Pillar 3 Disclosures

Year ended 31st December 2017

PENRITH

BUILDING SOCIETY | for life

Contents

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 2017.

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 2015 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 2017. 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. Board and Committee structure

The Society's Board of Directors comprises three executive directors (Chief Executive, Retail Operations Director 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:

Remuneration Committee

The Remuneration Committee comprises all the non-executive directors. The Committee is responsible for setting the Society's remuneration policy for executive directors and settles all other benefits and matters relevant to executive directors including contracts of employment with the Society.

Nominations Committee

The Nominations Committee comprises of two non-executive directors and the Chief Executive. The Committee 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. It has an annual responsibility to review the Society's Succession Plan and to ensure this remains appropriate to the on-going needs of the Society.

Audit, Risk and Compliance Committee (ARCC)

The ARCC comprises three non-executive directors. The role of the ARCC includes ensuring that the Society complies with all regulatory and prudential requirements and reviewing the Society's internal controls and management systems. The ARCC is also responsible for the review of the effectiveness of the compliance monitoring and internal audit functions, approval of their respective annual review plans and the monitoring of the external auditors' independence, objectivity and effectiveness.

Conduct Risk Committee (CRC)

The CRC comprises one non-executive director and both executive directors. The role of the CRC is to review the Society's policies, procedures and collated management information in all areas having impact on the Society's members and makes recommendations thereon to the Board and management.

Assets and Liabilities Committee (ALCO)

The ALCO is a management committee comprising both executive directors and members of the senior management team. The role of the ALCO is to monitor liquidity, treasury and basis risk and to review product development for both savings and mortgages against the market. It reviews forward looking economic data and how the Society's cash flow forecasts and budget projections respond to market conditions.

3. Capital resources

The capital resources of the Society, split between Tier 1 and Tier 2 capital, are summarised below at 31 December 2017:

	£000
General Reserves	10,964
Common Equity Tier 1 Capital Resource	**10,964**
Collective Provision	72
Tier 2 Capital Resource	**72**
Total Capital Resource	**11,036**

The Society's main source of capital is from retained profits which are added to the general reserves that have accumulated since the Society's formation in 1877. In addition, the Society holds a collective provision for bad and doubtful mortgage debts, which qualifies as additional capital resources.

4. Capital requirements

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 Pillar 1 capital resource requirement for each year of the plan using:

- the Standardised Approach for credit risk; and
- the Basic Indicator Approach for operational risk,

applying a risk weighting of 10.25% of the Society's risk weighted assets under the approaches above.

The table below summarises the Society's Pillar 1 capital requirements as at 31 December 2017 by asset class:

	£000
Institutions	417
Secured on real estate property	2,495
Past due items	56
Other items	90
Total credit risk capital requirements	**3,058**
Operational Risk	259
Pillar 1: Minimum Capital Requirement	**3,317**
Total Capital Resources	11,036
Excess over Pillar 1	**7,719**

The main areas of impact to the Society from the CRD legislation are capital buffer requirements. These include higher thresholds for all forms of capital with an increased focus on Common Equity Tier 1 (CET1).

The Society has always maintained a strong capital position and as at 31 December 2017, the Society's CET1 ratio was 28.36% (2016: 26.6%). This is significantly above the initial capital requirements of 4.5% outlined in the CRD.

The Society was last subject to a formal SREP by the PRA in March 2015. The PRA issued Individual Capital Guidance (ICG) confirming the percentage of risk weighted assets under Pillar 1 to be held as 10.25% from 1 January 2016 until advised otherwise.

In addition to the capital buffers calculated under Pillar 1, from 2016 the Society was required to hold a capital conservation buffer equivalent to 2.5% of risk weighted assets. In addition, during periods of excessive credit growth in the market, a countercyclical buffer, also equivalent to 2.5% of risk weighted assets, may be required. Neither of these additional buffer requirements would cause concern for the Society, based on the CET1 capital resource at this time.

The legislation also introduces a leverage ratio measure. The Basel Committee is using the period to 2017 to test a minimum Tier 1 leverage ratio of 3.0%. At 31 December 2017, the Society's Tier 1 leverage ratio is 10.1% (2016: 9.8%).

There is still further work to be completed by the European Banking Authority (EBA) and the PRA to embed the changes in legislation across the sector and the Society will continue to monitor this area and comply with necessary reporting changes as they arise.

5. Key risks

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 may also raise funds on the wholesale market if considered necessary, although it has not had the need to raise funds in this way for many years.

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.

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.

For the second line of defence, the Society has a dedicated Head of Risk & Compliance, reporting into the Board, who provides an independent internal control over how risk is being managed and responded to in the Society. Due to the size of the Society and conflicts of interest which may arise in fulfilling this role, a co-source arrangement is in place with an external third party to provide support in undertaking reviews of certain business areas. This third party also provides operational support to the Society on an ad-hoc basis across all areas of risk and compliance which may arise, including emerging risks and PRA developments in this area.

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 Board monthly and ARCC on a quarterly basis. 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 2017 was £259,000 (2016: £200,000).

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 2017:

£000	**Exposure**	**Risk Weighted**	**Capital Required**
Liquidity			
Cash	55	0	0
Credit institutions	15,547	5,214	417
Gilts/ Treasury bills	9,989	0	0
Total liquidity	**25,591**	**5,214**	**417**
Loans and advances			
Residential performing loans	66,546	23,613	1,889
Residential commitments	4,630	1,621	130
Non-residential performing loans	12,050	4,218	337
Commercial loans	1,738	1,738	139
Past due items	706	706	56
Total loans and advances*	**85,670**	**31,896**	**2,551**
Other exposures (fixed and other assets)	1,128	1,128	90
Total Credit Risk Exposures		**38,238**	**3,058**

*The Society's Annual Report and Accounts, year ended 31 December 2017 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 three properties in possession at 31 December 2017 and continues to manage these to minimise any loss to the Society from their subsequent disposal. No new arrears cases of concern have arisen during 2017. The average loan to value of the mortgage book at 31 December 2017 was 43.72% (2016: 43.60%).

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	43,424	303	9,066	191
Other England and Wales	22,539	212	2,984	-
Scotland	583	-	-	-
Totals	**66,546**	**515**	**12,050**	**191**

The residual maturity analysis for loans and advances to customers is provided in Note 14 of the Society's Annual Report and Accounts, year ended 31 December 2017 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 2017 also provides full detail of the provisioning methodology in Note 1 along with the movement on provisions in Note 15.

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 F1 (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 2017. 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/F1+	5,523	4,012	-	9,535
Building Society - rated	502	501	-	1,003
- unrated	2,505	2,504	-	5,009
Gilts/ Treasury Bills	3,000	6,989	-	9,989
Totals	**11,530**	**14,006**	**-**	**25,536**

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 2017 the stress test recorded a £135,000 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.

Full detail of the financial risks and instruments used by the Society are given in Note 27 to the Society's Annual Report and Accounts, 31 December 2017.

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.

The Society has a separate Conduct Risk Committee, a sub-committee of the Board, which meets on a quarterly basis to review management information, both quantitative and qualitative in respect of conduct related matters.

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.

6. Directors

The Society's remuneration 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 executives 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 and the Chairman of the CRC 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 2017, which is available to download on our website www.penrithbuildingsociety.co.uk.

Remuneration Staff

The Remuneration Committee has determined that as at 31 December 2017, 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 2017.

	2017		2016	
	No of staff	**Total remuneration £000**	**No of staff**	**Total remuneration £000**
Material Risk Takers (Executive Directors)	3	244	2	206