Penrith Building Society

Pillar 3 Disclosures

Year ended 31st December 2013

PENRITH

BUILDING SOCIETY | for life

1. Introduction

The European Union introduced the legislative framework known as the Capital Requirements Directive (CRD) from the start of 2007. This framework is commonly known as Basel 2 and governs how much capital all banks and building societies must hold to protect their members, depositors and shareholders.

In the UK, the Prudential Regulation Authority (PRA) is responsible for ensuring that the banks and building societies that it regulates have implemented the CRD. 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 Capital Resource Requirement (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 July 2013.

Pillar 3 – This looks at disclosure of capital requirements under Pillars 1 and 2 and is in accordance with the Rules laid down in the PRA handbook, BIPRU Chapter 11.

The Society's overall capital requirement is reviewed by the PRA under the Supervisory Review and Evaluation Process (SREP), taking into account the Society's 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 August 2013.

The figures quoted in this disclosure document are drawn from the Society's Annual Report and Accounts as at 31st December 2013.

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 user 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 7QY.

2. Risk Management Policies and Objectives

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

Credit Risk
This is the risk that losses may arise due to the failure of the borrower or counterparty to meet the obligation to repay. The Board is responsible for reviewing the Society's Responsible Lending Policy and the monitoring of arrears. The Board has delegated responsibilities to the Assets and Liabilities Committee (ALCO) for the maintenance of the list of approved counterparties and the limits applicable to each of those counterparties under the Society's Liquidity Policy. The institutions in which the Society invests are based in the UK and include banks and other building societies and are maintained in line with the Building Society's Sourcebook (BSOCS) limits.

Liquidity Risk
This is the risk that the Society will be unable to meet its financial obligations as they fall due. The Society's 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.

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

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. There is no intention to move to a more advanced approach in the short to medium term.

The Society manages its operational risks through internal controls and various risk mitigation techniques, such as insurance and business continuity planning.

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.

Concentration Risk
As a local building society, it is considered that the Society faces concentration risk because its activities are highly concentrated in residential lending funded by retail savings. The Society faces geographical concentration risk as the majority of its products are held by customers based in Cumbria, but both lending and savings on a more national basis are being encouraged to reduce this risk and the customer profile is monitored by management and the Board.

The Society monitors at Board level its concentration risk arising from large exposures (to borrowers and liquidity counterparties) which arise as a result of the relatively small size of the Society.

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. Since April 2013 the Society has been 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.

Residual Risk
The Society holds capital to cover events that can be anticipated with a reasonable degree of certainty and also to cope with scenarios that result from stressed conditions. The level of capital maintained is in excess of the minimum requirement of the PRA.

Full detail of the financial risks and instruments used by the Society are given in Note 24 to the Annual Report and Accounts, 31st December 2013, which are available on the Society's website.

3. Main Board and Committee Structure

The Society's Board of Directors comprises two executive directors (Chief Executive and Finance Director) and five 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:

Audit, Risk and Compliance Committee (ARCC)
The ARCC comprises 3 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 ARC 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 2 non-executive directors and 1 executive director. 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 management team. The role of the ALCO is to monitor liquidity and treasury 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 cashflow forecasts and budget projections respond to market conditions.

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 skills sets, who are fit and proper and independent. The Committee 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.

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. The Committee also settles all other benefits and matters relevant to Executive Directors including contracts of employment with the Society.

4. Risk weighted exposure amounts and operational risk capital

The Society has adopted the 'Standardised' approach to credit risk as specified by the CRD. As noted earlier, it uses the BIA to evaluate additional capital required to cover the operational risk associated with the Society's activities. The resulting capital requirements at 31st December 2013 are as follows:

	Exposure £000	**Risk Weighted £000**	**Capital Required £000**
Liquidity			
Cash	18	0	0
Credit Institutions	24,103	8,543	683
Gilts	3,206	0	0
Treasury Bills	4,003	0	0
Total liquidity	**31,330**	**8,543**	**683**
Loans and advances			
Residential performing loans	58,704	20,636	1,651
Non-residential performing loans	1,795	1,795	144
Past due items	1,086	1,086	87
Total loans and advances*	**61,585**	**23,517**	**1,882**
Other exposures (fixed and other assets)	**704**	**704**	**56**
Total Credit Risk Exposures	**93,619**	**32,764**	**2,621**
Operational Risk			**179**
Off balance sheet items (mortgage commitments)	**5,052**	**1,010**	**81**
Total Pillar 1 Capital Requirement			**2,881**

*The Annual Report and Accounts as at 31st December 2013 reports total loans and advances net of all general and specific provisions. The total here is before any provisions are applied.

In June 2013, the European Union Council formally adopted the Capital Requirement Directive (CRD) IV package. This package consists of two legislative instruments that amend and replace the existing capital requirement directives.

The Capital Requirement Regulations contain Pillar 1 and Pillar 3 requirements and is directly applicable by EU law. The accompanying Capital Requirement Directive contains Pillar 2 measures that allow a degree of national discretion by the UK Regulators, being the PRA. The objectives of the new 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. The CRD IV legislation was implemented on 1 January 2014.

The main areas which will impact on the Society are capital buffer requirements. These include higher thresholds for all forms of capital with an increased focus on Common Equity Tier 1. The Society has always maintained a strong capital position and as at 31st December 2013, the Society's CET1 ratio was 31.00%. This is significantly above the initial capital requirements outlined in the legislation.

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 31st December 2013, the Society's Tier 1 leverage ratio is 10.88%.

There is still further work to be completed by the European Banking Authority 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. Capital resources and business strategy

The capital resources of the Society are calculated under Pillar 1 of the CRD. Total assets at 31st December 2013 were £93,381,628.

At 31st December 2013 the Society's capital resources totalled £10,247,271 and comprised:

Common Equity Tier 1- Accumulated profits held as general reserves	£10,156,996
Common Equity Tier 2 – General provisions for bad debts	£90,275

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.

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 is required to undertake an ICAAP which is a formal process that calculates the Society's capital requirement in normal and stressed conditions. The ICAAP process involves reviewing all of the Society's business activities and calculating the capital required to support them.

The Society undertakes regular stress testing with the results of this testing influencing business decisions on an on-going basis.

The Society has in place lending limits for both mortgages and the investment of surplus funds which control the level of exposures which the Society may have in those areas of business.

6. Credit risk - counterparties

The Society's 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 at least once annually and more often as circumstances dictate.

	Maturity Of Treasury Investments			
	Up to 3 mths	**3-12 mths**	**Over 12 mths**	**Total**
	£000	**£000**	**£000**	**£000**
Fitch rated F1/F1+	9,478	8,586	1,014	19,078
Fitch rated F2	1,016	-	-	1,016
Building Society - rated	504	1,503	-	2,007
- unrated	501	1,501	-	2,002
Gilts and Treasury Bills	4,858	154	2,197	7,209
Cash	18	-	-	18
Totals	**16,375**	**11,744**	**3,211**	**31,330**

7. Credit risk - mortgages

The Society's current Responsible Lending Policy, as agreed by the Board, reflects the Society's low credit risk appetite in mortgages. Consequently, the arrears profile of the Society is minimal. The Society had taken a portfolio of properties into possession at the start of 2013 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 2013. The average loan to value of the mortgage book at 31st December 2013 was 37.39%.

The table below details the 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.

	Residential		Non-residential	
	Past Due	**Performing**	**Past Due**	**Performing**
	£000	**£000**	**£000**	**£000**
Postcode areas CA10, CA11	723	18,579	187	1,458
Other CA postcodes	167	10,799	-	-
Other England and Wales	9	29,054	-	337
Scotland	-	272	-	-
Totals	**899**	**58,704**	**187**	**1,795**

8. Mortgage loss provisions

Loss provisions are calculated following an appraisal of all outstanding loans and other assets.

Specific provisions are considered for all loans which are 3 months or more in arrears or where a mortgaged property has been taken into possession. A provision is made where the loan balance plus any likely costs to be incurred exceeds the estimated sale value of the property.

General provisions are based on the Society's experience and general economic conditions and are made against the loan book overall, excluding any loans specifically provided for, to cover potential losses which may arise due to unforeseen events.

The Society's general and specific provisions are detailed below:

	Loans fully secured on residential property		Loans fully secured on land		
	Specific	**General**	**Specific**	**General**	**Total**
	£	**£**	**£**	**£**	**£**
As at 1st January 2013	179,189	76,893	20,536	13,382	290,000
Amount utilised in year	(47,166)	-	(20,853)	-	(68,019)
(Credit)/ charge for the year	(87,082)	-	85,376	-	(1,706)
As at 31st December 2013	**44,941**	**76,893**	**85,059**	**13,382**	**220,275**

9. Directors Remuneration

The Society's remuneration policy is to reward Directors through salary and fees according to their skills, expertise, experience and overall contribution, taking into account salary and fee levels in comparable organisations.

The Society's policy is to set remuneration at levels sufficient to attract and retain executives 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 Chief Executive's and Finance Director's contracts of employment require a 12 month and 6 month notice period respectively.

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 Audit, Risk and Compliance Committee and the Chairman of the Conduct Risk Committee 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.

Details of remuneration are shown below:

Fees for services as non-executive directors:		**2013**	**2012**
		£	**£**
J S Hollins-Gibson		15,164	14,109
G Silburn		11,786	10,454
D Driver		11,786	11,122
A G Waterfield		9,798	9,653
R J Cairns (Appointed 1st May 2013)		6,532	-
P O'M Campbell (Retired 30th April 2013)		3,266	10,975
G M Rigg (Retired 30th September 2013)		7,348	9,653
Total for non-executive directors		**65,680**	**65,966**
Fees for services as executive directors:			
A S Fazal	- Salary	100,000	75,004
	- Pension contributions	10,000	8,000
E L James (Appointed 1st January 2013)	- Salary	70,000	-
	- Pension contributions	7,000	-
C Hayward (Retired 31st December 2012)	- Salary	-	76,167
	- Pension contributions	-	34,000
Total for executive directors		**187,000**	**193,171**
Grand Total		**252,680**	**259,137**