Building Societies Association

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e-mail: andrea.jeffries@bsa.org.uk
direct line: 020 7520 5911
direct fax: 020 7240 5290

Ms Michelle Sansom
Technical Director
Accounting Standards Board
5th floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

Dear Michelle

Revised proposals for the future of financial reporting standards in the UK and Republic of Ireland

Thank you again for offering the BSA the opportunity to put forward suggested changes to the financial reporting exposure drafts issued at the end of January this year. We very much appreciate this gesture, particularly as we are submitting additional comments after the official closing date.

There were three main areas on which we argued for change. These were impairment, disclosures for financial instruments and the effective interest rate.

Impairment

The key requirement in accounting for loan impairment by deposit takers is that the accounting framework must permit boards to make appropriate provisioning in response to realistic expectation of losses, having regard to known and reasonably foreseeable factors influencing future credit losses in advance of the event. This is a key requirement to maintenance of member confidence in mutual deposit takers such as building societies.

To achieve this objective, the accounting framework has to acknowledge that future events are a "known unknown" which can only be assessed by a qualitative assessment of relevant forward look indicators judged to affect the outcome. Application of qualitative judgement to the credit portfolio at the assessment date can be achieved effectively and proportionately without expensive credit impairment models for UK GAAP (essentially small and medium-sized) building societies. A key requirement of this approach would be for the board to clearly document factors identified as influencing the judgement and their application to each segment of the portfolio to determine the level of provisioning.

While some of the larger UK GAAP societies have access to credit models, at different levels of depth and frequency of reporting, the majority of societies do not. Even where such models are used, they are designed for the assessment of capital requirements and calibrated on past loss experience, which is not necessarily a guide to the future. Using models to predict future losses is simply a translation of qualitative judgements into a model framework. As a result it is no better in principle than a qualitative assessment of the future likelihood of losses determined by the board.

A way forward

Retaining a realistic general/collective provision for assets based on information known and more importantly "reasonably foreseeable" at the balance sheet date will permit early recognition of the likely deterioration in credit quality across the portfolio. With the transfer of loans to the specific provisioning bucket, on identifiable deterioration in credit quality and where full recovery of the advance and interest is not anticipated, provisioning can flow from the levels recognised in advance in collective to specific. The requirement for frequent re-appraisal of both specific and general provisions will ensure they recognise appropriate provisions for each point in the cycle.

The proposals outlined in the attached document represent a pragmatic solution to the determination of impairment provisions through an evolution of the current approach under UK GAAP and avoid the disproportionate cost and complexity in the development of formal impairment models. Proposals for enhanced disclosure improve the information available to our members. *Please note that we have shared this proposal with the British Bankers' Association and the Association of British Credit Unions which have both signalled initial support.*

Disclosures for financial instruments

We agree that there should be greater disclosure of the risks associated with financial instruments for financial institutions. But it is important to be clear about the operation of mutuals such as building societies. They are, of course, financial institutions, but as mutuals, far removed from the business models used by plc banks. This distinction is sometimes overlooked by commentators.

At our meeting with ASB staff in April this year, it became clear that the additional, principles-based disclosures on financial instruments purely for financial institutions might apply more widely than previously indicated. "Financial instruments" may now include, for example, mortgages and savings. Even using this expanded definition, we believe the additional disclosures for financial institutions listed in chapter 34.17 of draft FRS 102 may be appropriate – **so long as they are properly proportionate and relevant to the users of the accounts of UK GAAP building societies.** This is a very important point – requiring these societies to, for example, provide the same range and level of information as plc banks could mislead their members and other stakeholders, even leading to unintended consequences.

We consider that societies could draw on existing disclosures in Pillar 3 which *inter alia* show how an institution manages risk and utilises capital, and to a certain degree replicate the proposed requirements in chapter 34.17. These disclosures can provide a comprehensive and holistic view of the institution. In addition, UK GAAP societies will be able to adapt disclosures made by larger peers. We consider this is an area where societies could work together to develop likely disclosures.

Effective interest rate

We have no issue in theory with income net of costs directly attributable to business generation being recognised in the interest line. We do, however, have a problem with the implementation of the effective life issue and early repayment charges. On effective life, we have a view that income net of costs is closely aligned to the specific product term, generally 2 to 5 years (for example, a 2 year discount or 5 year fix). On smaller pools of business, where individual cases deviating from the norm have a much greater impact due to the size of pools, we think it would be better to recognise the income over the product term or, for a lifetime deal, a consistent period. This removes the administrative expense and complexity involved in monitoring multiple pools of business, and the risk of error or misstatement in the same.

While the answer is likely to be much the same, moving to an estimated life basis is much more expensive, complex to administer, prone to error and unnecessarily open to material volatility in outcome given small loan pool sizes. A simple amortisation of cost net of income over product term would be much more proportionate to administer and simpler to audit.

Hedge accounting

We are aware of the role of the EIR in hedge effectiveness testing and would seek to review the application of the approach proposed once the hedge accounting aspects of IFRS have been published in H2 2012.

Yours sincerely

Andrea Jeffries

Andrea Jeffries
Policy Advisor

encs: proposal for impairment
sample disclosures

cc Deepa Raval
Project Director
Accounting Standards Board

Purpose	To document a proposal for accounting for loan impairment provisioning under FRSME for discussion
Outcome	To agree and finalise a proposal for loan impairment provisioning under the proposed FRSME for submission to the ASB by 18 May 2012

A. Impairment under UK GAAP

The approach of UK GAAP Societies on provisioning and impairment continues to be based on the BBA Statement of Recommended Practice on Advances (1997)[1], accepting that the BBA SORP was withdrawn on 31 December 2006 on transition to IFRS for listed entities.

For completeness a brief overview of the relevant paragraphs of the BBA SORP on Advances[2] are summarised below:

Type	Definition	Impairment allowance	Assessement Basis
General	Impairment existing in the portfolio at the balance sheet date.	Subjective judgement by the Directors of impairment existing in the portfolio taking into account current economic and other factors. The definition of impairment and threshold for specific provisioning will have a bearing.	Collective
Specific (Advance)	Identifiable deterioration in the creditworthiness of the borrower such that recovery of the advance in full is no longer expected	Assessment of the amount required to reduce the carrying value to the ultimate net realisable value.	Individual or Collective by Portfolio
Interest Suspended	Interest where there is significant doubt as to its collectability	The amount of interest charged in the 12 month accounting period	Individual or Collective by Portfolio

The principal difference between this approach and that under IFRS at present is the extent to which the general or collective provision must be supported by observable events.

When actual deterioration in creditworthiness becomes apparent and full recovery of both interest and amount advanced is subject to significant doubt or full recovery is not anticipated specific provisioning is then made. Whilst the approach to calculation of the provision is different under IFRS at present, the provision being based on an assessment of the present value of future cashflows recoverable, the principle is broadly the same insofar as provisions are recognised as incurred.

[1] http://www.bba.org.uk/media/article/bba-statements-of-recommended-accounting-practice-sorps
[2] Paragraphs 12-16, Specific Provisioning and Paragraphs 17-19, General Provisions and Paragraphs 34-40 Interest

In respect of disclosure the requirements under IFRS at present are much more advanced than those under UK GAAP and accordingly this area warrants review and enhancement.

B. Impairment and IFRS 9

A brief summary of our understanding of the current proposed approach to impairment under discussion in respect of IFRS 9 is summarised as follows[34]:

Impairment is based on a 3 bucket approach as detailed below:

Bucket	Definition	Impairment allowance	Assessment Basis
1	No or insignificant deterioration in credit quality since initial recognition	12 months expected losses	Collective or Individual
2	There has been more than insignificant deterioration in credit quality since initial recognition and it is at least reasonably possible that cashflows may not be fully recoverable	Full remaining lifetime expected losses (LEL)	Collective
3	There has been more than insignificant deterioration in credit quality since initial recognition and it is at least reasonably possible that cashflows may not be fully recoverable	Full remaining lifetime expected losses (LEL)	Individual

- All loans are initially in bucket 1 irrespective of credit quality
- The bucket 1 impairment allowance is losses expected within the next 12 months (PD over 12 months multiplied by LGD)
- Loans transfer from bucket 1 to bucket 2 or 3 requiring recognition of lifetime expected losses subject to 2 initial criteria:
  - More than insignificant deterioration in credit quality since initial recognition
  - Likelihood of default is such that it is at least reasonably possible cashflows may not be fully recoverable
- The difference between buckets 2 and 3 is the unit of assessment, 2 is assessed collectively and 3 individually
- The move to recognition of lifetime expected losses is anticipated to result in increased provisions sooner than at present with implications for regulatory capital
- Assets can be grouped together if they have shared risk characteristics, i.e. a collective provision can be assessed, or if not will be assessed individually.
- The assessment of transfer from bucket 1 to bucket 2 or 3 is based on assessed PD
- If the PD subsequently improves loans may move back from bucket 3 to 2 or 1

[3] Impairment – assessing the impact of the new proposal – March 2012 http://www.ey.com/Publication/vwLUAssets/IFRS_practical_matters_-_March_2012/$FILE/IFRS%20Practical%20Matters%20-%20Impairment.pdf

[4] IFRS 9 Impairment of financial assets – a step closer to completion – April 2012 http://www.ey.com/Publication/vwLUAssets/IFRS_Developments_Issue_26/$File/IFRS%20Developments%20Issue%2026.pdf

- In determining whether to recognise LEL an assessment of all available reasonable and supportable information, including the Boards proposed list of forward looking indicators applicable both individually and collectively
- The point of transfer from bucket 1 to bucket 2 or 3 is critical as it has a material impact on the size of the impairment provision.
- Development of forward looking assumptions requires significant judgement
    - The majority of asset level indicators proposed are based on current information about a borrowers performance to date
    - Incorporation of forward looking, macro level economic indicators such as unemployment, house prices etc. will represent a challenge

C. Current Proposals under IFRS 9 – Barriers to success for UK GAAP Societies

The principal concern with the impairment proposals is the focus on development of formal impairment models to drive provisioning assumptions.

All UK GAAP Societies currently operate on the standardised approach to credit risk under Basel II which recognises that development and use of formal credit models is not appropriate for smaller institutions.

Whilst some of the larger societies under UK GAAP have access to credit models, at different levels of depth and frequency of reporting, the majority of societies do not. Even where such models are utilised they are designed for assessment of capital requirements and calibrated on past loss experience which is not necessarily a guide to the future. Utilising models to predict future losses is simply a translation of qualitative judgements into a model framework. As a result it is no better in principle than a qualitative assessment of the future likelihood of losses determined by the Board.

As a result it should be possible to develop the existing provisioning approach and disclosures under UK GAAP whilst retaining the focus on qualitative judgement by the Board as a pragmatic solution for smaller financial institutions subject to FRSME.

D. An alternative proposal for adoption within FRSME

A brief overview of the alternative approach proposed is outlined below:

Bucket	Definition	Impairment allowance	Assessement Basis
Bucket 1	Impairment existing and reasonably foreseeable in the portfolio at the balance sheet date.	Subjective judgement by the Directors of impairment existing in the portfolio taking into account current and supportable forecast economic and other factors. The definition of impairment and threshold for specific provisioning will have a bearing.	Collective
Bucket 2	Identifiable deterioration in the creditworthiness of the borrower such that full recovery of the advance and interest is no longer expected	Assessment of the amount required to reduce the carrying value and interest in the current accounting period to the ultimate net realisable value with a refresh for interest on an annual basis.	Collective by Portfolio
Bucket 3	Identifiable deterioration in the creditworthiness of the borrower such that full recovery of the advance and interest is no longer expected	Assessment of the amount required to reduce the carrying value and interest in the current accounting period to the ultimate net realisable value with a refresh for interest on an annual basis.	Individual

- All loans are initially in bucket 1 irrespective of credit quality
- Assumptions for determination of provisions in bucket 1 would be based upon:
    - Assessment of each element of the loan portfolio segmented into suitably homogenous pools of assets based on Board assessed criteria, taking into account factors such as loan type, indexed LTV and the strength of borrower covenant.
    - A realistic assessment of the outlook for the creditworthiness of the assets taking into account current and supportable forecasts of predominantly macroeconomic indicators such as unemployment, house prices and average earnings.
- Where societies have access to credit models designed for determination of capital requirements these may be utilised in conjunction with more qualitative judgements in determination of provisioning requirements in all buckets.
- In terms of buckets 2 and 3 assets can be grouped together if they have shared risk characteristics, i.e. a collective provision by portfolio can be assessed, or if not will be assessed individually.
- Loans move from bucket 1 to buckets 2 or 3 when Board defined impairment criteria are triggered which means credit quality has deteriorated since origination and there is a reasonable possibility that future cashflows may not be fully recovered.
- The specific provision would be based on the assessed likelihood of migration from different stages of impairment to possession and loss on sale above the ultimate net realisable value of the security.

- Interest would be provided for as a specific provision on an annual basis avoiding the complexity of assessment of an appropriate time to disposal. The provision would be reviewed on an annual basis.
- If the loan fell back below the impairment triggers subsequently loans may move back from bucket 3 to 2 or 1

In respect of disclosure this should be brought into line with requirements currently applicable to IFRS Societies, subject to simplification for more straightforward institutions as appropriate, and amended to reflect the final IFRS 9. A sample disclosure from the Annual Accounts of Skipton Building Society[5] is attached by way of example of current requirements for larger entities which, subject to a review of proportionality for UK GAAP Societies, may be appropriate.

E. Conclusion

The key requirement in accounting for loan impairment by deposit takers is that the accounting framework must permit Boards to make appropriate provisioning in response to realistic expectation of losses, having regard to known and reasonably foreseeable factors influencing future credit losses in advance of the event. This is a key requirement to maintenance of member confidence in mutual deposit takers such as building societies.

To achieve this objective the accounting framework has to acknowledge that future events are a 'known unknown' which can only be assessed by a qualitative assessment of relevant forward look indicators judged to affect the outcome. Application of qualitative judgement to the credit portfolio at the assessment date can be achieved effectively and proportionately without expensive credit impairment models for UK GAAP Societies. A key requirement of this approach would be for the Board to clearly document factors identified as influencing the judgement and their application to each segment of the portfolio to determine the level of provisioning.

Retaining a realistic general/collective provision for assets based on information known and more importantly 'reasonably foreseeable' at the balance sheet date will permit early recognition of the likely deterioration in credit quality across the portfolio. With the transfer of loans to the specific provisioning bucket, on identifiable deterioration in credit quality and where full recovery of the advance and interest is not anticipated, provisioning can flow from the levels recognised in advance in collective to specific. The requirement for frequent re-appraisal of both specific and general provisions will ensure they recognise appropriate provisions for each point in the cycle.

The proposals outlined above are considered to represent a pragmatic solution to the determination of impairment provisions through an evolution of the current approach under UK GAAP and avoiding the disproportionate cost and complexity in development of formal impairment models. Proposals for enhanced disclosure improve the information available to our members.

[5] Skipton Building Society Annual Report & Accounts 2011 pgs 93-98

33. Financial instruments (continued)

The Group also has equity investments in Jade Software Corporation Limited and Northwest Investments NZ Limited which are denominated in New Zealand Dollars. The foreign currency fluctuations in relation to these equity investments are not material and are not hedged, but are recognised in the Group's translation reserve.

A number of the Group's businesses undertake transactions denominated in foreign currency as part of their normal business. Any amounts outstanding at the year end are not material.

Other price risk

As at 31 December 2011, the Group had a small amount of issued equity savings products outstanding. Derivative contracts to eliminate this exposure are taken out by the Group which exactly match the terms of the savings products and the market risk on such contracts is therefore fully hedged.

Credit risk

Credit risk is the risk of suffering financial loss should borrowers or counterparties default on their contractual obligations to the Group.

The Group faces this risk from its lending to:

- individual customers (retail mortgages);
- businesses (through historic commercial lending). The Society ceased new commercial lending in November 2008 when we concluded that the outlook for commercial property was poor; and
- other financial institutions (wholesale lending). Credit risk within our treasury portfolio assets arises from the investments held by the Group in order to meet liquidity requirements and for general business purposes.

Changes in the credit quality and the recoverability of loans and amounts due from counterparties influence the Group's exposure to credit risk. Adverse changes in the credit quality of counterparties, collateral values or deterioration in the wider economy, including rising unemployment, deterioration in household finances and further contraction in the UK property market leading to falling property values, could affect the recoverability and value of the Group's assets and influence its financial performance. A reversal of the economic recovery and continuation of the falls in house prices and commercial property values could affect the level of impairment losses.

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

The maximum exposure to credit risk is represented by the carrying amount of each financial asset, except for loans and advances to customers where a fair value adjustment for hedged risk of £240.9m (2010: £206.0m) is included.

Retail mortgage lending to customers

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

The Group has established comprehensive risk management processes in accordance with the Board's credit risk appetite which defines a number of limits regarding customer and collateral credit quality to which all lending activity must adhere. The Group maintains a low risk appetite for new lending.

The credit decision process is achieved by automated credit scoring and policy rules with lending policy criteria supporting manual underwriting. All aspects of the credit decision process are subject to regular independent review and development ensuring they support decisions in line with Board expectations.

The Group also has credit exposures through Amber and NYM which comprise residential UK mortgages, including buy-to-let, across prime and specialist lending markets. In light of the prevailing deteriorating economic conditions, new lending in these portfolios ceased in early 2008.

Commercial lending to customers and businesses

The Society retains a commercial mortgage portfolio which is UK based and, following a reduction in the Group's risk appetite, was closed to new lending in November 2008. We have retained an appropriately skilled team of staff to ensure these loans are managed appropriately and their credit performance is actively monitored.

Notes to the Accounts - continued

33. Financial instruments (continued)

Other loans

The majority of these loans have an original maturity of less than one year and include a number of business and personal loans, and loans made by our factored debt and invoice discounting business, Skipton Business Finance.

Wholesale lending to other financial institutions

Wholesale credit risk arises from the wholesale investments held by the Society's Treasury function, which is responsible for managing this aspect of credit risk in line with Board approved risk appetite and wholesale credit policies. Wholesale counterparty limits are reviewed monthly by the Group Wholesale Credit Committee based on analyses of counterparties' financial performance, ratings and other market information to ensure that limits remain within our risk appetite. During 2011, in light of the continuing uncertain global economic outlook, we have further reduced the number of counterparties to whom we will lend, and for those that remain, we have reviewed both the amount and duration of any limits.

A further deterioration in wholesale credit markets could lead to volatility in the Group's portfolio of available-for-sale assets together with the risk of further impairment within our treasury investments portfolio.

ALCO provides oversight to the effectiveness of wholesale credit risk management.

Credit risk - loans and advances to customers

The table below shows the mix of the Group's loans and advances to customers:

Loans and advances to customers	**Group**			
	2011		2010	
	£m	**%**	£m	%
Total residential mortgages	**9,532.5**	**94.4**	9,092.7	93.9
Commercial loans	**467.1**	**4.6**	501.2	5.2
Other lending:				
Debt factoring loans	**42.0**	**0.4**	39.5	0.4
Other loans	**58.4**	**0.6**	54.7	0.5
Gross balances	**10,100.0**	**100.0**	9,688.1	100.0
Impairment provisions	**(88.1)**		(79.4)	
Fair value adjustment for hedged risk	**240.9**		206.0	
	10,252.8		9,814.7	

a) Residential mortgages

The majority of loans and advances to customers are secured on UK residential properties with no particular geographic concentrations. By their nature, our residential lending books are comprised of a large number of smaller loans, and historically have a low volatility of credit risk outcomes.

The Group's portfolio of loans fully secured on residential property includes the Society, SIL, which lends in the Channel Islands, and the specialist mortgage lending in Amber Homeloans and North Yorkshire Mortgages.

The tables below provide further information on types of lending and geographical split.

Lending analysis	**Group**		**Society**	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Total book:				
Prime	**6,291.0**	5,678.1	**5,506.2**	4,929.9
Buy-to-let	**1,790.3**	1,801.6	**1,399.0**	1,397.1
Fast track	**182.8**	238.4	**182.8**	238.4
Self certified	**775.1**	827.3	**-**	-
Sub-prime	**445.7**	474.0	**-**	-
Self build	**47.6**	73.3	**47.6**	73.3
	9,532.5	9,092.7	**7,135.6**	6,638.7

33. Financial instruments (continued)

Geographical analysis	Group		Society	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Total book:				
North	**343.7**	334.3	**288.7**	275.1
Yorkshire	**1,012.3**	1,029.3	**885.1**	890.2
East Midlands	**596.7**	591.7	**476.5**	463.5
East Anglia	**562.8**	540.5	**437.8**	409.5
London	**1,175.6**	1,106.0	**853.1**	756.0
South East	**1,940.6**	1,815.4	**1,531.1**	1,362.7
South West	**795.2**	771.6	**645.3**	608.4
West Midlands	**554.9**	535.5	**423.8**	397.6
North West	**1,032.6**	1,039.7	**834.5**	832.5
Wales	**188.3**	178.5	**111.3**	97.9
Scotland	**690.8**	604.1	**613.6**	519.6
Northern Ireland	**68.7**	63.2	**34.8**	25.7
Channel Islands	**570.3**	482.9	**-**	-
	9,532.5	9,092.7	**7,135.6**	6,638.7

Loan-to-value information on the Group's residential loan portfolio is set out as follows:

Indexed loan-to-value analysis	Group		Society	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Total book:				
<70%	**3,980.9**	4,014.7	**3,497.6**	3,502.3
70% - 80%	**1,437.1**	1,253.5	**1,196.8**	1,016.6
80% - 90 %	**1,579.3**	1,355.8	**1,248.9**	1,006.7
>90%	**2,535.2**	2,468.7	**1,192.3**	1,113.1
	9,532.5	9,092.7	**7,135.6**	6,638.7

Indexed loan-to-value analysis	Group		Society	
	2011	2010	**2011**	2010
	%	%	**%**	%
Total book:				
<70%	**41.7**	44.1	**49.0**	52.7
70% - 80%	**15.1**	13.8	**16.8**	15.3
80% - 90 %	**16.6**	14.9	**17.5**	15.2
>90%	**26.6**	27.2	**16.7**	16.8
Average indexed loan-to-value	**55.5**	55.5	**50.9**	50.6

The indexed loan-to-value is updated on a quarterly basis to reflect changes in the Halifax house price index which is applied to the portfolio on a regional basis.

Notes to the Accounts - continued

33. Financial instruments (continued)

The table below provides further information on residential loans and advances by payment due status:

	Group				Society			
	2011		2010		**2011**		2010	
	£m	**%**	£m	%	**£m**	**%**	£m	%
Neither past due nor individually impaired	**8,981.6**	**94.2**	8,542.2	93.9	**6,967.5**	**97.7**	6,454.3	97.3
Past due but not individually impaired:								
Up to 3 months	**74.2**	**0.8**	91.1	1.0	**57.6**	**0.8**	74.9	1.1
3 to 6 months	**12.2**	**0.1**	15.1	0.2	**7.1**	**0.1**	9.4	0.2
6 to 9 months	**5.0**	**0.1**	4.8	0.1	**3.5**	**-**	3.1	-
9 to 12 months	**2.3**	**-**	3.3	-	**0.8**	**-**	2.2	-
Over 12 months	**3.3**	**-**	4.3	-	**0.9**	**-**	1.8	-
Total	**9,078.6**	**95.2**	8,660.8	95.2	**7,037.4**	**98.6**	6,545.7	98.6
Individually impaired	**420.8**	**4.4**	406.6	4.5	**89.6**	**1.3**	87.7	1.3
Possessions	**33.1**	**0.4**	25.3	0.3	**8.6**	**0.1**	5.3	0.1
	9,532.5	**100.0**	9,092.7	100.0	**7,135.6**	**100.0**	6,638.7	100.0

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

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

Notes to the Accounts - continued

Fair value of collateral held:	Group		Society	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Not individually impaired	**16,711.6**	15,946.5	**13,914.7**	13,025.1
Impaired	**424.2**	413.4	**96.1**	92.6
Possessions	**29.5**	22.1	**7.4**	4.6
	17,165.3	16,382.0	**14,018.2**	13,122.3

The collateral held consists predominantly of residential properties. The use of such collateral is in line with terms that are usual and customary to standard lending activities.

Upon initial recognition of loans and advances, the fair value of collateral is based on valuation techniques commonly used for the corresponding assets. In subsequent periods, the fair value is updated by reference to market price or indices of similar assets.