Pillar 3 Disclosures

Year ended 31 December 2019

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1. Introduction

The European Union (EU) introduced the legislative framework known as the Capital Requirements Directive in 2007. The framework governed how much capital building societies and banks must hold to protect their members, depositors and shareholders. The framework was expanded on 1 January 2014 to cover both the Capital Requirements Regulation (CRR) and the Capital Requirements Directive, collectively known as CRD IV.

CRR contain Pillar 1 and Pillar 3 requirements and is directly applicable by EU law. The accompanying CRD contains Pillar 2 measures that allow a degree of national discretion by the UK Regulator, being the Prudential Regulation Authority (PRA). The objectives of the legislation is to improve the financial services industry's ability to absorb shocks arising from financial or other economic stresses, so reducing the potentially destabilising impact on the financial sector in the real economy.

Penrith Building Society's (the Society's) aim is to ensure that members' savings are protected by maintaining sufficient levels of capital even at times of significant economic downturn.

Below are the three main 'Pillars' that make up the CRD:

Pillar 1 – Sets out the minimum capital requirements and uses a risk-based capital calculation focusing on credit and operational risk, to determine the CRR.

Pillar 2 – Assesses whether there are further capital requirements beyond Pillar 1. An annual exercise is carried out by the Society, the Internal Capital Adequacy Assessment Process (ICAAP) to consider the key risk factors facing the Society under stressed conditions and determines additional capital requirements to manage these risks. The most recent review was completed in December 2019.

Pillar 3 – This looks at disclosure of the CRD in relation to key information about risk management and capital. This document discloses the information in accordance with regulatory guidance.

The Society's overall capital requirement is reviewed by the PRA under the Supervisory Review and Evaluation Process (SREP), taking into account the ICAAP. From this an Individual Capital Guidance (ICG), being the regulatory minimum capital, the Society should hold, is set. The last review by the PRA of the capital requirements was completed in March 2019 and the Society continues to maintain a capital base significantly above the minimum regulatory requirements.

The figures quoted in this disclosure document are drawn from the Society's Annual Report and Accounts, year ended 31 December 2019, as published on the Society's website, www.penrithbs.co.uk but are not subject to audit.

This document is reviewed annually by the Board and is published on the Society's website to coincide with the release of the Society's results for the financial year end.

In the event that a reader of this document needs additional information, a request should be made in writing to the Finance Director at Penrith Building Society, 7 King Street, Penrith, CA11 7AR.

2. Risk assessment

The Society is primarily a producer and retailer of financial products, mainly in the form of mortgages and savings. These products give rise to a financial asset or liability and are termed financial instruments. As well as mortgage and savings, the Society also uses wholesale financial instruments to invest in liquid assets. The Society has also raised funds from the wholesale market to meet liquidity requirements.

The Board has an established risk management framework for the Society that is proportionate to both the size of the Society and the risks to which it is exposed. This framework enables the Board to identify, monitor, control and report on the key risks faced by the Society.

The Board has developed from the Society's vision, a statement of overall risk appetite, being that the Society:

"Put in place an appropriate risk management framework that sets out the amount of risk the Society is prepared to accept in pursuit of its objectives, being to achieve its strategic aims, support and direct financial stability, focus on treating our customers fairly and creating a Society built on trust. The Society would not knowingly take risks that threaten the capital position of the Society and the ability to continue as an independent building society"

The Society looks to manage the risks that arise from its operations. The ways in which risks are managed include using forecasting and stress test models to help guide business strategies; producing key risk information and indicators to manage and monitor performance; and using management and Board committees to monitor and control specific risks.

Board and committee structure

The Society's Board of Directors comprises two Executive Directors (Chief Executive and Finance Director) and six Non-Executive Directors. The Board members are professional and business people from a variety of backgrounds, bringing a mixture of skills and diversity together with sector knowledge.

The Board has delegated responsibilities to five sub-committees as follows:

Nominations Committee	- Comprises three Non-Executive Directors and the Chief Executive - Is responsible for: ▪ making recommendations on appointments to the Board ▪ ensuring that the Board has sufficient directors with appropriate skill sets, who are fit and proper and independent ▪ reviewing the Society's Succession Plan to ensure this remains appropriate to the on-going needs of the Society at least annually.
Asset and Liabilities Committee	- A management committee including the Executive Directors and members of the management team - Is responsible for: ▪ monitoring liquidity, treasury, interest, funding and basis risk ▪ reviewing product development for both savings and mortgages against the market ▪ reviewing forward looking economic data and how cash flow forecasts/budget projections respond to market conditions
Audit, Risk and Compliance Committee	- Comprises four Non-Executive Directors - Is responsible for: ▪ ensuring that the Society complies with all regulatory and prudential requirements ▪ reviewing the Society's internal controls and management systems ▪ ensuring an effective risk management framework is in place ▪ reviewing of the effectiveness of the compliance monitoring and internal audit functions, approval of their respective annual review plans ▪ monitoring of the external auditors' independence, objectivity and effectiveness
Executive Risk Committee	- A management committee including the Executive Directors, Head of Risk & Compliance and the Retail, Operations and Distribution Executive - A Non-Executive Director acts as the Society's risk champion and attends the ERC quarterly - Is responsible for: ▪ monitoring the core risk areas each month ▪ ensuring that risk events arising are being reported and resolved appropriately ▪ monitoring that controls for all risk areas are being managed effectively ▪ inputting to the ARCC on key risk areas for consideration from an audit perspective

Remuneration Committee	- Comprises all Non-Executive Directors - Is responsible for: ▪ Setting the Society's remuneration policy for Executive Directors ▪ Managing all other benefits and matters relevant to Executive Directors including contracts of employment with the Society ▪ Approving the annual payrises for the entire staff, based on recommendations from the Executive Directors

Three lines of defence

In considering risk within the Society risk management has been set up using the three lines of defence model. This can be summarised as follows:

First line of defence	Second line of defence	Third line of defence
Management controls (Individual Heads of Areas)	**Oversight function (Risk & Compliance Department)**	**Independent assurance (Internal Audit)**
- Takes risks in pursuit of business objectives - Ownership, accountability and responsibility for risk - Implement, maintain and monitor controls to mitigate risks identified	- Develops a risk management framework - Oversees and challenges risk management in the first line - Assists management in managing risks and issues	- Provides independent assurance over risks and the risk management framework - Reports to the Audit, Risk and Compliance Committee (ARCC) in order to perform its duties independently

Within the Society, each area of risk, as defined below, has been assigned to an individual risk owner, or group of owners as appropriate, who are the first line of defence and are responsible for the day to day management of risks across the Society through effective procedures and a robust control framework to which they attest on a quarterly basis.

For the second line of defence, the Society has a dedicated Risk & Compliance function, reporting into the Board through the Finance Director, who provide an independent internal control over how risk is being managed and responded to in the Society.

For the third line of defence, the Society outsources its internal audit services to a third party. The third party reviews the risk environment of the Society on an annual basis through discussions with the Executive Directors and members of the ARCC and from this formulates a risk based internal audit plan.

Changes to the risk environment during the year are monitored by the ERC monthly and ARCC on a quarterly basis. A summarised report is provided to the Board monthly. Any adjustments to the coverage of risk in any of the lines of defence can be made through either the Board, or more commonly the ARCC, to ensure the Society is not unduly exposed to changes in an existing area of risk or new areas of risk.

Requirements to react to changes in risks are initially tasked to the first line of defence, but as appropriate second and third lines of defence will undertake reviews to satisfy the ARCC and Board that risks are being appropriately controlled and mitigated in line with the approved risk appetite statement.

Consideration of the main risks faced by the Society is as follows:

Operational Risk

This is the risk of loss arising from failed or inadequate internal processes or systems, human error or other external factors.

Within operational risk the Society considers a number of different risk areas. These include IT, cyber, fraud, financial crime, personnel and physical risks to the business. The Society manages its operational risks through internal controls and various risk mitigation techniques, such as insurance cover and business continuity planning. Separate incident response plans have been put in place to manage the threat of cyber-attacks and other data security breaches.

Certain roles within the Society require specialist skills, which can be difficult to resource at short notice. To mitigate this risk the Society has a Succession Plan for all directors and senior members of staff.

The Society has adopted the Basic Indicator Approach (BIA) to operational risk which is expressed as a percentage of the average of the latest three years of the sum of net interest income and net non-interest income. The requirement for 2019 was £285,000.

Credit Risk

The main areas of credit risk for the Society are in respect of mortgage lending and treasury investments. The table below sets out the breakdown of credit risk under the Standardised Approach at 31 December 2019:

£000	Exposure	Risk Weighted	Capital Required
Liquidity			
Cash	50	-	-
Credit institutions	11,509	3,656	292
Gilts/ Treasury bills	9,979	-	-
Total liquidity	**21,538**	**3,656**	**292**
Loans and advances			
Residential performing loans	76,581	27,062	2165
Residential past due loans	705	705	56
Non-residential performing loans	11,950	4,182	335
Non-residential past due loans	-	-	-
Commercial loans	1,630	1,630	130
Commitments Pipeline	4,489	1,571	126
Total loans and advances*	**95,355**	**35,150**	**2,812**
Other exposures (fixed and other assets)	1,098	1,098	88
Total Credit Risk Exposures		**39,904**	**3,192**

*The Society's Annual Report and Accounts, year ended 31 December 2019 reports total loans and advances net of collective and individual provisions. The total here is before any provisions are applied and includes loan commitments.

Credit Risk – mortgages

Credit risk arising from mortgage loans to customers is managed through the Board approved Responsible Lending Policy and the monitoring and proactive management of arrears.

The Responsible Lending Policy reflects the Society's low credit risk appetite in mortgages. Consequently, the arrears profile of the Society is minimal. The Society had no properties in possession at 31 December 2019. The average loan to value of the mortgage book at 31 December 2019 was 42.31%.

The table below details the residential loan book by geographical area. An item is deemed 'past due' where a loan is over 3 months in arrears. The past due amounts relate to overall mortgage balances, not the amount in arrears. All commercial loans are in Cumbria.

	Residential		Non-residential	
	Performing	**Past Due**	**Performing**	**Past Due**
	£000	**£000**	**£000**	**£000**
Cumbria	43.29	0.71	6.97	-
Other England and Wales	32.40	-	6.41	-
Scotland	0.89	-	0.20	-
Totals	**76.58**	**0.71**	**13.58**	**-**

The residual maturity analysis for loans and advances to customers is provided in Note 13 of the Society's Annual Report and Accounts, year ended 31 December 2019 and is on the basis that loans and advances run for their full contractual term and does not take into account any instalments receivable over the life of the exposure. The Society's Annual Report and Accounts, year ended 31 December 2019 also provides full detail of the provisioning methodology in Note 1 along with the movement on provisions in Note 14.

The Society also insures its residential mortgage book against losses using Mortgage Indemnity (MIG) insurance. MIG is taken out on all lending where the loan to value (LTV) exceeds 80% at origination.

Credit Risk – counterparties

This is the risk that losses may arise due to the failure of a counterparty in a treasury investment, to meet the obligation to repay. It is the responsibility of the ALCO to manage this risk, through the maintenance of a list of approved counterparties and monitoring of activity against the limits set under the Board approved Liquidity Policy and Financial Risk Management Policy.

The Liquidity Policy and Financial Risk Management Policy have been drawn up to ensure that the Society can obtain the best possible return on its investments whilst operating within prudential limits in respect of counterparties.

In selecting counterparties and the limits to be applied to them, the Society makes use of rating information, balance sheet data, and any other background information available. The Society's policies require that funds are only invested in Government backed securities (Gilts or Treasury Bills), financial institutions with a minimum Fitch IBCA short term rating of F2 (unless a counterparty with a lower rating is expressly approved by the Board) and building societies which satisfy the Society's requirements in respect of the level of free capital available.

The limits applied to counterparties and the appointment of new counterparties must be approved by the Board. All counterparties and limits are reviewed as a minimum annually and more often as circumstances dictate.

The table below shows the breakdown of treasury investments by maturity (excluding cash), based on their rating at 31 December 2019. No exposures are impaired or past due:

	Maturity of Treasury Investments			
	Up to 3 mths	**3-12 mths**	**Over 12 mths**	**Total**
	£000	**£000**	**£000**	**£000**
Fitch rated F1+/F2	6,988	3,016	-	10,004
Building Society - rated	-	-	-	
- unrated	-	1,505	-	1,505
Gilts/ Treasury Bills	2,998	6,981	-	9,979
Totals	**9,978**	**11,502**	**-**	**21,488**

Interest Rate Risk (including Basis Risk)

This is the risk of changes to the financial position of the Society caused by changes in market interest rates. The Society has limited exposure to this risk as any fixed rate mortgage lending undertaken is matched by fixed rate retail savings and no derivative financial instruments are used.

The balance sheet is subject to a stress-test of a 2% rise/ fall in interest rates on a monthly basis. This is monitored by ALCO. Limits have been set at a maximum of 1.5% of capital. At 31 December 2019 the stress test recorded a £76,000 exposure to a movement in interest rates, compared to the limit of £160,000.

Liquidity and Financial Risk

This is the risk that the Society will be unable to meet its financial obligations as they fall due. The Liquidity Policy specifies the minimum levels of liquidity which must be held and the financial instruments in which that liquidity may be invested to ensure that there are sufficient funds available at all times to meet all calls, foreseen and unforeseen, on the Society. Monitoring of compliance with the Liquidity Policy is reported through the ALCO to the Board.

The key regulatory metric to monitor short term liquidity risk is the Liquidity Coverage Ratio (LCR) which measures the potential net cash outflow within a 30 day period under a prescribed set of assumptions as a proportion of high quality liquid assets that are held as a liquidity buffer. The regulatory requirement is that the LCR should be greater than 100%.

The LCR at 31 December 2019 was 437.08%.

Full detail of the financial risks and instruments used by the Society are given in Note 29 to the Society's Annual Report and Accounts, 31 December 2019.

Conduct Risk

This is the risk that the Society does not treat its customers fairly and of inappropriate consumer outcomes. The principles set out by the Financial Conduct Authority (FCA) to ensure the Society has due regard for the interests of its customers and to treat them fairly at all times, are firmly embedded within the Society's culture.

Regulatory Risk

This is the risk that the volume and complexity of regulatory issues may impact the Society's ability to compete and grow in the future. The Society is supervised by two regulators in the UK, the PRA and FCA. The Board monitors changes arising from both these supervisory bodies, together with European changes, to ensure the Society continues to meet all of its regulatory requirements.

3. Capital resources

The capital resources of the Society, split between Tier 1 and Tier 2 capital, are summarised below:

	2019
	£000
General Reserves	11,295
Common Equity Tier 1 (CET1) Capital	**11,295**
Collective Provision	107
Tier 2 Capital	**107**
Total Regulatory Capital	**11,402**
Total Risk Weighted Assets (RWA)	**41,809**
CET1 Ratio (as a % of RWA)	**27.02**
Total Regulatory Capital (as a % of RWA)	**27.27**

The Society's main source of capital is from retained profits, which are added to the general reserves each year.

In addition, the Society holds a collective provision for bad and doubtful mortgage debts, which qualifies as additional capital resources under Tier 2.

4. Capital adequacy assessment

Capital requirement

It is essential that the Society maintains sufficient capital to support its ongoing activities and this requirement is an integral part of the Society's corporate planning process. The Society's Corporate Plan projects forward three years and takes into account the need to maintain adequate financial and non-financial resources to support the Corporate Plan objectives.

In addition to the corporate planning process the Society reviews its capital position via the ICAAP. This process reviews the Society's capital requirement in normal and stressed conditions, taking into consideration all of the Society's business activities and key areas of risk, and determines levels of capital required to support each area.

The ICAAP acts as the Society's capital planning document for the period of the Corporate Plan.

It includes a calculation of the minimum Pillar 1 capital requirements for each year of the plan using:

- the Standardised Approach, applying a risk weighting of 8% to the risk weighted asset values to determine the minimum requirement for credit risk; and
- the Basic Indicator Approach, applying a risk weighting of 15% to the average net income over the previous three years to determine the minimum requirement for operational risk.

The Society is provided with a Total Capital Requirement (TCR) by the PRA, with the latest issued TCR set at 8% of risk weighted assets. TCR is the amount and quality of capital the Society must maintain to comply with the minimum capital requirements under the Capital Requirements Regulations (575/2013) (CRR)(Pillar 1) and the Pillar 2A capital requirements.

The table below summarises the Society's minimum Pillar 1 capital requirements and the total capital requirements:

	2019		
	Exposure	**RWA**	**Minimum Capital Required**
	£000	**£000**	**£000**
Credit Risk			
Total treasury exposures	21,538	3,656	292
Total loans and advances to customers*	90,866	33,579	2686
Fixed and other assets	1,101	1,101	88
Total on-balance sheet exposures	**113,505**	**38,336**	**3,066**
Mortgage pipeline	4,489	1,571	126
Total off-balance sheet exposures	**4,489**	**1,571**	**126**
Total Credit Risk Exposure	**117,994**	**39,907**	**3,192**
Operational Risk		**1,902**	**285**
Pillar 1: Minimum Capital Requirement		**41,809**	**3,477**
Total Regulatory Capital			**11,402**
Excess over Pillar 1 : Minimum Capital Requirements			**7,925**

*This is gross of individual and collective mortgage provisions and is therefore different to the Statement of Financial Position in the Annual Report and Accounts at 31 December 2019

Capital buffers

The Society is required to hold a Countercyclical Buffer (CCYB) dependent on the geographical breakdown of its assets. It is set by individual countries and is designed to limit excessive credit growth. As the Society is wholly located in the UK, the UK element of the CCYB is set by the Financial Policy Committee (FPC) and can range from 0% to 2.5%. At 31 December 2019 it was 1.0%. The Society's CCYB requirement is £417k.

Additionally, as with other UK financial institutions, the Society is required to hold a Capital Conservation Buffer (CCOB), which can be used to absorb losses during periods of economic and financial stress, to avoid breaching minimum capital requirements. The CCOB is also set as a percentage of RWA's and at 31 December 2019 was 2.5%. The Society's CCOB requirement is £1,042k.

Leverage ratio

The leverage ratio is a simple, transparent, non-risk based measure that allows a comparison between financial institutions. It is calculated as Tier 1 Capital divided by the adjusted balance sheet exposures, as follows:

	2019
	£000
Total assets as per published financial statements	113,385
Adjustments for off-balance sheet items (mortgage pipeline)	4,489
Leverage ratio total exposure measure	**117,874**
Tier 1 Capital	11,295
Leverage ratio	**9.58%**

CRD IV requires a minimum leverage ratio of 3.35%, which the Society has met at 31 December 2019.

5. Remuneration policies and practices

The Remuneration Policy ('the Policy') follows the 'Remuneration Code' guidelines put in place by the Financial Conduct Authority (FCA), which sets out the standards and policies the Society is required to meet when setting pay for Directors, focusing on the risks around the structure of remuneration arrangements rather than the absolute amount of remuneration.

The Policy is to reward Directors through salary or fees according to their skills, expertise, experience and overall contribution, taking into account salary and fee levels in comparable organisations. The policy is to set remuneration at levels sufficient to attract and retain Executive and Non-Executive Directors of sufficient calibre and expertise.

Executive Directors' remuneration comprises basic salary and pension benefits. The Society does not have bonus or share option schemes. Their salaries are considered by the Remuneration Committee which meets at least once a year. Salary levels are set having regard to job content and responsibilities, the performance of the individual and salaries in similar organisations. The Society does not have a defined benefit or final salary pension scheme. The Society makes contributions to the private pension arrangements of the Executive Directors.

The remuneration of all Non-Executive Directors is fee based and is reviewed annually by the Board. They do not participate in any performance pay scheme, pension arrangements or other benefits and do not have service contracts. The Chairman of the Board, Chairman of the ARCC, Chairman of Nominations and Risk Champion receive higher fees than other Non-Executive Directors in recognition of the additional workload and responsibilities incumbent on those positions.

An advisory vote on the Directors Remuneration Policy is taken at every Annual General Meeting.

Information on the relevant experience of the Executive and Non-executive Directors and details of their remuneration is provided in the Annual Review for the year ended 31 December 2019, which is available to download on our website www.penrithbs.co.uk

Remuneration Staff

The Remuneration Committee has determined that as at 31 December 2019, the three Executive Directors (being Chief Executive, Retail Operations Director and Finance Director) are designated as being Material Risk Takers (MRTs), as per the EBA technical standards; and are subject to both the PRA Remuneration Rules and the FCA SYSC 19D Dual Regulated Firms Remuneration Rules.

The table below sets out the aggregate remuneration for staff who are MRTs in relation to their services to the Society for the year ended 31 December 2019. All remuneration in both years was fixed.

	2019	
	No of staff	**Total remuneration £000**
Material Risk Takers (Executive Directors)	3	228