence level, by definition, does not take account of changes in value that might occur beyond this level of confidence. The VaR numbers may not therefore encompass all potential events, particularly those that are extreme in nature.
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

Sensitivity analysis (PV01)

This is used to assess the change in value of the Group's current net worth against a one basis point (0.01%) parallel rise in interest rates. As is the case with VaR, this analysis is done on a daily basis separately for each currency (but with the main risk arising from Sterling exposures) and in aggregate.

Stress testing (PV200)

This is calculated in a similar manner to PV01 but against a much more severe 200 basis point (2.0%) parallel rise in interest rates. Both PV01 and PV200 numbers are generated and monitored daily.

Interest rate risk summary

The average gross Sterling exposures (before deduction of the above mentioned benchmark profile) through 2007/08 were as follows:

	Average 2007/08 £m	High 2007/08 £m	Low 2007/08 £m
VaR	37.3	47.9	31.7
Sensitivity analysis (PV01)	1.6	1.9	1.4
Stress testing (PV200: all currencies)	316.5	374.5	272.8

All exposures include investment of the Group's reserves.

6.3 Foreign Exchange Risk

A proportion of treasury funding and investment activity is undertaken in foreign currencies and some commercial loans are denominated in Euros. Foreign currency exposure is hedged on the balance sheet or by using derivatives to reduce currency exposures to acceptable levels. In line with the prudential guidance applying to all building societies, and after taking account of foreign currency derivatives, the Group has no substantial net exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates. ALCO sets limits on the level of exposure by currency which are monitored daily.

VaR is used to monitor the risk arising from open foreign currency positions. Open currency positions represent the net value of assets, liabilities and derivatives in foreign currency. The parameters of the VaR methodology and frequency of reporting are exactly as described above in Interest Rate Risk (section 6.2).

The Group's Pillar 1 minimum capital requirement allows for Foreign Exchange risk through the foreign exchange risk requirement PRR (see section 4.4).

Foreign exchange risk summary

The average gross Sterling equivalent exposures through 2007/08 were as follows:

	Average 2007/08 £m	High 2007/08 £m	Low 2007/08 £m
VaR	0.2	0.4	0.0

7 Operational Risk

Nationwide has adopted the standardised approach to operational risk and has applied the industry standard definition, namely: “the risk of loss arising from inadequate or failed internal processes, people and systems or from external events”. This has been aligned to the Group’s integrated corporate risk map and ensures that there is oversight of the key risk exposures facing Nationwide in the following risk categories:

- Financial management & control
- Third party
- Fraud
- Business continuity
- Information security
- Change
- Information technology
- Premises & physical assets
- People
- Customer experience
- Legal & regulatory

Responsibility for each of these risk categories is allocated to a risk owner, all of whom are Directors or Senior Managers reporting to an Executive Director. As described previously, Nationwide operates within a three lines of defence model. Each division has a dedicated Operational Risk Officer as the first line of defence. The Group-wide network of Operational Risk Officers is supported by a hub and spoke approach with a centralised Operational Risk Unit providing the second line of defence to ensure consistency across the Group.

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

In order to manage the Group’s key operational risks, data is captured at a divisional and risk oversight level from a variety of sources. These include regular control risk self-assessments, internal and external incident analysis, material losses and control failures. The information is analysed and monitored against defined risk appetite tolerances using a central operational risk management database, and is reported to the relevant committees by way of an Operational Risk Information Pack.

Under the Basel Capital Accord, for the standardised approach to operational risk, gross income is regarded as a proxy for the operational risk exposure within each business line. The capital charge for operational risk is calculated separately, based upon gross income over the preceding three years.

