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# Pillar 3

## Risk Disclosures 2011

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Certain statements in this Pillar 3 Disclosure document are forward looking. Although Nationwide believes that the expectations reflected in these forward-looking statements are reasonable, Nationwide can give no assurance that these expectations will prove to be an accurate reflection of actual results. Because these statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by these forward-looking statements.

Nationwide undertakes no obligation to update any forward-looking statements whether as a result of new information, future events or otherwise.

# 1 Overview

## 1.1 Background

The European Union Capital Requirements Directive came into effect on 1 January 2007. This introduced consistent capital adequacy standards and an associated supervisory framework in the EU based on the Basel II Accord. The Directive is enforced in the UK as rules and guidance by the Financial Services Authority (“the FSA”) in the Handbook. The rules include disclosure requirements known as “Pillar 3” which apply to banks and building societies. These are designed to promote market discipline through the disclosure of key information about risk exposures and risk management processes.

In May 2008, the FSA granted Nationwide permission to use Internal Ratings Based (IRB) approaches for credit risk and capital management. The disclosures in this document are based on IRB approaches for certain portfolios and Standardised for the remainder of credit risks and operational risk, as detailed in the capital management section (4.1).

## 1.2 Basis and Frequency of Disclosures

This document sets out the 2011 Pillar 3 Disclosures for Nationwide. The sole purpose of these disclosures is to give information on the basis of calculating Basel II capital requirements and on the management of risks faced by the Group. This is in accordance with the rules laid out in the FSA Handbook (BIPRU Chapter 11). The disclosures may differ from similar information in the Annual Report and Accounts 2011 prepared in accordance with International Financial Reporting Standards (‘IFRS’); therefore, the information in these disclosures may not be directly comparable with that information.

Unless otherwise stated, all figures are as at 4 April 2011, Nationwide’s financial year-end, with comparative figures for 4 April 2010 where relevant. Pillar 3 Disclosures are published annually and as soon as is practicable after the publication of the Annual Report and Accounts.

## 1.3 Location and Verification

These disclosures have been reviewed by the Executive Risk Committee and the Group’s Audit Committee, and are published on the Group’s corporate website ([nationwide.co.uk/investorrelations](http://nationwide.co.uk/investorrelations)).

All figures disclosed within this document have been subject to internal verification. These disclosures have not been externally audited and do not constitute any part of the Group’s financial statements.

## 1.4 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”). The Group also includes the business combinations that occurred in the financial year 2008/09 from the mergers with Derbyshire and Cheshire building societies, and assets and liabilities acquired from the Dunfermline Building Society (together, the “regional brands”).

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:

- The Mortgage Works (UK) plc
- UCB Home Loans Corporation Limited
- Derbyshire Home Loans Limited
- E-Mex Home Funding Limited
- Nationwide Syndications Limited

All of the Group’s subsidiaries are included in the Pillar 3 disclosures. Full details of the principal subsidiary undertakings are included in Note 20 to the Annual Report and Accounts.

Nationwide International Limited is regulated by the Isle of Man Financial Supervision Commission and has its own regulatory capital requirement. In addition, Nationwide has a branch in Republic of Ireland (Nationwide UK Ireland) which is a retail deposit taker and is regulated by the Central Bank and Financial Services Authority of Ireland. 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.

## 1.5 Remuneration

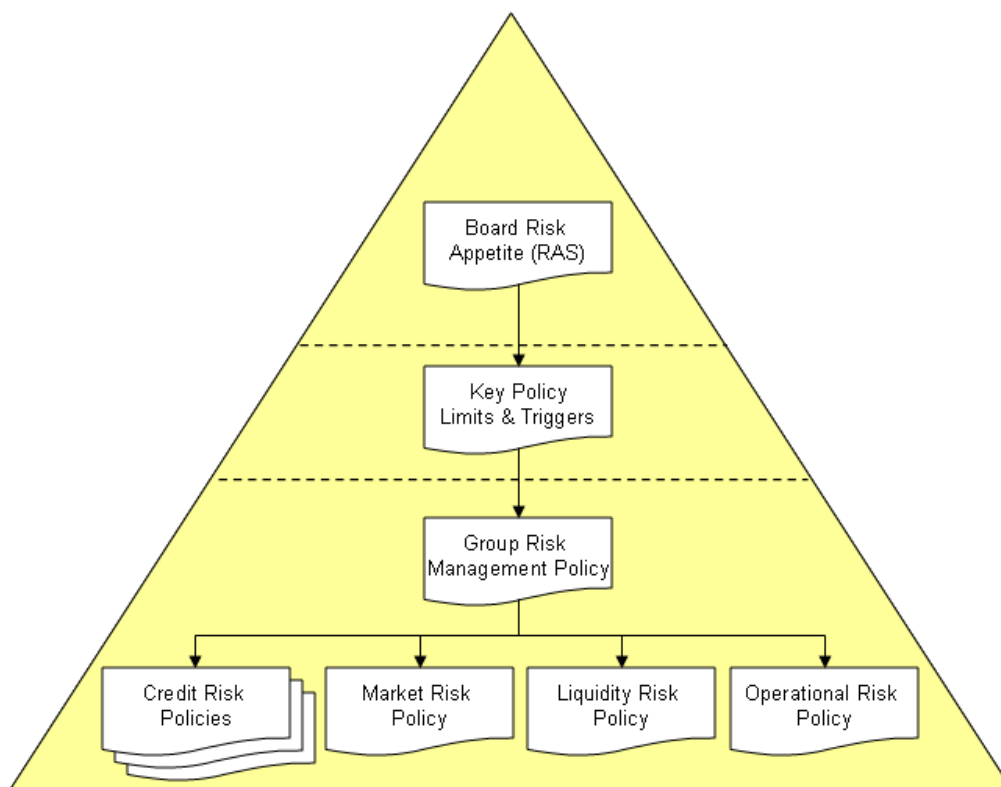
Following new regulation, Nationwide has included a section on remuneration as section 9. This outlines the responsibilities and decision-making process for determining remuneration policy, the link between pay and performance and the design and structure of remuneration, including the performance pay plans.

## 2 Risk Management

### 2.1 Group Risk Management Framework

Nationwide operates within a comprehensive Group Risk Management Framework (GRMF) which comprises the following:

1. The Board Risk Appetite Statement (RAS);
2. Key policy limits, triggers and mandates owned by the Board;
3. An overarching Group Risk Management Policy approved by the Board;
4. Detailed Risk Management Policies for specific risks approved by risk committees with delegated powers;
5. The adoption of the “Three Lines of Defence” approach to managing the risks.



The framework interacts with key processes of corporate management, which the Board also oversees:

- Corporate planning, strategy and performance review;
- Internal Capital Adequacy Assessment Process (ICAAP);
- Internal Liquidity Adequacy Assessment (ILAA);
- Stress testing of capital and liquidity; and
- Risk management for the Group.

### 2.2 Board 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 Risk Committee, on behalf of the Board, has agreed to adopt an overall low Risk Appetite, expressed in terms of the following six categories:

- |             |                       |
|-------------|-----------------------|
| • Solvency  | • Asset Quality       |
| • Liquidity | • Quality of Earnings |
| • Funding   | • Operational Risk    |

The Board owns, sets and monitors key policy limits and triggers for the first five categories that provide the context for the detailed risk management policies, limits and triggers. In addition, separate Key Risk Indicators are set and monitored for operational risk appetite in respect of the key operational risk categories outlined in Section 8.

### 2.3 Risk Management Policies

The principal risks to which the Group is exposed are credit risks, market risks, liquidity and funding risks, and operational risks. The Board Risk Appetite sets the context for each of these with detailed risk management policies including specific limits and triggers, documented as follows:

#### 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. These are owned and approved by the relevant mandated risk committee and the Board, 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 most significant credit risk exposures. The systems and models 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. These are embedded within risk policies 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; 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 borrowers remains acceptable.

Business streams are responsible for all of the material risks within Nationwide's Risk Profile to ensure that appropriate mitigation techniques are undertaken which 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 Risk Management Policies. Management information is provided to the risk committees and to the Executive Risk Committee every month. Risk Appetite is also monitored by the Board Risk Committee and 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.

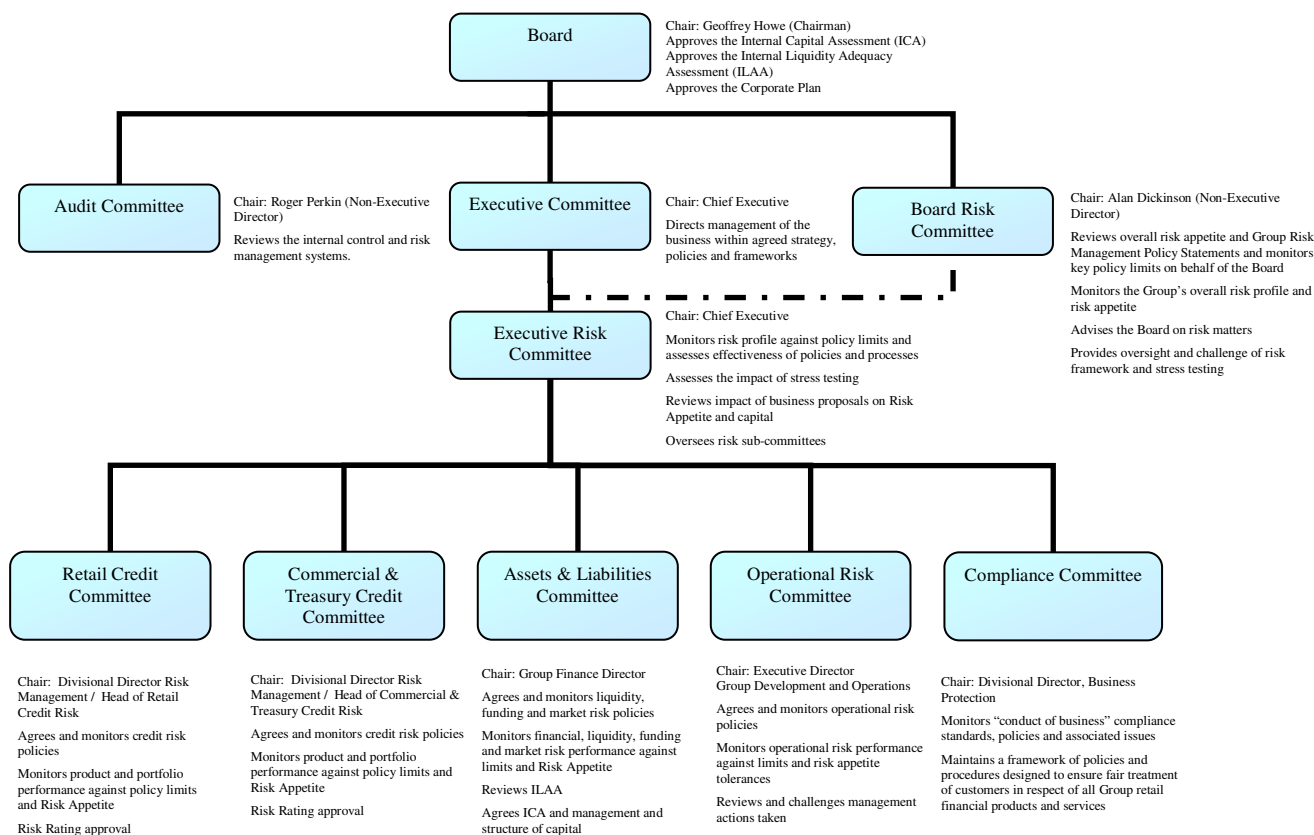
#### Risk governance & responsibilities

Governance and responsibilities for risk management is aligned to the Three Lines of Defence. Detailed responsibilities for risk committees and individuals in both Business Streams and Risk Management Division are set out in risk policies and include mandates where appropriate.

Risk committees ensure that risk policies and their terms of reference are reviewed annually or more frequently as required.

## 2.4 Board and Risk Management Committee Structure

The framework is supported by a well-established risk committee structure, 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 Board 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. In addition, the Board Risk Committee in its oversight capacity reviews Risk Appetite and supporting policies and may request changes or additional measures.

The framework includes feedback mechanisms to ensure the continuing relevance and appropriateness of the governance, structure and risk monitoring metrics and escalation of issues.

## 2.5 Coverage of Risks

Pillar 3 disclosures in this document cover credit risks (section 5), market risks (section 6), liquidity and funding risks<sup>1</sup> (section 7) and operational risks (section 8). Additional information regarding risk can be found in the 2011 Annual Report and Accounts (pages 37-45).

## 2.6 Three Lines of Defence

Responsibility for risk management (first line of the "Three Lines of Defence" model) lies with operational areas. Responsibilities for risk oversight and governance (the second line) lie with the specialist risk support functions in Risk Management Division (RMD) and powers delegated through the Executive Risk Committee to specialist risk committees. The third line of defence is represented by the Group Internal Audit function.

<sup>1</sup> Included for completeness as liquidity and funding risk falls outside the disclosure requirements for Pillar 3.

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 <sup>1</sup>
<b>Credit Risk</b>			
• Retail credit risk	Retail Distribution channels	Retail Credit Risk	Retail Credit Committee
• Commercial credit risk	Commercial Division	Commercial & Treasury Credit Risk	Commercial & Treasury Credit Committee
• Treasury credit risk	Treasury Division	Commercial & Treasury Credit Risk	Commercial & Treasury Credit Committee
<b>Market Risk</b>	Treasury Division and Product Areas	Balance Sheet Management	Assets & Liabilities Committee
<b>Liquidity and Funding Risk</b>	Treasury Division and Product Areas	Balance Sheet Management	Assets & Liabilities Committee
<b>Operational Risk</b>	All business areas	Operational Risk Unit	Operational Risk Committee

<sup>1</sup> Oversight of all risk governance committees is provided by the Executive 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 in Section 2.1). This requires them to manage their areas in line with operational performance targets and objectives cascaded from the Group's Corporate Plan, capital limits set within its Capital Plan, and risk exposure limits set within Group Risk Management Policies.

#### Second line of defence: risk committees

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.

#### Second line of defence: specialist risk support functions

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 Risk Analysis & Capital Planning 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 Executive Risk Committee.

#### Third line of defence: Internal Audit

Group Internal Audit independently provides objective assurance as to the adequacy and effectiveness of internal controls across the business. A risk-based programme of work is undertaken which is designed to provide appropriate coverage of the key risks and processes. The Audit Committee approves the Annual Audit Plan and receives regular reports on the results of audit work.

### 3 Capital Resources

#### 3.1 Total Available Capital

At 4 April 2011 and throughout the financial year, the Group complied with the capital requirements that were in force as set out by the FSA. The Group's Internal Ratings Based (IRB) Waiver Application was approved by the FSA in May 2008 with subsequent confirmation from the FSA that Nationwide had met the conditions required to use its IRB models to calculate capital requirements.

The following table shows the composition of capital resources under Pillar 3 for the Nationwide Group as at 4 April 2011:

**Table 1: Capital composition**

	Group		Solo	
	2011	2010	2011	2010
	£m	£m	£m	£m
<b>Tier 1</b>				
General reserve	6,679	6,363	6,464	6,160
Permanent Interest Bearing Shares (PIBS) <sup>1</sup>	1,510	1,524	1,510	1,524
Pension fund deficit adjustment <sup>2</sup>	33	355	33	355
Intangible assets <sup>3</sup>	(529)	(353)	(529)	(353)
Deductions <sup>4</sup>	(256)	(232)	(256)	(232)
Material holdings in non-solo consolidated subsidiaries	-	-	(16)	(16)
	<b>7,437</b>	<b>7,657</b>	<b>7,206</b>	<b>7,438</b>
<b>Tier 2</b>				
Revaluation reserve	70	68	70	68
Subordinated debt <sup>1</sup>	1,884	2,132	1,884	2,132
Collective impairment allowance	118	97	118	97
Deductions <sup>4</sup>	(256)	(232)	(256)	(232)
Material holdings in non-solo consolidated subsidiaries	-	-	(16)	(16)
	<b>1,816</b>	<b>2,065</b>	<b>1,800</b>	<b>2,049</b>
Qualifying holdings in non-solo consolidated subsidiaries	-	-	(39)	(46)
<b>Total capital</b>	<b>9,253</b>	<b>9,722</b>	<b>8,967</b>	<b>9,441</b>
<b>Risk weighted assets - Pillar 1</b>				
Retail Mortgages	15,081	14,653	15,081	14,653
Commercial Loans	17,610	18,316	17,610	18,316
Treasury	4,088	8,351	4,142	8,414
Other	6,420	4,375	6,394	4,487
Operational Risk	4,137	4,328	4,137	4,328
Market Risk	72	50	72	50
<b>Total risk weighted assets</b>	<b>47,408</b>	<b>50,073</b>	<b>47,436</b>	<b>50,248</b>

<sup>1</sup> Permanent interest bearing shares and subordinated debt include fair value adjustments related to changes in market interest rates, adjustments for unamortised premiums and discounts that are included in the consolidated balance sheet, and any amortisation of the capital value of lower Tier 2 instruments required by regulatory rules for instruments with less than five years to maturity.

<sup>2</sup> The regulatory capital rules allow the pension fund deficit to be added back to regulatory capital and a deduction taken instead for an estimate of the additional contributions to be made in the next 5 years, less associated deferred tax.

<sup>3</sup> Intangible assets do not qualify as capital for regulatory purposes.

<sup>4</sup> Certain deductions from capital are required to be allocated 50% to Tier 1 and 50% to Tier 2 capital. Deductions are subject to different treatment under IRB in respect of net expected loss over accounting provisions and certain securitisation positions. These are calculated in accordance with FSA guidance.

Risk weighted assets were 5.3% lower than the previous year, at £47.4 billion (2010: £50.1 billion), driven by changes to the credit risk measurement methodology of exposures to central banks and governments (including multilateral development banks). These assets are held by the Group as part of a substantial liquidity portfolio. The capital requirements of these exposures are now calculated using the standardised approach resulting in a zero risk rating (previously Foundation IRB), in accordance with FSA guidance.

Total capital fell by 4.8% over the year to £9.3 billion (2010: £9.7 billion), following a commitment to make additional contributions to the Nationwide Pension Fund to remove the funding deficit (£99 million payment made in 2010/11, with a further contribution of £240 million to be paid in 2011/12) and a growth in intangible assets. The growth in intangible assets relates primarily to the Society's investment in a new systems platform to meet the future needs of the business.

The Group issued €750 million of lower Tier 2 subordinated debt in July 2010 to refinance subordinated debt called in 2010.

### 3.2 Tier 1 Capital

Tier 1 capital comprises:

- General reserve;
- Permanent Interest Bearing Shares (PIBS); and
- Adjustments as required by the rules governing capital resources.

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

PIBS are unsecured, deferred shares and rank behind the claims of all subordinated note-holders, depositors, creditors and investing members of Nationwide. Further details about PIBS are provided in Note 34 to the 2011 Annual Report and Accounts.

Adjustments are required by the rules governing capital resources:

- 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 deducted from the general reserve. For capital purposes this amount is added back to the Group's capital position; instead, a deduction is made for the additional funding that is expected to be paid to the Fund over the next five years. At 4 April 2011, £33 million had been added back to capital in this regard which represents the aggregate of this adjustment.
- An adjustment is also made in respect of intangible assets. For accounting purposes, items including computer software, other intangibles resulting from business combinations, and goodwill are capitalised as intangible fixed assets where they meet certain criteria. Intangibles are deducted from capital under the regulatory rules; at 4 April 2011 £529 million had been deducted from capital in respect of intangible assets.
- Deductions (£256 million) are also made under Basel II in respect of expected loss, where it exceeds accounting provisions for IRB portfolios, and securitisations held that have an external credit rating below BB-. These are split equally between Tier 1 and Tier 2.

### 3.3 Tier 2 Capital

Tier 2 capital comprises:

- The Group's property revaluation reserve;
- Qualifying subordinated notes;
- Collective impairment allowance (for exposures treated on the Standardised basis); and
- Adjustments as required by the rules governing capital resources.

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 33 to the 2011 Annual Report and Accounts.

Adjustments are required by the rules governing capital resources:

- Deductions (£256 million) are made under Basel II in respect of expected loss, where it exceeds accounting provisions for IRB exposures, and certain securitisations split equally between Tier 1 and Tier 2.

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.

### 3.4 Solo Consolidation

Under the solo consolidation basis, deductions are required in respect of material holdings in subsidiaries that are excluded from solo consolidation. Material holdings represent shares and any other interest in the capital of an individual credit institution or financial institution where they exceed 10% of the share capital of the issuer. A deduction of £32 million is made for material holdings allocated evenly between Tier 1 and Tier 2 capital.

In addition, qualifying holdings in subsidiaries are excluded from solo consolidation (£39 million); under the rules these are deducted before the total of Tier 1 and Tier 2 capital to give the final capital position for the Solo Group. A qualifying holding is a direct or indirect holding in a non-financial undertaking which represents 10% or more of the capital or of the voting rights which makes it possible to exercise a significant influence over the management of that undertaking.

### 3.5 Capital Impact of Basel III

The Basel Committee on Banking Supervision (BCBS) issued its revised Basel III text in December 2010. The objective of the reform package is to improve the banking sector's ability to absorb shocks arising from financial and / or economic stress, thus reducing the risk of 'spill-over' from the financial sector into the 'real economy'. The reforms raise both the quality and quantity of the regulatory capital base and enhance the risk coverage of the capital framework. This is supplemented by a leverage ratio that is intended to protect against model risk and measurement error. Basel III also introduces a number of macro-prudential elements into the capital framework to help contain systemic risks. The Basel III text has yet to be incorporated into the European and UK regulatory framework and therefore remains subject to change.

#### Impact of rules effective in full from 1 January 2013

An indicative impact assessment is contained below, providing an insight into the potential effect of the new rules on Nationwide's capital position:

- Securitisation exposures:
  - Securitisation positions that are currently deducted from capital will be risk-weighted at 1250%.
- Counterparty credit risk:
  - An additional capital charge for credit valuation adjustment risk is required. The majority of the charge is from the use of derivative instruments (with highly-rated counterparts) to manage interest rate and foreign exchange risk associated with covered bond issuances; and
  - An additional capital charge is required for all financial transactions with firms that have total assets greater than or equal to US\$100 billion.
- Unrealised gains:
  - The revaluation reserve, which is currently an addition to Tier 2 capital, will be included in Core Tier 1 capital.

Recognising that the revised capital framework is subject to change, the combined impact of the above four items is expected to reduce the Society's Core Tier 1 ratio by approximately 0.8% in 2013. Nationwide has a strong track record of robust capital ratios and is confident that it is well positioned to maintain its overall capital strength. Note, this impact assessment does not assume mitigating actions, but does allow for the amortisation/maturity of securitisation exposures.

#### Impact of other rules

In addition to the changes effective in full from 1 January 2013, the BCBS has proposed a number of other reforms:

- 31 December 2011: amended rules for market risk and re-securitisations are implemented, commonly referred to as Basel II.5. The impact to Nationwide's capital position is negligible;
- 1 January 2013: permanent interest bearing shares (PIBS) and subordinated debt will be phased out over ten years. The effect on the capital recognition of subordinated debt is minimal, with PIBS only materially impacted in the final years of the grandfathering period. Nationwide intends to maintain its strong core capital position, and expects an appropriate Core Tier 1 capital instrument for mutual organisations will be available, ensuring access to capital markets is maintained; and
- 1 January 2014-18: changes and additions to capital deductions will be phased in at 20% per annum. The impact of these is expected to be manageable, as most of the drivers (e.g. unrealised losses on Available For Sale (AFS) assets and deferred tax assets) are forecast to reduce by 2014. However, this assessment is subject to potential change as regulators start to focus on the practical application and interpretation of the reforms.

In addition to the strengthened capital standards, the Basel III text requires firms to calculate a non-risk-based leverage ratio. The BCBS is using the period to 2017 to test a minimum Tier 1 leverage ratio of 3%. Using the Basel III guidelines and the transitional arrangements outlined above, Nationwide's leverage ratio is comfortably in excess of the proposed 3% testing limit. The BCBS is considering implementing the ratio as a Pillar 1 measure by 2018.

## 4 Capital Adequacy

### 4.1 Capital Management

Nationwide manages its capital resources in excess of regulatory requirements. Capital is monitored on a monthly basis against the capital plan and supported by a range of limits and triggers that ensure that capital continues to be within the Board's Risk Appetite. In addition to calculating the minimum Capital Resource Requirement (CRR) as required under BIPRU rules, the Group uses an economic capital framework to support the management of its capital requirements. The CRR covers all Pillar 1 risks (credit risk, operational risk and market risk).

#### Credit risk

The Group has adopted Internal Ratings Based (IRB) approaches for certain credit risk portfolios following FSA approval in May 2008. The scope of Internal Ratings Based permission for the year ended 4 April 2011 is as follows:

<b>Retail IRB</b>	Society prime mortgages <sup>2</sup> , unsecured lending (personal loans), and qualifying revolving credit risks (FlexAccount and credit cards).
<b>Foundation IRB</b>	Treasury exposures (excluding corporates, central banks and governments, and certain multi-lateral development banks).

All other credit risks adopt the Standardised approach. The more significant credit risk portfolios currently using the Standardised approach (commercial lending, Private Finance Initiatives, specialist retail mortgage lending and prime retail mortgages from the regional brands) will migrate to IRB approaches under a rollout plan.

#### Market risk

Market risk for the Group arises from foreign exchange risk under Pillar 1 due to foreign currencies in the banking book. The Foreign Exchange Position Risk Requirement (FX PRR) charge is the amount of regulatory capital required to cover the risk of losses on open foreign currency positions due to movements in foreign exchange rates. This is calculated in accordance with the FSA Handbook. Other market risks are not included in regulatory capital under Pillar 1 as the Group does not have a trading book.

#### Operational risk

The Standardised Approach is adopted for operational risk.

#### Reporting

Capital is reported monthly in the Board Performance Pack. More detailed reports of capital and risk, including information by Business Stream, are considered monthly by the Executive Risk Committee and the Liquidity and Capital Management Committee (LCMC), a sub-committee of the Assets and Liabilities Committee (ALCo). Specific reports of capital by Business Stream are also included in the monthly packs of the risk committees as appropriate.

### 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 for Pillar 2 purposes. This internal assessment considers risks included in the Pillar 1 CRR as well as other risks not included in Pillar 1. 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 five-year horizon, and takes account of severe economic stresses to satisfy the regulatory requirements and the effects of these on capital.

The ICA is presented to LCMC, ALCo and Board Risk Committee, on behalf of the Board, for challenge and approval. The FSA assesses Nationwide's ICA and sets Individual Capital Guidance (ICG) for the Group on an IRB basis. The company retains capital in excess of the ICG at all times.

### 4.3 Minimum Capital Requirement: Pillar 1

Nationwide's overall minimum Capital Resource Requirement (CRR) under Pillar 1 is calculated by adding the credit risk charge (section 4.4) to that required for market risk and operational risk. The following table shows the Group's CRR and capital resources surplus under Pillar 1 at 4 April 2011:

<sup>2</sup> Prime mortgages originated by Nationwide and Portman only; prime mortgages from the regional brands are treated under the Standardised approach.

Table 2: Total minimum Pillar 1 capital requirement

	Group		Solo	
	2011	2010	2011	2010
	£m	£m	£m	£m
Credit Risk (IRB)	1,219	1,397	1,217	1,406
Credit Risk (Standardised)	2,237	2,259	2,241	2,264
Market Risk (FX PRR)	6	4	6	4
Operational Risk (Standardised)	331	346	331	346
<b>Capital Resources Requirement under Pillar 1</b>	<b>3,793</b>	<b>4,006</b>	<b>3,795</b>	<b>4,020</b>
Capital resources (per Table 1)	9,253	9,722	8,967	9,441
<b>Capital resources surplus over requirement</b>	<b>5,460</b>	<b>5,716</b>	<b>5,172</b>	<b>5,421</b>

#### 4.4 Minimum Capital Requirement: Credit Risk

The following table shows the composition of the minimum capital requirement for credit risk at 4 April 2011. The solo figures are slightly higher than the Group as a result of loans to non-solo consolidated subsidiaries.

Table 3: Minimum capital requirement for credit risks

	Group		Solo	
	2011	2010	2011	2010
	£m	£m	£m	£m
<b>Internal Ratings Based (IRB) exposure classes</b>				
Central governments & central banks	-	301	-	301
Institutions	131	169	131	169
Retail mortgages (prime secured against residential property)	428	432	428	432
Qualifying revolving retail	273	175	273	175
Other retail (unsecured loans)	149	71	149	71
Securitisation positions	86	84	86	84
Non-credit obligation assets (fixed assets and other)	92	93	90	102
Counterparty Credit Risk (Derivatives)	59	72	59	72
	<b>1,218</b>	<b>1,397</b>	<b>1,216</b>	<b>1,406</b>
<b>Standardised exposure classes</b>				
Central governments & central banks	-	-	-	-
Regional governments & local authorities	2	3	2	3
Multilateral Development Banks	-	-	-	-
Corporates (Non Commercial)	36	37	45	47
Retail mortgages (secured against residential property)	716	668	716	668
Other Retail	1	1	1	1
Commercial lending (secured against property)	1,132	1,207	1,132	1,207
Commercial lending (PFI & other commercial)	156	143	156	143
Past due	181	185	181	185
Other	14	15	8	10
	<b>2,238</b>	<b>2,259</b>	<b>2,241</b>	<b>2,264</b>
<b>Total</b>	<b>3,456</b>	<b>3,656</b>	<b>3,457</b>	<b>3,670</b>

The overall capital requirements in 2011 are lower compared to 2010. The most significant movement in capital requirements is a result of the FSA granting a permanent exemption in 2010/11 for Nationwide to calculate exposures to all central banks and governments, and certain multi-lateral development banks, on a standardised basis. As a result, all such exposures have been zero risk weighted. The capital requirements for qualifying retail exposures have also increased due to interim calculations whilst models are being re-developed. This is explained in section 5.2.

The total minimum capital requirements are not materially different on a Group or solo basis; the disclosures in the remainder of this document are therefore shown on a Group basis only.

## 5 Credit Risks

### 5.1 Credit Risk Overview

#### Introduction

Credit risk is defined as the risk of suffering financial loss should a borrower or counterparty default on their contractual obligations to the Group. Risks are inherent across most of the Group's activities and may arise from changes in credit quality, and the recoverability of loans and amounts due from counterparties. 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 the Group's overall governance framework to measure, mitigate and manage credit risk within the Group's Risk Appetite.

Exposure as shown in these credit risk disclosures is defined as Exposure Value under the regulatory definitions for capital purposes. Exposure Value (calculated as exposure at default (EAD) under IRB) is an estimate of the expected utilisation of a credit facility and will be equal to or greater than the drawn exposure excluding any credit risk mitigation.

#### Exposures

The credit risk exposures at 4 April 2011 and the averages for the year are summarised as follows:

**Table 4: Credit risk exposures**

	Average	Year End	Average	Year End
	2010/11	2011	2009/10	2010
	£m	£m	£m	£m
<b>Internal Ratings Based (IRB) exposure classes</b>				
Central governments & central banks	-	-	37,805	35,519
Institutions	10,319	9,131	17,511	14,581
Retail mortgages (prime secured against residential property)	108,612	107,156	112,280	110,848
Qualifying revolving retail	9,413	5,690	8,771	9,684
Other retail (unsecured loans)	1,186	1,252	1,198	1,165
Securitisation positions	6,143	5,887	6,778	6,601
Non-credit obligation assets (fixed assets and other)	1,129	1,152	1,374	1,159
Counterparty Credit Risk (Derivatives)	3,302	3,572	3,641	3,656
	<b>140,104</b>	<b>133,840</b>	<b>189,358</b>	<b>183,213</b>
<b>Standardised exposure classes</b>				
Central governments & central banks	28,221	23,299	-	-
Regional governments & local authorities	30	27	35	35
Institutions	-	-	38	-
Multilateral Development Banks	1,920	1,756	-	-
Corporates (Non Commercial)	443	440	475	458
Retail mortgages (secured against residential property)	23,338	24,189	22,603	22,613
Other Retail	12	11	18	14
Commercial lending (secured against property)	20,137	19,832	20,972	20,624
Commercial lending (PFI & other commercial)	1,926	1,946	1,592	1,792
Past due	1,874	1,890	1,776	1,934
Other	727	857	682	677
	<b>78,628</b>	<b>74,247</b>	<b>48,191</b>	<b>48,147</b>
<b>Total*</b>	<b>218,732</b>	<b>208,087</b>	<b>237,549</b>	<b>231,360</b>

\*Note that the total here differs from the total assets figure reported in the Annual report due to a different calculation to derive exposures for capital requirement purposes, including adjustments for derivatives.

The following tables show the geographical distribution; these are followed by the residual maturity of these exposures at 4 April 2011:

**Table 5: Geographical distribution of credit risk exposures (2011)**

	UK £m	Other European countries £m	North America £m	Rest of the World £m	Total £m
<b>IRB exposure classes</b>					
Institutions	2,283	4,037	2,166	645	9,131
Retail mortgages (prime secured against residential property)	107,156	-	-	-	107,156
Qualifying revolving retail	5,690	-	-	-	5,690
Other retail (unsecured loans)	1,252	-	-	-	1,252
Securitisation positions	2,254	1,721	1,788	124	5,887
Non-credit obligation assets (fixed assets and other)	1,152	-	-	-	1,152
Counterparty Credit Risk (Derivatives)	831	2,451	251	39	3,572
	<b>120,618</b>	<b>8,209</b>	<b>4,205</b>	<b>808</b>	<b>133,840</b>
<b>Standardised exposure classes</b>					
Central governments & central banks	21,011	1,415	873	-	23,299
Regional governments & local authorities	27	-	-	-	27
Multilateral Development Banks	-	1,686	-	70	1,756
Corporates (Non Commercial)	112	250	66	12	440
Retail mortgages (secured against residential property)	24,189	-	-	-	24,189
Other Retail	11	-	-	-	11
Commercial lending (secured against property)	18,957	875	-	-	19,832
Commercial lending (PFI & other commercial)	1,946	-	-	-	1,946
Past due	1,719	171	-	-	1,890
Other	789	25	43	-	857
	<b>68,761</b>	<b>4,422</b>	<b>982</b>	<b>82</b>	<b>74,247</b>
<b>Total</b>	<b>189,379</b>	<b>12,631</b>	<b>5,187</b>	<b>890</b>	<b>208,087</b>

**Table 6: Geographical distribution of credit risk exposures (2010)**

	UK £m	Other European countries £m	North America £m	Rest of the World £m	Total £m
<b>IRB exposure classes</b>					
Central governments & central banks	28,138	3,758	1,731	1,892	35,519
Institutions	4,380	6,057	2,564	1,580	14,581
Retail mortgages (prime secured against residential property)	110,848	-	-	-	110,848
Qualifying revolving retail	9,684	-	-	-	9,684
Other retail (unsecured loans)	1,165	-	-	-	1,165
Securitisation positions	2,412	1,935	2,097	157	6,601
Non-credit obligation assets (fixed assets and other)	1,158	-	-	-	1,159
Counterparty Credit Risk (Derivatives)	940	2,364	307	45	3,656
	<b>158,725</b>	<b>14,114</b>	<b>6,699</b>	<b>3,674</b>	<b>183,213</b>
<b>Standardised exposure classes</b>					
Regional governments & local authorities	35	-	-	-	35
Institutions	-	-	-	-	-
Corporates (Non Commercial)	89	285	71	13	458
Retail mortgages (secured against residential property)	22,613	-	-	-	22,613
Other Retail	14	-	-	-	14
Commercial lending (secured against property)	19,421	1,203	-	-	20,624
Commercial lending (PFI & other commercial)	1,792	-	-	-	1,792
Past due	1,916	18	-	-	1,934
Other	616	18	43	-	677
	<b>46,496</b>	<b>1,524</b>	<b>114</b>	<b>13</b>	<b>48,147</b>
<b>Total</b>	<b>205,221</b>	<b>15,638</b>	<b>6,813</b>	<b>3,687</b>	<b>231,360</b>

Table 7: Residual maturity of credit risk exposures (2011)

	On demand	Up to 12 months	1-5 years	5-10 years	More than 10 years	Total
	£m	£m	£m	£m	£m	£m
<b>IRB exposure classes</b>						
Institutions	-	6,793	1,490	807	41	9,131
Retail mortgages (prime secured against residential property)	-	1,409	3,512	9,740	92,495	107,156
Qualifying revolving retail	5,690	-	-	-	-	5,690
Other retail (unsecured loans)	-	55	1,037	160	-	1,252
Securitisation positions	-	-	312	1,089	4,486	5,887
Non-credit obligation assets (fixed assets and other)	84	-	790	269	9	1,152
Counterparty Credit Risk (Derivatives)	-	250	2,836	484	2	3,572
	5,774	8,507	9,977	12,549	97,033	133,840
<b>Standardised exposure classes</b>						
Central governments & central banks	-	12,685	3,959	4,578	2,077	23,299
Regional governments & local authorities	-	2	13	6	6	27
Multilateral Development Banks	-	100	1,219	370	67	1,756
Corporates (Non Commercial)	-	136	221	83	-	440
Retail mortgages (secured against residential property)	14	230	1,257	3,255	19,433	24,189
Other Retail	-	-	2	3	6	11
Commercial lending (secured against property)	-	1,647	6,010	2,021	10,154	19,832
Commercial lending (PFI & other commercial)	-	249	114	133	1,450	1,946
Past due	-	450	430	283	727	1,890
Other	786	-	19	52	-	857
	800	15,499	13,244	10,784	33,920	74,247
<b>Total</b>	<b>6,574</b>	<b>24,006</b>	<b>23,221</b>	<b>23,333</b>	<b>130,953</b>	<b>208,087</b>

Table 8: Residual maturity of credit risk exposures (2010)

	On demand	Up to 12 months	1-5 years	5-10 years	More than 10 years	Total
	£m	£m	£m	£m	£m	£m
<b>IRB exposure classes</b>						
Central governments & central banks	-	23,871	3,155	4,973	3,520	35,519
Institutions	-	10,562	2,842	1,115	62	14,581
Retail mortgages (prime secured against residential property)	-	1,047	3,675	10,193	95,933	110,848
Qualifying revolving retail	9,684	-	-	-	-	9,684
Other retail (unsecured loans)	-	156	856	153	-	1,165
Securitisation positions	-	2	358	1,038	5,203	6,601
Non-credit obligation assets (fixed assets and other)	210	8	5	366	569	1,159
Counterparty Credit Risk (Derivatives)	-	79	2,006	1,568	2	3,656
	9,894	35,725	12,897	19,406	105,289	183,213
<b>Standardised exposure classes</b>						
Regional governments & local authorities	-	1	19	8	7	35
Institutions	-	-	-	-	-	-
Corporates (Non Commercial)	-	90	285	83	-	458
Retail mortgages (secured against residential property)	8	138	1,054	2,794	18,619	22,613
Other Retail	-	-	5	6	3	14
Commercial lending (secured against property)	-	1,315	6,320	2,586	10,402	20,624
Commercial lending (PFI & other commercial)	-	17	443	49	1,284	1,792
Past due	-	275	429	344	885	1,934
Other	619	-	-	58	-	677
	627	1,836	8,555	5,928	31,200	48,147
<b>Total</b>	<b>10,521</b>	<b>37,561</b>	<b>21,452</b>	<b>25,334</b>	<b>136,489</b>	<b>231,360</b>

The maturity of exposures is shown on a contractual basis rather than the actual redemptions experienced by the Group, and does not take into account any instalments receivable over the life of the exposure. As a consequence, actual maturity is likely to be materially different.

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 Executive Risk Committee.

## 5.2 Retail Credit Risk

Prime mortgages<sup>3</sup>, revolving retail (Flex Account and credit card), and unsecured loans adopt the Retail IRB approach where Probability of Default (PD), Exposure Value and Loss Given Default (LGD) are calculated using internal rating systems. Other retail portfolios are calculated on the Standardised basis.

The following table shows the Group's exposure for prime Society mortgages under IRB at 4 April 2011:

**Table 9: Prime retail mortgage exposures under IRB**

PD band	Exposure Value		Exposure Weighted Average LGD		Exposure Weighted Average RW	
	2011	2010	2011	2010	2011	2010
	£m	£m	%	%	%	%
0.00 - 0.019	25,417	26,412	5.6	3.5	0.6	0.6
0.02 - 0.029	26,369	27,098	10.0	6.3	1.1	1.0
0.03 - 0.049	17,708	18,358	11.9	8.4	1.7	1.8
0.05 - 0.099	18,204	18,826	16.6	12.3	3.8	3.9
0.10 - 0.49	14,400	15,177	17.3	13.7	8.7	8.7
0.50 - 0.99	484	522	11.6	9.2	11.9	12.9
1.00 - 2.99	2,770	2,700	17.2	12.2	31.4	31.6
3.00 - 9.99	512	537	13.9	10.4	61.7	62.8
10.00 - 19.99	506	460	14.8	9.6	83.0	83.0
20.00 - 99.99	437	454	13.4	9.7	70.1	72.2
100.00 - (in default)	349	304	21.5	15.1	195.7	199.3
<b>Total</b>	<b>107,156</b>	<b>110,848</b>				

The PD model for prime mortgages uses a hybrid rating system that combines Point in Time (PiT) grade distributions with conservatively-adjusted probabilities of default. The PiT grade distributions are mapped from the application scores, behavioural scores and arrears status. Each grade is assigned a conservatively-adjusted or long run average PD that is used in the capital calculation. The model allows ratings migration to occur dependent on the economic cycle.

Both LGD and Exposure Value models calculate PiT and downturn estimates, the latter of which are fed into the capital calculation. LGD takes account of house price forecasts, collection costs, loan-to-value (LTV), external credit rating data and the likelihood of loss in the event of default to predict the loss on the property at the point of sale. The regulatory floor of 10% is applied when appropriate and any estimated recoveries after sale are not included. Exposure Value takes account of balances and an adjustment to include the potential for additional months' interest prior to default.

Internal data covering the period back to the early 1990s has been used in the development of both PD and LGD models. This has been supplemented with industry data where appropriate.

The following table shows the Group's exposure for qualifying revolving retail portfolios (FlexAccounts and credit cards) under Retail IRB at 4 April 2011:

**Table 10: Qualifying revolving retail exposures under IRB**

Exposure Weighted Average PD		Exposure Value		Exposure Weighted Average LGD		Exposure Weighted Average RW	
2011	2010	2011	2010	2011	2010	2011	2010
%	%	£m	£m	%	%	%	%
1.39%	1.87%	5,605	9,500	85.0	48.5	50.5	23.1
Default	Default	85	184	85.0	32.8	689.3	-
<b>Total</b>		<b>5,690</b>	<b>9,684</b>				

<sup>3</sup> Prime mortgages originated by Nationwide and Portman only; prime mortgages from the regional brands are treated as Standardised.

The following table shows the Group's exposure for other retail (unsecured lending) under IRB at 4 April 2011:

**Table 11: Other retail (unsecured lending) exposures under IRB**

Exposure Weighted Average PD		Exposure Value		Exposure Weighted Average LGD		Exposure Weighted Average RW	
2011	2010	2011	2010	2011	2010	2011	2010
%	%	£m	£m	%	%	%	%
5.30%	2.70%	1,189	1,099	85.0	62.1	133.7	81.0
Default	Default	63	67	85.0	62.0	425.9	-
<b>Total</b>		<b>1,252</b>	<b>1,165</b>				

Nationwide is in the process of updating its unsecured models. In the interim, Nationwide has calculated the RWAs for its exposures using a prudent, simplified approach. This applies a flat Probability of Default by product to non-defaulted accounts and a single Loss Given Default across portfolios, as outlined in the above table. The Exposure at Default calculations have also been simplified to add on a static amount to performing balances in Credit Cards and FlexAccounts.

### Management of retail credit risks

Retail credit risks are managed in accordance with limits set out within the Retail Credit Risk Management Policy. The policy sets out lending criteria and circumstances where specialist underwriting may be needed.

For residential mortgages, a combination of lending policy criteria, credit scoring, policy rules and underwriting are used to make a decision on applications for credit. The primary factors considered are affordability, residential status, buyer types, 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.

A range of LTV limits apply for new business across the mortgage portfolio as a whole and also at portfolio level (prime, specialist lending). Limits are also set for the concentrations of LTV bands.

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 scoring every month.

For unsecured portfolios, credit scoring is used to support the customer account management process in the following ways:

- To set customer maximum lending limits;
- To determine account specific recommended limits and product types;
- To set shadow limits to manage unauthorised borrowing; and
- To prioritise collections activity.

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, Executive Risk Committee and Board Risk Committee on a monthly basis.

Forbearance options are considered on a case-by-case basis and are in line with industry guidance and practice. These include capitalisation, interest only concession, payment holiday and term extension for secured products, and payment plans for credit cards. Across both the secured and unsecured portfolios, all account management / forbearance options are either low in materiality or fully recognised within provisioning. Further detail can be found in the Business Review.

### 5.3 Commercial Credit Risk

Nationwide's commercial lending activity relates to the provision of facilities to meet the funding requirements of property investors and private sector landlords, registered social landlords, and project finance initiatives.

The following table provides an analysis of commercial lending exposure by industry sector (including past due) at 4 April 2011:

**Table 12: Commercial lending by industry sector under the Standardised approach**

	2011	2010
	£m	£m
Registered Social Landlords	8,938	8,890
Project Finance Initiatives (PFI) <sup>1</sup>	1,707	1,507
Property Finance lending:		
• Retail	3,628	3,776
• Office	2,635	2,859
• Residential	2,112	2,309
• Industrial and warehouse	1,929	2,037
• Leisure and hotel	1,114	1,141
• Owner occupier	600	667
• Other	260	286
Regional governments and local authorities (lease receivables)	27	35
<b>Total</b>	<b>22,950</b>	<b>23,507</b>

<sup>1</sup> Project Finance treated as unrated corporates

Commercial credit risks are managed in accordance with limits and asset quality measures which are set out in the Commercial Credit Risk Management Policy. The policy places limits on business volumes as well as the sector, geography, size and seniority of exposures. Reports relating to the profile of the commercial lending portfolio are sent to the Commercial & Treasury Credit Committee and the Executive 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 (PD). 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 model outputs and a qualitative overlay based on expert judgement. Factors taken into consideration are:

- 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 Executive Risk Committee. Consideration is also given to risk mitigation measures which will provide the Group with protection; examples are 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 regulatory and economic capital as measured against a series of limits / targets disseminated from the Corporate Plan.

Monitoring of asset quality in the commercial portfolio is based upon a number of measures including, regulatory / economic capital, financial covenant monitoring and external input from rating agencies and other organisations where appropriate. All commercial lending relationships are subjected to regular reviews, at least once a year, to ensure that facilities are fully performing in accordance with the terms of original sanction and provide an opportunity to review exposure to each counterparty in the light of the most recently available financial and non-financial information and to refresh risk grading data.

Watchlist procedures have been established that are designed to identify cases of potential cause for concern, before arrears arise, in order that risk mitigating action may be initiated at the earliest opportunity. Renewals and review frequencies will be more intense for those borrowers perceived to be of higher risk.

Where appropriate, a specialist 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 and asset quality measures which are set out in the Treasury Credit Risk Management Policy. The Commercial and Treasury Credit Risk function in Risk Management Division has a level of delegated sanctioning authority. Large or higher risk exposures are subject to further approval by the Commercial & Treasury Credit Committee and / or Executive Risk Committee.

Lending and investment decisions are subject to a manual, subjective underwriting process supplemented by the outputs of a financial strength rating model. All credit lines and exposures are reviewed at least on an annual basis which entails a comprehensive analysis of the counterparty's financial performance, their rating status (both external and internal ratings) and recent developments to ensure that the agreed credit limits and internal ratings remain at appropriate levels. Review frequencies will usually be more intense for those counterparties perceived to be higher risk.

Nationwide uses Standard and Poor's (S&P), Moody's, and Fitch as External Credit Assessment Institutions (ECAIs) for treasury credit risk exposures. S&P is used for Sovereigns, Institutions, Asset Backed Securities, Covered Bonds and Corporates. Moody's is used for Sovereigns, Institutions, Covered Bonds and Asset Backed Securities. Fitch is used for Asset Backed Securities.

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

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

An Internal Ratings Based (IRB) model is used to determine Probability of Default (PD) for Treasury exposures (excluding corporates which are treated as Standardised). Under Foundation IRB, regulatory parameters are used for Loss Given Default (LGD) and the conversion factor. The PD model for banks consists of two key elements – a statistically-driven quantitative financial strength rating and a qualitative overlay. For non-bank entities and investment banks, external ratings are substituted for the quantitative element.

The qualitative adjustment is applied to the calculated quantitative rating or external rating as appropriate to reflect material changes in internal and external operating conditions that may not yet be reflected in the financials or published external ratings. The adjustment also recognises any external support mechanisms that would take effect in the event of the counterparty encountering financial difficulties, environmental (external) factors and business environment (internal) factors.

The model generates a long-term, unsecured debt rating by combining these quantitative and qualitative factors. The output is a numerical rating ranging from 1 to 22, with grades 1 to 10 equating to investment grade status and grade 22 representing default. The following table shows the mapping of internal default grades to external ratings at 4 April 2011:

**Table 13: Internal default grades mapped to external ratings**

Internal Default Grades	S&P Ratings	Moody's Ratings	Fitch Ratings
1 – 3	AAA to AA	Aaa to Aa2	AAA to AA
4 – 6	AA- to A	Aa3 to A2	AA- to A
7 – 9	A- to BBB	A3 to Baa2	A- to BBB
10 – 12	BBB- to BB	Baa3 to Ba2	BBB- to BB
13 – 16	BB- to B-	Ba3 to B3	BB- to B-
17 – 22	CCC+ to D	Caa1 to D	CCC to D

The following table shows the Exposure Values associated with institutions under Foundation IRB including commitments at 4 April 2011. Repurchase agreements are included in this table which affects the exposure weighted average LGD where appropriate.

**Table 14: Institutions under Foundation IRB**

Internal Default Grades	PD band %	Exposure Value		Exposure Weighted Average LGD		Exposure Weighted Average RW	
		2011 £m	2010 £m	2011 %	2010 %	2011 %	2010 %
1 - 3	0.000 - 0.03	785	2,487	17.2	13.2	6.5	4.1
4	0.031 - 0.04	681	765	44.5	44.9	11.0	12.6
5	0.041 - 0.05	4,016	6,350	19.1	20.2	6.5	6.6
6	0.051 - 0.07	1,645	2,482	47.2	47.2	20.8	22.3
7	0.071 - 0.10	692	1,162	33.4	38.2	15.8	19.8
8	0.101 - 0.20	620	636	48.1	52.1	41.4	50.1
9	0.201 - 0.30	143	334	49.6	42.0	53.1	42.4
10	0.301 - 0.50	354	280	45.5	52.9	68.1	87.4
11	0.501 - 0.75	-	-	-	-	-	-
12	0.751 - 2.00	59	14	45.0	45.0	86.6	90.3
13-21	2.001 - 99.99	76	-	45.0	-	231.8	-
22	100.00% (in default)	60	71	45.0	45.0	-	-
<b>Total</b>		<b>9,131</b>	<b>14,581</b>				

The following table shows the Exposure Values with each credit quality step for corporate treasury exposures under the Standardised approach at 4 April 2011:

**Table 15: Corporates under Standardised**

Credit Quality Step	Risk weight %	S&P ratings	Moody's ratings	Exposure values	
				2011 £m	2010 £m
1	20	AAA to AA-	Aaa to Aa3	38	40
2	50	A+ to A-	A1 to A3	20	22
3	100	BBB+ to BBB-	Baa1 to Baa3	-	-
4	100	BB+ to BB-	Ba1 to Ba3	-	-
5	150	B+ to B-	B1 to B3	89	-
6	150	CCC+ and below	Caa1 and below	-	90
Unclassified	100	Unknown	Unknown	293	306
<b>Total</b>				<b>440</b>	<b>458</b>

Exposure Values for equities are risk-weighted at 100% and included under Standardised "other" (see Table 4). Exposure Values for Asset Backed Securities can be found in section 5.9.

## 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, delinquency or default in interest or principal payments or the debt is 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 2011. For the purposes of these disclosures, "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.

**Table 16: Past due loans and provisions for impaired exposures**

	Retail secured lending		Retail unsecured lending		Commercial lending		Other operations		Total	
	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Neither past due nor impaired	119,967	122,844	2,335	2,074	20,212	22,451	481	538	142,995	147,907
<b>Past due:</b>	-	-	-	-	-	-	-	-	-	-
<b>Up to 3 months</b>	3,282	3,058	37	45	1,086	315	4	5	4,409	3,423
<b>3 to 6 months</b>	561	622	50	60	111	233	1	14	723	929
<b>6 to 12 months</b>	415	456	44	67	235	318	3	15	697	856
<b>Over 12 months</b>	266	303	-	45	378	191	3	4	647	543
Possessions	163	190	-	-	1	-	-	-	164	190
<b>Total Past Due</b>	<b>4,687</b>	<b>4,629</b>	<b>131</b>	<b>217</b>	<b>1,811</b>	<b>1,056</b>	<b>11</b>	<b>38</b>	<b>6,640</b>	<b>5,940</b>
<b>Outstanding balances</b>	<b>124,654</b>	<b>127,473</b>	<b>2,466</b>	<b>2,291</b>	<b>22,023</b>	<b>23,507</b>	<b>492</b>	<b>576</b>	<b>149,635</b>	<b>153,847</b>
Provisions	201	160	90	148	463	422	11	20	765	750
Charge for the year	101	89	83	126	175	299	-	35	359	549

Past due loans, impaired loans and provisions are all UK-based with the exception of £39.5m impairment charge (2010: £36m) relating to a portfolio of European commercial loans. For more detail of commercial lending, see Table 12.

The following table summarises the movement during the year in impairment provisions:

**Table 17: Movement in impaired provisions**

	Individual provisions		Collective provisions		Total	
	2010/11	2009/10	2010/11	2009/10	2010/11	2009/10
	£m	£m	£m	£m	£m	£m
Balance at 5 April	450	229	300	241	750	470
Charge for the year	229	375	130	174	359	549
Write-offs	(172)	(135)	(162)	(124)	(334)	(259)
Recoveries	4	4	24	16	28	20
Unwind of discount	(33)	(23)	(5)	(7)	(38)	(30)
<b>Balance at 4 April</b>	<b>478</b>	<b>450</b>	<b>287</b>	<b>300</b>	<b>765</b>	<b>750</b>

Further information on the charge to the income statement for provisions and more detailed analysis is included in Note 11 in the Annual Report and Accounts.

The impairment charge during the year on investment securities of £66 million (2010: £36 million) comprises a £66 million charge on Available For Sale investment securities (2010: £36 million).

### 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.

A subsequent decline in the fair value of an investment security classified as Available For Sale is recognised in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised directly in the Available For Sale reserve. If the fair value of an investment debt security classified as Available For Sale increases in a subsequent period (and the increase can be related objectively to an event occurring after the impairment loss was recognised in the income statement), the impairment loss is reversed through the income statement to the extent of the increase in fair value.

### 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 the market in that region and historically higher asset value growth trends. As at 4 April 2011, approximately 34% (2010: 34%) of residential exposures by account was concentrated in the south-east and Greater London. By their nature, residential mortgages and unsecured lending comprise a large number of intrinsically highly-diversified small loans and with a low volatility of credit risk outcomes.

For commercial lending, total portfolio exposure is controlled within self-imposed cap set at 15% of Nationwide's total business assets. Within this overriding limit, further limits on the extent of exposure to individual sector and sub-sectors have been set to ensure an acceptable spread of risk is maintained. Limits are also set to restrict the size of aggregate exposure to any single counterparty or group of closely-connected counterparties.

In terms of counterparty concentration, the largest single commercial customer, including undrawn commitments, represents only 1% (2010: 1%) of the commercial portfolio.

Policy limits have also been set to enable the management of treasury credit risk concentrations. These limits are actively monitored and relate high level portfolio limits to control the make-up of the portfolio with more granular limits applied to cover sub-portfolios, country and asset class / sector exposures and aggregated counterparty groups, to prevent unacceptable concentrations.

### 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, indexed valuation (further advances) or by 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).

For property-based lending, supporting information such as professional valuations is an important tool to help determine the suitability of the property offered as security and, in the case of investment lending, that the property generates sufficient cash flow 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 / five years for Registered Social Landlords (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 and is specifically prepared by independent solicitors.

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 variable 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 Group's preferred method of documenting derivative activity is the International Swaps and Derivatives Association (ISDA) Master Agreement. 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. For repurchase transactions Global Master Repurchase Agreement (GMRA) documentation is utilised. 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.

The Group's legal documentation with its counterparties for derivative and repurchase transactions also grants legal rights of set-off for those transactions respectively. Accordingly, negative market values will offset positive market values with the same counterparty in the calculation of credit risk, subject to an absolute exposure of zero by counterparty.

### **5.8 Credit Derivatives**

The purchase of a credit derivative (credit default swap) is treated as credit substitution and enables 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).

At 4 April 2011, the Group had no exposure to credit derivatives.

### **5.9 Securitisation**

#### **Retained securitisation positions**

The Silverstone Master Trust programme for retail mortgages is currently the only vehicle that securitises assets originated by the Group. Notes are issued by the Silverstone Master Issuer plc to external counterparties and to the Society, either for the purposes of creating collateral to be used for funding or for subsequent sale of notes to investors outside the Group to provide wholesale funding. Nationwide Building Society is both originator and servicer of the programme. Other roles fulfilled by the Society are fully described in the Silverstone base prospectus.

In October 2010 Silverstone Master Issuer plc issued a residential mortgage backed securitisation. US \$0.85 billion and €1.1 billion 3 - 5 year bonds were issued, raising £1.52 billion Sterling equivalent funding.

All of the assets pledged are retained in the Society's balance sheet as the Society substantially retains the risks and rewards relating to the loans. The Silverstone programme is rated by S&P, Moody's and Fitch.

#### **Purchased securitisation positions**

The total Group exposure to purchased securitisation positions at 4 April 2011 was £5.9 billion by market value with mortgage-backed securities accounting for the majority of this exposure. Securitisation provides the Group with a diversified, capital-efficient source of investment income. Investment is undertaken within clearly defined credit risk policy. Nationwide employs a ratings-based approach for calculating risk weighted exposure on its securitisation portfolio. The exposure is managed although there have been limited additions to, or disposals from, the portfolio since April 2010. Reduction in the size of the portfolio as a result of maturing assets has been offset by an increase in the market value of underlying securities.

The following table shows the breakdown of these exposures split by credit quality steps with indicative external credit assessment ratings:

**Table 18: Aggregate exposure to purchased securitisation positions**

Credit Quality Step	Risk weight most senior	Base	Non-granular pool	S&P ratings	Moody's ratings	Fitch ratings	Exposure values		Exposure Weighted average RW	
							2011	2010	2011	2010
							£m	£m	%	%
	%	%	%							
1	7	12	20	AAA	Aaa	AAA	3,724	4,911	9.8	9.8
2	8	15	25	AAA	Aa	AAA	834	651	13.1	12.2
3	10	18	35	A+	A1	A+	164	123	14.6	11.8
4	12	20	35	A	A2	A	181	218	24.3	17.9
5 <sup>1</sup>	20	35	35	A-	A3	A-	131	69	36.9	36.6
6	35	50	50	BBB+	Baa1	BBB+	123	43	40.7	42.0
7	60	75	75	BBB	Baa2	BBB+	175	87	75.1	72.5
8	100	100	100	BBB-	Baa3	BBB-	102	58	106.0	106.0
9	250	250	250	BB+	Ba1	BB+	19	73	265.0	265.0
10	425	425	425	BB	Ba2	BB	37	17	450.5	450.5
11	650	650	650	BB-	Ba3	BB-	-	-	-	-
<b>Total (Credit Quality Steps 1 -11)</b>							<b>5,490</b>	<b>6,250</b>		
Below 11	1250	1250	1250	Below BB-	Below Ba3	Below BB-	397	351		

<sup>1</sup> Counterparties classified under non-granular pool with a risk weight of 35% have been classified under Credit Quality Step 5.

Note: An additional scalar of 6% is applied on risk weighted averages.

The following table shows the breakdown of purchased positions split by exposure type:

**Table 19: Aggregate amount of securitisation positions purchased by exposure type**

	2011	2010
	£m	£m
Residential mortgages	3,138	3,479
Commercial mortgages	871	940
Credit card receivables	195	229
Loans to corporates or SMEs	727	559
Consumer loans	822	1,273
Other assets	134	121
<b>Total</b>	<b>5,887</b>	<b>6,601</b>

The following table shows the breakdown of retained or purchased positions split by geographic region:

**Table 20: Aggregate amount of securitisation positions purchased by geographic region**

	2011	2010
	£m	£m
Europe	3,975	4,347
Americas	1,788	2,097
Asia/Pacific	-	-
Others	124	157
<b>Total</b>	<b>5,887</b>	<b>6,601</b>

Further details of securitisation can be found in the Annual Report & Accounts under Business Review (pages 24-25), Note 1 (page 93) and Note 18 (pages 114-115).

### 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 Nationwide holds 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 2011:

**Table 21: Net exposures to counterparty credit risk for derivative contracts**

	Total	
	2011	2010
	£m	£m
Interest rate contracts	1,484	1,976
Foreign exchange contracts	2,473	2,872
Other contracts	4	4
Gross positive fair value of contracts	3,961	4,852
Netting benefits <sup>1</sup>	(389)	(1,196)
Netted current credit exposure	3,572	3,656
Collateral held	(1,031)	(1,151)
<b>Net derivative credit exposure</b>	<b>2,541</b>	<b>2,505</b>

<sup>1</sup>Netting benefits is after including Potential Future Credit Exposure

The net derivatives credit exposure represents the credit exposure to derivative transactions after taking account of legally enforceable netting agreements and collateral arrangements, and after including Potential Future Credit Exposure (PFCE) as required in the calculation of exposure. Included within this net exposure are amounts that relate to derivatives held in respect of the Nationwide Covered Bonds LLP which are subject to collateralisation when individual bank credit ratings fall below a certain threshold. This threshold has not yet been reached.

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 re-balancing 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.

As part of its regular reporting, the Group calculates any additional requirements to post collateral in the event of a downgrade in its external rating.

Wrong-way risk may occur when exposure to a counterparty is adversely correlated with the credit quality of that counterparty. Hence, there is a tendency for the exposure to increase as the creditworthiness decreases. Where such risk arises, this is taken into account when counterparty reviews are undertaken to allow for management assessment of where appropriate mitigation is required.

### 5.11 Credit Risk Model Performance

Expected loss is the forecast loss over a one-year time horizon as a result of applying the Group's PD, LGD and Exposure Value models. There are material differences between the methodologies and underlying principles for calculating expected loss according to regulatory requirements rather than under accounting standards. Any comparisons must therefore take into consideration these key differences. Notable differences include timing with regard to default and impairment, and cyclicalities where models take account of long run average over the cycle.

The following table sets out model performance as expected loss versus provisions as at year end.

**Table 22: Comparison of expected loss and actual loss**

	Expected loss at 4 April 2010	Impairment charge at 4 April 2011
	£m	£m
<b>Internal Ratings Based (IRB) exposure classes</b>		
Institutions	40	36
Retail mortgages (prime secured against residential property)	83	40
Qualifying revolving retail	188	46
Other retail (unsecured loans)	61	51

Nationwide uses a conservative estimate of expected loss in a downturn when calculating its capital requirements; this explains the differences seen between expected and actual losses for retail mortgages. During the year, Nationwide wrote off all credit card and FlexAccount balances in litigation. This has resulted in a reduction of the impairment charge as at 4 April 2011 for qualifying revolving retail.

### 5.12 Model Approvals & Validation

The performance and accuracy of credit risk models is critical both in terms of effective risk management and the determination of Basel risk parameters. PD parameters are modelled to calculate RWAs for all IRB approaches. In addition, where advanced IRB approaches are used, Loss Given Default LGD and Exposure Value parameters are also modelled by the Group to determine RWAs. Models that are used to determine IRB parameters have to be reviewed and approved for first use by the FSA as part of the rollout programme.

Internal review and approval for models is carried out by the relevant risk committee (e.g. Retail Credit Committee for retail models). They are supported in this by more technical committees and a Models Group forum (comprising managers of modelling teams across the Group). The approval process therefore ensures that Divisional Directors, senior managers of business areas and technical staff are involved as appropriate.

A key input to the approval process is independent model validation which is carried out by technical staff who have not been involved with building the models. This includes an evaluation of the model development and validation of the dataset used, logic and assumptions, and performance of the model analysis. Where required due to an internal materiality assessment, the Group also engages external risk management consultants to undertake independent reviews. This provides a benchmark against industry practices for consideration under the model approval process by relevant committees.

The validation results are a key factor in deciding whether a model is recommended for use. The frequency, depth and extent of the validation are consistent with the materiality and complexity of the risk being managed. The Group's validation processes include:

- Developmental evidence: to ensure that the credit risk model adequately discriminates between different levels of risk and delivers accurate risk estimates.
- Process verification: whether the methods used in the credit risk models are being used, monitored and updated in the way intended in the design of the model. Initial testing and validation is performed when the model is developed with the performance of models being assessed on an ongoing basis.

Models are subject to regular validation monitoring and performance is reported to the relevant risk committee. If the actual performance of a model falls outside expected criteria, then it will be subject to review. Nationwide's policy is to review all models annually. The models may then be modified or recalibrated as a result.

## 6 Market Risks

### 6.1 Market Risk Overview

Market risk is the risk of changes in value of, or income arising from, the Group's assets and liabilities as a result of changes in interest rates, exchange rates, or other market indices. Market risk arises only in the banking book as the Group does not have a trading book. The significant market risks that affect the Group are:

- Interest Rate Risk, including:
  - Basis Risk;
  - Prepayment Risk, Attrition Risk and Access Risk for fixed-rate products; and
  - Swap Spread Risk.
- Foreign Exchange Risk; and
- Credit Spread Risk

In addition to these risks, the Group also has funding obligations for a number of defined benefit pension schemes. This exposes the Group to various market risks including interest rate risk, inflation risk and equity risk. Of the above risks, the only market risk that is included under Pillar 1 is in respect of Foreign Exchange (see Section 4); all other market risks are covered under Pillar 2 which is beyond the scope of these disclosures.

Discretionary market risk exposures are measured daily and reported monthly to the Assets and Liabilities Committee (ALCo). Other strategic exposures are measured and reported monthly or quarterly.

### 6.2 Interest Rate Risk

Interest rate risk arises from the mortgage, savings and other financial services products that the Society offers. The varying interest rate features and maturities on these products, and the use of wholesale funds to support these products, create exposures to interest risks. This is due to the imperfect matching of interest rates and timing differences on the re-pricing of assets and liabilities.

The interest earned on the Group's free reserves has been protected through Nationwide's policy of investing such balances with an interest rate maturity profile of several years.

The Group's Treasury Division has a mandate to actively and efficiently manage the Group's net interest rate risk position, subject to limits, in light of market conditions and business flows. Treasury Division uses derivative instruments in managing various aspects of market risk, complying with the Building Societies Act 1986, which limits the use of derivatives to the reduction in risk, as defined by the legislation.

The contractual terms of products and transactions determine the flexibility to manage net interest margin. In the current low interest rate environment, this flexibility has been constrained by a natural floor, at zero percent, for banking and savings rates, and a contractual ceiling for Base Mortgage Rate (BMR) products, relative to the base rate. New mortgages written by the society do not contain a contractual cap relative to Base Rate in order to increase the Society's flexibility in this regard.

Linear interest rate risk is measured by Value at Risk (VaR), PV01 and PV200 (detailed below). Limits have been set for each of these metrics to reflect the Group's low risk appetite and are monitored by ALCo.

The average gross Sterling equivalent exposures (including the investment of the Group's reserves) through 2010/11 were as follows:

**Table 23: Interest rate risk exposures**

	Average		High		Low	
	2011	2010	2011	2010	2011	2010
	£m	£m	£m	£m	£m	£m
VaR	74	83	81	88	66	79
Sensitivity analysis (PV01)	2	2	2	2	2	2
Stress testing (PV200)	409	390	438	463	373	362

#### 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 un-weighted daily market data from the last two years. Exposures against limits are reviewed daily by management. Actual outcomes are monitored periodically to test the validity of 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:

- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures;
- 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;
- Historic data is not necessarily a reliable guide to future events.

#### **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 shift 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. PV01 is calculated and monitored daily.

#### **Stress testing (PV200)**

This is calculated in a similar manner to PV01 but against a much more severe 200 basis point (2%) parallel shift in interest rates. PV200 is calculated and monitored daily.

### **6.3 Basis Risk**

Basis risk is the risk of loss arising from changes in the relationship between interest rates which have similar but not identical characteristics (e.g. Bank of England base rate and LIBOR).

The Group's exposure to basis risk has been a net Base asset position throughout the period, reflecting customer preferences towards variable rate mortgages and fixed-rate savings.

The current measure for LIBOR-Base basis risk considers the potential losses, arising over one year, from a shock in the 3-month LIBOR-base rate differential applied to the average basis exposure over the next 12 months.

Exposures are reported monthly to ALCo and are subject to limits and triggers for consideration of mitigation activity. Risks are managed through transfer pricing, the management of new product mix and by derivative instruments executed by the Group's Treasury department, where permitted under the Building Societies Act 1986.

### **6.4 Prepayment, Attrition and Access Risk**

Other interest rate risks arise when customer behaviour is different from that anticipated in respect of fixed-rate products: prepayment risk (early redemption or overpayment of fixed-rate mortgages), access risk (early withdrawal of fixed-rate savings), and attrition risk (higher or lower take-up of fixed-rate mortgages). The lower interest rates have exposed us to changes in customer behaviour, driven by associated changes in the financial dynamics of transactions.

The Group uses individual behavioural models to calculate interest rate risk arising from attrition, prepayment and early access, under defined scenarios. Exposures are reported monthly to ALCo and are subject to triggers for consideration of mitigation activity. Risks are managed through appropriate restrictions in product terms and conditions, application and offer procedures, transfer pricing and close analysis of the product pipeline and prepayment behaviour.

### **6.5 Swap Spread Risk**

Swap spread risk is the risk of loss arising from the changes in the relationship between swap rates and sovereign debt yields. Swap spread risk arises at Nationwide from long-dated sovereign debt that has been purchased for liquidity purposes. This fixed-rate debt has been swapped into LIBOR using an interest rate swap. After taking the swap into account, the mark to market value of the debt falls if the credit spread on sovereign debt increases relative to the credit spread on inter-bank borrowing. The risk is only crystallised if the sovereign debt and associated swap are sold.

Swap spread risk is measured by PV01 and is subject to an ALCo limit. A Value at Risk model is also used for the UK portfolio, which is a majority of the balance. The model uses two years' data, a 99% confidence interval and a 10-day holding period. Exposures are reported monthly to ALCo.

## 6.6 Foreign Exchange Risk

Foreign exchange risk arises from movements in the foreign exchange market adversely affecting the value of the Group's foreign currency holdings and planned future cash flows. 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. After hedging, Nationwide has no substantial net exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates. Assets and Liabilities Committee set limits on net currency exposure and these limits 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 as described above in Interest Rate Risk (section 6.2).

The average Sterling equivalent exposures through 2010/11 were as follows:

**Table 24: Foreign exchange exposure**

	Average		High		Low	
	2011	2010	2011	2010	2011	2010
	£m	£m	£m	£m	£m	£m
VaR	0.1	0.2	0.5	0.6	0.0	0.0

In addition, the Group's Pillar 1 minimum capital requirement includes foreign exchange risk through the Foreign Exchange Position Risk Requirement (FX PRR) (see section 4).

## 6.7 Credit Spread Risk

Credit spread risk arises from changes in the credit and liquidity risk premia on marketable assets. This risk is reflected in a reduction in the market value of marketable assets, but is only crystallised if the asset is sold. Risk is calculated as the change in value of asset backed security holdings arising from a one basis point (0.01%) parallel shift in discount rates (CV01). This risk is reported to Commercial and Treasury Credit Committee on a regular basis.

## 6.8 Pension Obligation Risk

The Group has funding obligations for a number of defined benefit schemes, the most significant being the Nationwide Pension Fund ("the Fund"), which is closed to new entrants. Pension risk is the risk that the value of the Fund's assets, together with ongoing employer and member contributions, will be insufficient to cover the projected obligations of the Fund over time. The return on assets, which includes equities and bonds, will vary with movements in equity prices and interest rates. The projection of the Fund's obligations includes estimates of mortality, inflation and future salary rises, the actual out-turn of which may differ from the estimates. The Fund is also exposed to possible changes in Pension legislation.

To mitigate these risks, management, together with the Trustees of the Fund, regularly review reports prepared by the Fund's independent actuaries to assess these risks and take appropriate actions which may, for example, include adjusting the investment strategy and / or contribution levels. The Triennial valuation of the Fund was undertaken during 2010/11. Agreement has been reached with the Trustees of the Fund regarding the funding level, cost of future benefits and additional contributions. As a consequence, the Society has committed to make additional contributions to the fund to remove the funding deficit calculated in the triennial valuation as at 31 March 2010, the first instalment of which was paid during 2010/11. Changes have also been made to future benefit accrual to lower the cost of future benefits.

## 7 Liquidity and Funding Risk

Liquidity and funding risk is the risk that the Group is not able to meet its obligations as they fall due, or can do so only at excessive cost. Nationwide's operations are funded primarily from retail sources supported by a well-diversified wholesale funding capability. Comprehensive liquidity and funding policies are in place in order to ensure that the Group continues to meet its funding obligations and maintain or grow its business.

Since June 2010, the Group has reported its liquidity position against Backstop Individual Liquidity Guidance (BILG) provided by the FSA for regulatory purposes. The FSA announced in November 2010 its decision to calibrate the UK liquidity regime once it has received final guidance from Europe. The Basel Committee of Banking Supervisors (BCBS) issued its Basel III guidelines for liquidity risk management in December 2010. These guidelines include a Liquidity Coverage Ratio (LCR, to promote the short term resilience of a bank's liquidity risk profile) and a Net Stable Funding Ratio (NSFR, to provide a sustainable maturity structure of assets and liabilities). The Group monitors compliance against these internal metrics and as at 4 April 2011 the LCR was estimated at 125% and the NSFR at 106%. Estimations are made using Nationwide's interpretation of the draft directive, which has yet to be incorporated into the European and UK regulatory framework and therefore remains subject to change.

Liquidity requirements arise primarily from on-demand retail deposits, maturing wholesale funding, lending commitments and downgrade obligations for asset-backed finance. A buffer of high-quality liquid assets is maintained to fulfil this requirement.

Liquidity risk is managed against limits using a number of stress scenarios. Stress scenarios are based upon forward liquidity ladders that extend for various periods out to three months. The scenarios are measured and monitored daily and reported weekly to ALCo. Liquidity is held in excess of the maximum cumulative outflows calculated within these stress scenarios.

The Group has actively managed its funding profile during the year and has issued in excess of £4 billion in the secured long-term debt markets through public issuances of Covered Bonds and RMBS. These issuances have provided breadth and diversification to the previous year's unsecured deals and have enabled the repayment of short-term repurchase transactions and prepayments to the Bank of England (BoE) Special Liquidity Scheme (SLS). In line with other major UK institutions, the Group made use of the SLS facility at the height of the market dislocation in 2008. The major part of this facility has now been repaid, well ahead of the repayment profile required by BoE, which expires in January 2012. Public issuances during the year included a second RMBS in Euros and US dollars that raised £1.52 billion sterling equivalent and a landmark £0.75 billion 15-year Covered Bond, which successfully reopened the Sterling Covered Bond market.

The quality of the liquid assets buffer has been increased to focus on the highest quality Government-issued debt. This internal categorisation of liquidity is regarded as the Society's core liquidity.

The proportion of short-term funding has been significantly reduced whilst the weighted average term of funding has been extended, and the overall funding requirements have been actively managed. Internal risk measures incorporate both on-balance sheet funding transactions (e.g. wholesale funding) and off-balance sheet funding transactions (e.g. collateral swaps, such as the Special Liquidity Scheme). Accordingly, funding risk cannot be inferred solely from the published balance sheet.

Executive management, through weekly ALCo, meets regularly to review the business plans and liquidity position of the Group. The maturity profile and refinancing of funding transactions will continue to be a significant factor within business decisions.

The Group remains predominantly funded from retail sources, maintains high levels of core liquidity, and continues to be perceived as a safe harbour for savings. Liquidity risk measures used by the Group as at the 4th April 2011 include the following key measures:

**Table 25: Liquidity risk exposure**

	2011	2010
Core liquid assets (as a percentage of Share and Deposit Liabilities)	13.8%	13.8%
Wholesale funding (as a percentage of Share and Deposit Liabilities)	25.9%	27.8%
Long-term wholesale funding (as a percentage of total wholesale funding)	56.6%	50.3%

## 8 Operational Risk

Operational risk is a result of the processes Nationwide operates to meet the needs of its members and generate sufficient profit to maintain a financially stable firm. The purpose of operational risk management is to ensure the business puts in place appropriate strategies to manage, avoid, transfer, mitigate and insure the risks that could impact the ability of the Group to meet its strategies and plans and damage reputation.

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 effective oversight, monitoring and reporting of the key operational risk exposures facing Nationwide as detailed below:

- Third Party
- Business Continuity
- Change
- Customer Experience
- Financial Control, Payments and Information Management
- Financial Crime
- Information Security
- Information Technology
- Legal and Regulatory
- People
- Premises and Physical Assets

### Operational Risk Framework

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

To ensure there is accountability for the effective management of operational risk Nationwide operates a ‘three lines of defence’ model. Each division, as the first line of defence, has a dedicated operational risk officer. In the second line of defence, the Group-wide network of operational risk officers is supported by a centralised Operational Risk Unit, whose role is to define and implement operational risk policies and processes consistent with corporate objectives, values and risk appetite. The third line of defence is provided through the Group Internal Audit function, which is responsible for providing independent assurance regarding the effectiveness of the operational risk framework.

In order to manage the Group’s key operational risks, data is captured at a divisional and risk category level from a variety of sources. These include regular “control risk self-assessments”, internal and external incident analysis, material losses and control failures. The status of the Group risk appetite metrics, significant operational risk exposures, incidents, losses and emerging trends are regularly reported to the Operational Risk Committee, Executive Risk Committee, Board Risk Committee and the Board. This ensures transparency, robust and effective challenge to the business and enables effective strategies to be put in place to ensure risks remain within appetite.

A key objective of the framework is to ensure the Group makes decisions that strike an appropriate balance between risk and reward that is consistent with the Groups overall strategies and risk appetite. To provide additional protection, the Group purchases insurance against specific losses for key risks and to comply with statutory requirements.

### Key operational risk categories

Responsibility for each of the key operational risk categories is allocated to a risk owner, all of whom are Directors or Senior Managers reporting to an Executive Director.

#### Third Party

The Group conducts its business in a fair and open manner and is committed to maximising customer value when undertaking expenditure on goods and services. Risks are monitored to ensure appropriate selection and management of third party suppliers and outsourced service providers, including compliance with contract law.

### Business Continuity

The management of a crisis situation to ensure continuity of business is a key priority of the Risk function. The purpose of Business Continuity is to ensure plans are in place to maintain continuity of service for critical activities in the event of disruption caused by an unexpected event ensuring Nationwide:

- Maintains a safe and secure business for the benefit of its customers;
- Minimises the losses which arise from unexpected events;
- Protects the reputation of the Nationwide brand; and
- Contributes to the integrity of the UK financial services industry.

### Change

It is recognised that effective change management is essential to meeting corporate objectives. Management of this risk ensures that the Group's project and programme portfolio is aligned to Nationwide's objectives, delivered efficiently, fit for purpose and sustainable.

### Customer Experience

It is essential that Nationwide delivers its customer promise by providing open, honest, good value, fair, safe and secure products and services that perform as customers have been led to expect. The purpose of this risk category is to ensure that customers can be confident that they are dealing with a firm where the fair treatment of customers is paramount, that an appropriate customer experience is consistently delivered and service levels are maintained.

### Financial Control, Payments and Information Management

This category covers management of the risk that would be associated with inefficient, ineffective and inappropriate controls over the Society's financial resources and money transmission. This includes the risks of inaccurate financial reporting and not complying with associated legal and regulatory requirements together with the risk associated with ineffective governance of information.

### Financial Crime

This is the risk of direct or indirect loss resulting from intentional actions or illegal activities by people within or outside the Group. Continuing success for Nationwide depends on maintaining the trust of its customers and controlling fraud losses to minimise the impact on costs and profit.

The Group's Fraud Strategy is designed to:

- Minimise the impact of fraud losses on overall costs;
- Provide cost-effective management of fraud prevention, detection and investigation;
- Create a Group-wide anti-fraud culture that deters internal and external fraud; and
- Meet regulatory requirements in respect of fraud management.

Nationwide combats fraud across all existing and emerging products, processes and channels, through the exploitation of technology and promoting awareness of fraud to customers and employees. This is supported by a portfolio of projects managed under the banner of the Strategic Fraud Initiative, which was established in 2005 to enhance the Group's fraud prevention approach. Key initiatives include enhancements to detection systems for card fraud and further development of systems and processes for mitigating employee and mortgage fraud.

### Information Security

Nationwide regards information as a highly valuable asset and the protection of its customers' information as a key priority. Accordingly, Nationwide strives to ensure that the confidentiality, integrity and availability of its information and business systems are maintained and controlled, limiting exposure to the risks arising due to loss, corruption, misuse or theft of its information assets.

### Information Technology

The risk associated with the failure (or inadequate management) of technology and the data captured, stored, processed and output via that technology. This risk is managed through the Information Technology Division. Its objective is to ensure that a stable, secure and reliable IT environment is provided to support the business, and that both systems and data are secure from unauthorised access and usage.

### Legal and Regulatory

As a regulated firm, Nationwide places significant importance on managing the business in a way that effectively manages the risk of fines or censure through non-compliance with laws and regulations. Oversight of legal and regulatory risks comprises ensuring that laws and regulations are not breached.

Nationwide identifies all material legal and regulatory requirements and relevant voluntary codes and standards affecting the Group and works with business areas to determine how they apply. This is supported by review mechanisms to ensure compliance with material regulatory and legal obligations and a suite of Key Risk Indicators. This enables the business to monitor progress against the key legal and regulatory risk exposures and take action where the Group is operating outside of risk appetite.

This framework of support, challenge and monitoring:

- Enables the Board and senior management to discharge their responsibilities and satisfy legal and regulatory requirements;
- Supports the business to achieve the Corporate Plan in a compliant manner;
- Ensures relevant legislation, regulations, codes and standards are fully complied with;
- Ensures regulatory compliance is consistent and effective across the Group;
- Prevents and minimises penalties and litigation arising from non-compliance; and
- Ensures reliable professional advice is sought on legal matters in order to select the optimum solutions.

The Compliance Committee monitors retail 'conduct of business' compliance standards, policies and issues, across Group product areas, distribution channels and servicing teams.

### People

One key differentiator of Nationwide's strategy is its people. As such, Nationwide is committed to ensuring that it effectively manages the risks associated with recruiting, developing, motivating, rewarding and retaining the required number of people who are competent and have the right skills within their role. This also includes the risk of not complying with people-related legal and regulatory requirements.

### Premises and Physical Assets

Nationwide ensures appropriate premises and physical assets are available to fulfil business operational needs. This means ensuring adequate, safe and secure premises are in place that conform to all relevant regulatory bodies' rules and regulations and provide a safe and healthy environment.

## 9 Remuneration

In compliance with the requirements set out in the FSA's Policy Statement PS10/21 'Implementing CRD3 requirements on the disclosure of remuneration' issued in December 2010, the following tables display the 2011 remuneration for Nationwide's managers and members of staff whose actions have a material impact on the risk profile of the Society (Code Staff). This includes executive and non-executive directors. The subsequent paragraphs provide further information on Nationwide's remuneration policies and governance.

**Table 26: Fixed and variable remuneration**

Code Staff	Total
	<b>2011</b>
<b>Number of Code Staff</b>	<b>71</b>
<b>Fixed<sup>1</sup></b>	
Cash (£m)	<b>12.6</b>
<b>Total Fixed</b>	<b>12.6</b>
<b>Variable<sup>2,3</sup></b>	
Cash (£m)	<b>6.4</b>
Deferred cash (£m)	<b>0</b>
<b>Total Variable Pay</b>	<b>6.4</b>

<sup>1</sup> Includes base salary and other cash payments in the year (excluding variable pay).

<sup>2</sup> Includes annual bonus payments in respect of the 2010/11 financial year and payments under the 2008 – 11 cycle of the Medium Term Performance Pay Plan.

<sup>3</sup> 50% of each Director's award under the 2010/11 APPP is subject to a six month retention period in line with the requirements of the FSA Code. The payment of the retained element is not guaranteed and is subject to further consideration by the Remuneration Committee at the end of the retention period and may be moderated downwards if the Committee judge that there have been any significant corporate or individual failings during this period.

There were no amounts of deferred remuneration awarded, paid out or reduced through performance adjustments during the financial year.

**Table 27: Sign on and severance payments**

Code Staff	Total
	<b>2011</b>
<b>Sign-on payments</b>	
Payments made during year (£m)	<b>0.2</b>
Number of beneficiaries	<b>1</b>
<b>Severance payments</b>	
Payments made during year (£m)	<b>2.0</b>
Number of beneficiaries	<b>6</b>
Highest individual award (£m)	<b>0.7</b>

### Decision-making process for determining remuneration policy

The Remuneration Committee (the 'Committee') of Nationwide meets regularly throughout the year and is responsible for:

- Determining the policy for the remuneration of the Chairman, the executive directors and group / divisional directors of the Society as well as any other employees who are deemed to fall within scope of the FSA Code ('Code Staff'). The objective of this policy is to ensure that the relevant individuals are provided with incentives to encourage enhanced performance within an appropriate risk framework and are rewarded, in a fair and reasonable manner, for their individual contributions to the success of the Society;
- Within the terms of the agreed policy, determining the specific remuneration packages for the Chairman, the executive directors, group / divisional directors and Code Staff both on appointment and on review;

- Approving the design of, and determining the performance targets for, any discretionary variable pay schemes operated by the Society for the benefit of employees within the Committee's remit, and approving the total annual payments under such schemes; and
- Overseeing the remuneration policy throughout the Society, with a specific focus on the risks posed by remuneration policies and practices.

The Committee's terms of reference were last reviewed and updated in April 2011. The full terms of reference are available on the Society's website.

The Committee met 10 times during the year.

#### **i) Remuneration policy**

The Committee is guided by the following overarching principles:

1. Pay will support the attraction and retention of high quality people;
2. There will be a clear link between performance and remuneration;
3. Our approach to pay will be uncomplicated;
4. Levels of remuneration will be determined by reference to the market for similar jobs within the UK financial services sector;
5. Pay will reflect the market and decisions are based on what is appropriate for Nationwide;
6. The incentive opportunity at Nationwide will not 'lead the market'; and
7. No pay arrangements should directly or indirectly expose Nationwide to inappropriate risk.

#### **ii) Composition of the committee**

The members of the Remuneration Committee are all independent non-executive directors of the Society and include two members of the Board Risk Committee. During the year the Committee members were:

Robert Walther (Chairman of Remuneration Committee from the 2010 AGM onwards)

Stella David (Chairman of the Remuneration Committee until stood down as a director following the 2010 AGM)

Suzanna Taverne

Bill Tudor John

Michael Jary

#### **iii) Role of relevant stakeholders**

The Committee is supported by Geoffrey Howe (Chairman of the Board), the Director of Human Resources and where appropriate the Chief Executive, who may also be invited to attend Committee meetings to provide further background information and/or context to assist the Committee in their duties. The Remuneration Committee is also supported by the Board Risk Committee on risk related matters including incentive plan design, the assessment of specific performance measures, and wider issues relating to risk and business protection. In no case is any person present when their own remuneration is discussed.

In performing its duties, the Remuneration Committee draws on the advice of independent external consultants. Ian Tinsley (formerly of Hay Group and retained as an independent adviser) and Hay Group provided independent advice during the year on market rates of pay, best practice and remuneration trends.

#### **Link between pay and performance**

All Nationwide's remuneration policies are designed to allow us to attract and retain talented individuals needed to deliver Nationwide's business strategy. Nationwide strongly believes in pay for performance, whilst ensuring that an appropriate proportion of the total package is fixed so as not to incentivise inappropriate risk.

Nationwide manages the risk implications of its remuneration arrangements in a number of ways, including:

- Striking the optimal balance between 'fixed' elements of pay (base salary and pension), and 'variable' pay (annual and medium-term performance incentives) to ensure variable pay overall and on an individual-by-individual basis remains an appropriate proportion of total pay;
- Establishing an appropriate balance between 'target' incentive outcomes and the 'maximum' opportunity in line with Nationwide's low-risk appetite;
- Ensuring performance for all variable pay plans is measured by reference to a range of factors including non-financial objectives, which take into account risk, sustainability of performance and Nationwide's values in order to take a rounded view of performance;

- Setting limits on variable pay for senior employees that are low by sector standards and which place greater emphasis on long-term rather than short-term performance;
- Establishing a specific risk measure for the MTPPP, which would cause outstanding awards to be cancelled if Nationwide's Core Tier 1 capital ratio, a key measure of the resilience of the Society's business, falls below an acceptable level that is pre-determined by the Board / Remuneration Committee; and
- Retaining the discretion to change or cancel payments under Nationwide's incentive plans if it is felt that they do not properly reflect the Society's performance or are otherwise unaffordable.

### Design and structure of remuneration

There are three main elements of remuneration:

- Base salary;
- Variable pay (annual performance pay and medium term performance pay); and
- Benefits (pension, car and healthcare).

The Remuneration Committee has reviewed the balance between fixed and variable pay for executive roles, and has set appropriate ratios for different groups of roles that reflect their nature, the Society's business and its risk appetite.

Non-executive Code Staff do not participate in any variable pay arrangements.

### Salary and fees

Executive Code Staff receive a salary and non-executive Code Staff receive fees. Base salaries for executives reflect the size of each role and remuneration at other similar companies, as well as reflecting the individual's skills, experience and performance. The Chairman's fee is reviewed and approved by the Remuneration Committee. The fees of other non executive directors are reviewed and approved by the executive directors and by the Chairman. The fees payable to non executive directors are set after reviewing the responsibilities of the non executive directors' roles compared with roles in similar organisations. Non executive directors are paid a basic fee, with an additional supplement paid for serving on or chairing a Board Sub-Committee.

### Directors' Annual Performance Pay Plan (APPP)

The purpose of the APPP is to reward the achievement of challenging performance targets set for each financial year against a range of financial and non-financial measures.

For the Chief Executive, the other Executive directors and Group and Divisional directors, the APPP is designed to deliver 40% of total variable reward to the participants, with the remaining 60% arising from the MTPPP (see below), which Nationwide regards as the deferred element of variable compensation and which vests in compliance with the FSA Remuneration Code. The Remuneration Committee sets targets in advance for each financial year and determines the level of payments for on-target and maximum performance.

The APPP is based on three main performance elements, the weighting of which varies for different roles:

- Group performance – assessed against a balanced scorecard of five equally weighted KPIs:
  - Underlying profit;
  - Non-margin Income;
  - Cost Income Ratio;
  - Customer Satisfaction Rating; and
  - Delivering Transformation Projects.
- Divisional performance (Group Directors and Divisional Directors only) – assessed against divisional performance objectives reflecting the division's contribution towards the delivery of the Corporate Plan; and
- Individual performance - assessed against individual performance objectives reflecting each individual's leadership and contribution towards delivery of the Corporate Plan.

This balanced scorecard approach ensures that participants cannot generate significant additional reward by delivering very high levels of performance in a single area at the expense of other corporate priorities. The APPP is discretionary and the Remuneration Committee is able to amend payments if it believes that they are not representative of overall performance. The Remuneration Committee may also reduce, defer or withhold payments in the event of Nationwide making a loss.

To further support Nationwide's reward principle that there will be a clear link between performance and remuneration, an additional retention period for APPP payments has been introduced. Accordingly, the payment of 50% of the award will be delayed for six months, and may be subject to downwards performance adjustment.

**Annual performance pay for Senior Executive level Code Staff**

Senior Executive level Code Staff participate in annual bonus plans that aim to recognise and reward an employee's personal contribution to the success of Nationwide. These are typically based on a mix of corporate and personal performance.

For the majority of Code staff not participating in the APPP, bonus awards will be paid from a bonus pool which is determined following the end of the financial year based on corporate performance. This is paid as a cash award in June following the end of the financial year.

The level of funding for the pool based scheme is related to the financial performance of Nationwide for the year. Individual awards are based on performance ratings against pre-agreed objectives for the year.

Individual bonus awards may be reduced where Nationwide become aware of any action by an individual which has exposed Nationwide to any form of unplanned risk (including, but not limited to, regulatory, legal or reputational risk).

All Code Staff within these plans currently fall into the 'de minimis exception' within the FSA Code, which means that no deferral is required.

**Director's Medium Term Performance Pay Plan (MTPPP)**

The MTPPP rewards sustained performance and the achievement of challenging financial targets over a three year performance cycle. A new three year performance cycle starts each year. Payouts under the plan are payable in cash and restricted to a percentage of base pay.

Following a review of remuneration structures during 2010/11, the Committee has decided that awards under the 2010-2013 MTPPP cycle will be assessed against the following long term measures, which reflect the strategic priorities for the business in the Corporate Plan:

- Cumulative underlying profit over the MTPPP period;
- Cumulative non-margin income over the MTPPP period;
- Cost Income Ratio achieved for the last year of the MTPPP period; and
- Customer Satisfaction rating achieved at the end of the MTPPP period.

A specific risk measure for the MTPPP has been introduced for all outstanding and future awards. Achievement of this measure will ensure that Nationwide maintains a strong capital base which is consistent with Nationwide's risk-appetite and regulatory requirements for the business. If Core Tier 1 capital, which is a key measure of the resilience of Nationwide's business, were to fall below an acceptable level that is pre-determined by the Board / Remuneration Committee, then all outstanding MTPPP awards would be cancelled.

The Remuneration Committee has also reviewed the targets for outstanding awards for the 2008-2011 and 2009-2012 cycles. The absence of a risk measure meant that the original scheme has become non-compliant with the new FSA Code. Also, consolidation in the industry peer group has meant that the relative basis for assessing performance that was originally proposed has become increasingly less stable as there are fewer companies in the group to measure against. The Committee has determined that these MTPPP cycles should be measured against the same measures agreed for the 2010-2013 cycle, with the exception of 'non-margin income' (which was not historically a business KPI and therefore does not lend itself to measurement over these time periods).

To ensure compliance with the deferral requirements introduced by the FSA Remuneration Code, for each cycle from 2009-2012 onwards two-thirds of the award earned will be paid following the end of the three year performance period and payment of the remaining one-third will be deferred for an additional year. During this further deferral period, awards may be subject to further performance adjustment if it emerges that the original assessment of performance was misleading or if performance against the MTPPP measures declines substantially over the following year.

The plan is discretionary and the Remuneration Committee has the discretion to amend payments if it believes that they are not representative of overall performance.

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## 10 Glossary of terms

APPP	Annual Performance Pay Plan. The purpose of the APPP is to reward the achievement of challenging performance targets set for each financial year against a range of financial and non-financial measures.
Asset Backed Securities (ABS)	Securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows, including credit card assets, but are commonly pools of residential or commercial mortgages. Investors in these securities have the right to cash received from future payments (interest and / or principal) on the underlying asset pool.
Basel II	The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough 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 FSA Handbook.
Basel III	In December 2010, the Basel Committee on Banking Supervision issued the Basel III rules text, which presents the details of strengthened global regulatory standards on bank capital adequacy and liquidity. The standards will be phased in gradually from 2013.
BIPRU	The prudential sourcebook for banks, building societies and investment firms which sets out the FSA's capital requirements.
Business Assets	Business assets are the total assets of the Group plus impairment provisions on loans and advances to customers less liquid assets, property, plant and equipment, intangible fixed assets and investment properties as shown in the Group balance sheet..
Commercial lending	Loans secured on commercial property, loans to Registered Social Landlords and loans undertaken under Private Finance Initiatives.
Core Tier 1 capital	Total Tier 1 capital (see definition below) less permanent interest bearing shares (PIBS).
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.
Covered Bonds	Debt securities backed by a portfolio of mortgages that are segregated from the issuer's other assets solely for the benefit of the holders of the Covered Bonds. The Group issues Covered Bonds as part of its funding activities.
Credit quality steps	A credit quality assessment scale as set out in BIPRU 3.4 (Risk weights under the standardised approach to credit risk) and BIPRU 9 (Securitisation).
Credit risk	The risk that a borrower or counterparty fails to pay the interest or to repay the capital on a loan. Credit risk is the largest risk category to which the Group is exposed and sub-divided as follows: retail products, commercial lending, and Treasury credit risks.
Credit risk mitigation	Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.
CRR	Capital Resources Requirement – the minimum amount of capital resources that a financial institution must hold as set out in Basel II Pillar 1 rules.
Default	Circumstances in which the probability of default is taken as 100% for the purposes of the calculation of regulatory capital and compliance with Basel II. This is defined as when a borrower reaches a predefined arrears status (90 days past due for most borrowing) or where a borrower is considered unlikely to repay the credit obligation in full without the lender taking action such as realising security.
EAD	Exposure at Default. A Basel II parameter used in IRB approaches to estimate the amount outstanding at the time of default.
ECAI	External Credit Assessment Institution. 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.
Economic Capital	An internal assessment of the amount of capital required to protect against potential unexpected future losses arising from business activities, across a defined time horizon and confidence interval.

EEA parent institution	A parent financial institution situated in a Member State of the European Economic Area which is not a subsidiary of another financial institution also situated in the EEA.
Expected loss (EL)	A Basel II calculation under the IRB approach to estimate the potential losses on current exposures due to potential defaults over a one-year time horizon. It is the product of PD, LGD and EAD.
Exposure	The maximum loss that a financial institution might suffer if a borrower, counterparty or group fails to meet their obligations or assets and off-balance sheet positions have to be realised.
Exposure Value	A Basel II parameter used in IRB approaches to estimate the exposure (amount outstanding) at the time of default.
Foundation IRB approach	A method of calculating credit risk capital requirements using internal PD models but with supervisory estimates of LGD and conversion factors for the calculation of EAD.
FSA	Financial Services Authority. The financial services industry regulator in the UK.
FX PRR	Foreign Exchange Position Risk Requirement. The capital requirement under BIPRU 7 (Market risk) as part of the calculation of the market risk capital requirement included in Basel II Pillar 1.
GENPRU	General Prudential Sourcebook for banks, building societies, insurers and investment firms which forms part of the FSA Handbook for Basel II.
Guarantee	An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.
ICA	Internal Capital Assessment – the document produced as a result of the ICAAP.
ICAAP	Internal Capital Adequacy Assessment Process. The Group'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 credit, market and operational risks) and for other risks including stress events.
ICG	Individual Capital Guidance. The minimum amount of capital the Group should hold as set by the FSA under Basel II Pillar 2 and informed by ICAAP.
Impaired loans	A loan is impaired if there is objective evidence that an impairment event has occurred, and that the event has an impact on the estimated future cash flows of the loan which can be reliably estimated. Impairment may be caused by a single event, or a combination of events. Impairment events include redundancy or marital breakdown.
Individually / collectively assessed	Impairment is measured individually for assets that are individually significant to the Group, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available. Collective assessment also covers losses that have occurred but are not yet individually identified on loans subject to individual assessment.
Interest rate risk	Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates.
IRB	Internal Ratings-Based approach. A Basel II approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk-sensitive than the Standardised Approach and may be Foundation or Advanced. IRB approaches may only be used with FSA permission.
ISDA	International Swaps and Derivatives Association master agreement. A standardised contract developed by ISDA and used to enter into bilateral derivatives transactions. The contracts grant legal rights of set-off for derivative transactions with the same counterparty. This reduces the credit risk of the derivatives to the extent that negative values offset positive values.
LGD	Loss Given Default. A Basel II parameter used to estimate the difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.
LIBOR	London Inter-Bank Offered Rate.
Liquid assets	Total of cash in hand and balances with the Bank of England, loans and advances to banks and investment securities.
Liquidity risk	The risk that the Group is not able to meet its financial obligations as they fall due or can secure them only at excessive cost.
Long run average PD	Probability of default based on a long run average default rate which would be expected over a full economic cycle.
LTV	Loan-To-Value. A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a quarterly basis to reflect changes in the house price index (HPI)).

Market risk	The potential losses or decrease in value of the Group balance sheet as a result of adverse market movements. Specific types of market risk include interest rate risk (banking book), swap spread risk and currency risk.
Maturity	The remaining time in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, interest and fees) under the terms of a loan agreement.
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.
Model validation	The process of assessing how well a risk model performs, using a predefined set of criteria including the discriminatory power of the model, the appropriateness of the inputs and expert opinion.
Monoline Insurer	An entity which specialises in providing credit protection to the holders of debt instruments in the event of default by the debt security counterparty. This protection is typically held in the form of derivatives such as credit default swaps referencing the underlying exposures held.
MTPPP	Medium Term Performance Pay Plan. The MTPPP rewards sustained performance and the achievement of challenging financial targets over a three year performance cycle.
Netting	The ability to reduce credit risk exposures by offsetting the value of any deposits against loans to the same counterparty.
Operational risk	The risk of loss arising from inadequate or failed internal processes, people and systems or from external incidents.
PD	Probability of Default. A Basel II parameter used in IRB approaches to estimate the probability that a borrower will default on their credit obligations in the next 12 months.
PIBS	Unsecured, deferred shares of the Society that are a form of tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors creditors and investing members of the Group. Also known as subscribed capital.
Pillar 1 – Minimum capital requirements	The part of the Basel II Accord which sets out the regulatory minimum capital requirements for credit, market and operational risk.
Pillar 2 – The supervisory review process	The part of the Basel II Accord which sets out the processes by which financial institutions review their overall capital adequacy. Supervisors then evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments. This includes all risks (including Pillar 1 risks) – ICG is an outcome from Pillar 2.
Pillar 3 – Market discipline	The part of the Basel II Accord which sets out the disclosure requirements for firms to publish details of their risks, capital and risk management. The aims are greater transparency and strengthening market discipline.
PiT	Point in time. A modelling approach which assesses the credit risk of an exposure at a single point in time.
Prime	Prime mortgages are mainstream residential loans, which typically have a higher credit quality and fit standard underwriting processes. As such, they are likely to have a good credit history, and pass a standard affordability assessment at the point of origination.
Project Finance	Loans advanced to provide financial support for "public-private partnerships" between the public and private sectors.
Provisions	Amounts set aside to cover incurred losses associated with credit risks.
PV01 / PV200	A calculation to assess the change in value of the net present value (NPV) of financial instruments with 1 basis point / 200 basis points parallel shifts in interest rates. PV01 shows the sensitivity while PV200 applies a more severe stress test.
Qualifying Revolving Retail Exposures	Facilities to retail customers that provide a revolving facility e.g. credit cards and overdrafts from which credit risks arise. Nationwide's current account is the FlexAccount.
Rating system	A system for assessing and ranking customers and accounts by risk. A rating system comprises all of the methods, processes, controls, data collection and IT systems that support the assessment of credit risk, the assignment of exposures to grades or pools (rating), and the quantification of default and loss estimates for credit risk exposures.

Repurchase agreement (repo)	A repurchase agreement that allows a borrower to use a financial security as collateral for a cash loan at a fixed-rate of interest. In a repo, the borrower agrees to sell a security to the lender subject to a commitment to repurchase the asset at a specified price on a given date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the party on the other end of the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or reverse repo.
Retail IRB approach	A Basel II approach for measuring exposure to retail credit risks. The method of calculating credit risk capital requirements uses internal PD, LGD and EAD models. IRB approaches may only be used with FSA permission.
Retail loans	Loans to individuals rather than institutions, including residential mortgage lending and consumer banking.
Risk Appetite	The articulation of the level of risk that the Group is willing to take (or not take) in order to safeguard the interests of the Society's members whilst achieving business objectives.
RWA	Risk weighted assets. The value of assets, after adjustment, under Basel II rules to reflect the degree of risk they represent.
Securitisation	A process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose entity (SPE) which then issues securities backed by the assets. The Group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool. In addition, the Group invests in various securitisation structures in its Treasury portfolio.
Society	Nationwide Building Society.
Specialist residential lending	Consists of Buy to Let, self-certified and sub-prime mortgages.
SREP	Supervisory Review and Evaluation Process, the FSA assessment of a firm's own capital assessment (ICA) under Basel II Pillar 2.
Standardised approach	The basic method used to calculate credit risk capital requirements under Pillar 1 of Basel II. In this approach the risk weights used in the capital calculation are determined by supervisory parameters. The Standardised approach is less risk-sensitive than IRB.
Stress testing	Various techniques that are used to gauge the potential vulnerability to exceptional but plausible events.
Subordinated debt	A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing members but before the claims of holders of permanent interest bearing shares (PIBS).
Sub-prime	Loans to borrowers that typically have weakened credit histories that include payment delinquencies and potentially more severe problems such as court judgements and discharged bankruptcies. They may also display higher risk characteristics as measured by credit scores, or other criteria indicating heightened risk of default.
The Standardised Approach (operational risks)	The standardised approach to operational risk, calculated using three-year historical net income multiplied by a factor of between 12-18%, depending on the underlying business being considered.
Tier 1 capital	A component of regulatory capital comprising general reserves from retained profits, permanent interest bearing shares (PIBS), less goodwill, intangible assets and other regulatory adjustments.
Tier 2 capital	A further component of regulatory capital comprising the property revaluation reserve, qualifying subordinated debt and the collective impairment allowance (for exposures treated on a Basel II standardised basis), less certain regulatory deductions.
Value at Risk (VaR)	A technique that estimates the potential loss 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 statistical confidence. In its day-to-day monitoring, Nationwide uses a 10-day horizon and a 99% confidence level.
Wrong-way risk	Defined by the FSA as a situation where there is an adverse correlation between the counterparty's probability of default and the mark-to-market value of the underlying transaction.

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