

# LOUGHBOROUGH BUILDING SOCIETY

## Pillar 3 Disclosures as at 31 October 2009

### Introduction

1. At the beginning of 2007, a new legislative framework, the Capital Requirements Directive (CRD - also referred to as 'Basel 2') was introduced in the European Union. This framework represents a new approach to capital adequacy for building societies governing the amount of capital required to be held by them in order to provide security for members and depositors. The Society seeks to ensure that it protects members savings by holding sufficient capital at all times.
2. The Financial Services Authority (FSA) is the regulator of Loughborough Building Society ("[The Society](#)") and is responsible for implementing the CRD in the UK. The Society adopted the new legislation on 1st January 2008, in line with the timetable agreed with the FSA. The Standardised approach was used for Credit risk, section 30, and the Basic Indicator Approach for Operational risk, section 31
3. The CRD comprises 3 main elements, or 'Pillars', as follows:
  - [Pillar 1](#): Minimum capital requirements, using a risk based capital calculation focussing particularly on credit and operational risk, to determine the Capital Resources Requirement (CRR).
  - [Pillar 2](#): Internal capital adequacy assessment process (ICAAP) and supervisory review and evaluation process (SREP). The Board of the Society has undertaken an assessment of all of the key risks facing the Society and additionally has stress tested those risks to establish a level of additional capital to be held under Pillar 2. This has then been reviewed by the FSA as detailed in section 4 below, as part of their SREP in September 2009.
  - [Pillar 3](#): This policy document deals with the requirements under Pillar 3 (disclosure) and the information provided is in accordance with the Rules laid down in the FSA handbook, BIPRU, section 11.
4. The Society Board approved the Society ICAAP dated October 2008 and it was then submitted to the FSA, prior to their visit in September 2009. The previous level of ICG set following the SREP in May 2008 has been updated and the October 2009 ICAAP is now concluded with the FSA advising of the percentage of Pillar 1 plus a capital add-on as the minimum capital requirement.
5. Whilst this capital requirement is higher than the level indicated in the Society ICAAP, actual Society capital held is significantly in excess of either measure.
6. The figures quoted in this disclosure have been drawn from the Society's Annual Report and Accounts as at 31 October 2009, unless otherwise stated.

### Risk Management Objectives and Policies

7. The Board is responsible for determining a framework for risk management and control. It approves all policies and Committee terms of reference. The Executive Directors are responsible for designing, operating and monitoring risk management and internal control processes. The Society uses a risk register to assess the likelihood and impact of its key risks. This is reviewed twice a year by the Board and it forms a base for the identification of risks for incorporation into the ICAAP under Pillar 2.
8. The Board Assets and Liabilities Committee (ALCO), comprising both non-executive and executive directors, is responsible for monitoring risks on both sides of the balance sheet. This is explained more fully in section 20. The Board Audit and Compliance Committee, consisting solely of non executives, considers the adequacy of internal controls, the Compliance function and the evaluation of risks. The system of internal control is designed to enable the Society to achieve its corporate objectives within a managed risk profile, not to eliminate risk.
9. The internal audit function provides independent and objective assurance that these processes are appropriate and effectively applied.

10. The principal business and financial risks to which the Society is exposed are credit, market, liquidity, regulatory, strategic and operational, these are detailed in sections 11 to 23 below.
11. Credit risk is the risk that losses may arise as a result of failure by a borrower or counterparty to meet its obligation to repay. The Board is responsible for reviewing the Lending policy of the Society and monitoring the arrears profile. The ALCO monitors exposure to treasury counterparties as detailed in section 42 below. Concentration risk, which adds a further dimension to credit risk, arises as a result of the concentration of exposures within the same category, whether it is geographical location, product type, industry sector or counterparty type. These risks are managed through adherence to Board-approved lending and liquidity policies, which provide for a range of limits that are regularly monitored and reviewed in the light of changing economic conditions and Society objectives.
12. The Society is predominantly a residential mortgage lender, which means that it is exposed to the housing market in England and Wales by virtue of its statutory nature limits. Within the residential mortgage business, the Society's main concentration risk is geographical, as the majority of its lending is in the East Midlands region, where the Society has its core area of operation.
13. Product type concentrations also exist in the Society's mortgage balances, in relation to commercial mortgages and buy-to-let mortgages. These are monitored regularly by the Board to ensure that lending policy limits are not exceeded. All concentrations are managed within limits which the Board believes are appropriate to current economic conditions and Society objectives. Commercial lending ceased during the year to October 2009.
14. The Board has ensured that the Society ICAAP makes provision for an additional amount of capital to be available to cover any downturn in house prices or increased mortgage losses, during periods of negative growth in the U.K.
15. Market risk incorporates the loss of income, mainly as a result of changes to interest rates. Exposure to this risk is primarily managed through a combination of natural hedges that exist in the Society balance sheet together with appropriate hedging contracts with external counterparties, as permitted under the Board Financial Risk Management policy. This is considered more fully in sections 43 to 47 below.
16. Liquidity risk concerns the Society's ability to meet its financial obligations, as they fall due as a result of imbalances in the cash flow of its activities. This risk is managed through adherence to the Board policies for both Liquidity and Financial Risk Management.
17. Regulatory Risk considers the risk that the volume and complexity of regulatory issues may impact on the Society's ability to compete over time.
18. Strategic Risk is the risk that the Society is exposed to external factors. These are considered by the Board as part of the corporate plan process, ensuring that the Society makes an adequate amount of profit and maintains sufficient capital.
19. Operational risk is associated with the Society's internal processes and systems and the potential for these not to function properly. It also covers human error and external events.
20. In addition to the operational risk function, the Society has a formal structure for managing financial risk, which includes the establishment of risk limits, reporting lines, mandates and other control procedures. The ALCO is charged with responsibility for managing and controlling balance sheet exposures and the use of financial instruments for risk management purposes.
21. Full details regarding the financial risks and instruments used by the Society are given in the Annual Report and Accounts 2009, Note 21, Financial Instruments.
22. The Board recognises that there are residual risks inherent in any business, which may not be identified specifically. Adequate provision has been made for general residual risks in the ICAAP by applying a buffer to the individual capital guidance (ICG) requirement issued by the FSA.
23. Loughborough Building Society has capital ratios in line with peer group society averages, as a

result of which the Society is able to maintain overall capital at a level well in excess of the ICG, even after the addition of the internal buffer referred to above.

## Capital Resources

24. Total Society capital resources at 31 October 2009, amount to £18.8m. This is made up predominantly of Tier 1 capital: general reserves (the accumulated profits of the Society,) Tier 2 capital is made up of revaluation reserves and general provisions for bad and doubtful debts.
25. [Table 1](#) provides details of the positive and negative components of Tier 1 capital, Tier 2 capital and total capital within the Society.

<b>TABLE 1</b>	<b>Society</b>
<b>Tier 1 capital resources</b>	<b>£m</b>
Gross (accumulated profits held as general reserves)	17.4
Deduction:	-
<b>Net Tier 1 capital resources</b>	<b>17.4</b>
<b>Tier 2 capital resources</b>	
Gross (general provisions for bad and doubtful debts)	0.7
Gross (revaluation reserves)	0.7
Deduction:	-
<b>Net Tier 2 capital resources</b>	<b>1.4</b>
<b>Total capital resources</b>	
Gross	18.8
Deduction	-
<b>Net Total capital resources</b>	<b>18.8</b>

## Capital Adequacy Assessment

26. The Society maintains a three-year strategic planning framework, this is reviewed by the Society's Board annually to take account of current and changing economic conditions. The process culminates in the annual production of a three-year corporate plan with detailed budgets covering the following year's activities.
27. The corporate plan is driven by reference to the Society ICAAP submission and in particular the Board's risk appetite for different business activities/risks.
28. The Society ICAAP also contains the capital plan for the next three years and the Board ensures that there are adequate capital resources to support the corporate goals contained within the plan.
29. In order to produce a detailed capital plan, the Society ICAAP contains calculations of the capital resources requirement (effectively, the minimum capital required) each year using the standardised approach for credit risk and the basic indicator approach for operational risk.
30. Under the standardised approach for credit risk, the Society applies a risk weighted asset value to each of its exposure classes and provides 8% of that risk weighted asset value as the minimum capital requirement for credit risk.
31. Under the basic indicator approach for operational risk, the Society calculates its average net income over the previous three years and provides 15% of that average net income as the minimum capital requirement for operational risk.
32. [Table 2](#) provides details of the calculation of capital resource requirements within the Society as at 31 October 2009, covering both liquidity and mortgage exposures.

TABLE 2			
CAPITAL RESOURCES REQUIREMENT	SOCIETY		
	Exposure £m	Risk weighted assets value £m	Minimum capital required £m
<b>Credit risk</b>			
<i>Non-cash liquidity exposures:</i>			
Central government (UK Gilts)	-	-	-
Regional & local government	-	-	-
Credit institutions	72.9	16.6	1.3
<b>Total non-cash liquidity exposures</b>	<b>72.9</b>	<b>16.6</b>	<b>1.3</b>
<i>Loans &amp; advances to customers</i>			
Non-residential & business - performing loans	15.9	15.7	1.3
Non-residential & business - past due loans	0.6	0.6	0.0
Residential use - performing loans	184.9	66.8	5.4
Residential use - past due loans	3.0	3.1	0.2
<b>Total loans &amp; advances to customers</b>	<b>204.4</b>	<b>86.2</b>	<b>6.9</b>
<i>Other exposures</i>			
Fixed and other assets	1.3	1.3	0.1
<b>Total other exposures</b>	<b>1.3</b>	<b>1.3</b>	<b>0.1</b>
<b>Credit risk - capital resources required</b>	<b>278.6</b>	<b>104.1</b>	<b>8.3</b>
<b>Operational risk - capital resources required</b>			<b>0.6</b>
<b>Society total capital resources required</b>			<b>8.9</b>

## Credit Risk-Mortgages

33. The Society regards as 'past due' any mortgage or loan account where more than three monthly repayments have not been made at the accounting date. Arrears of mortgage repayments are monitored closely and the Society has performed satisfactorily in comparison with national arrears and possession statistics.

34. [Table 3](#) provides a Society analysis, for capital adequacy purposes, of loans and advances exposures at 31 October 2009:

TABLE 3						
Society	Non-residential			Residential		
Loans and advances exposures 31 October 2009	Performing £m	Past Due £m	Total £m	Performing £m	Past Due £m	Total £m
Society	15.9	0.6	16.5	184.9	3.0	187.9
<b>TOTAL</b>	<b>15.9</b>	<b>0.6</b>	<b>16.5</b>	<b>184.9</b>	<b>3.0</b>	<b>187.9</b>

35. A reconciliation of the above table to Note 12 of the Annual Report and Accounts 2009 'Loans and advances to customers' is provided in [Table 4](#):

TABLE 4	
Reconciliation of Society Loans and Advances to Customers	£m
Society loans and advances to customers per note 12, Report & Accounts	203.6
Add back: General and Specific loss provisions	0.8
<b>Society accounting value of loans and advances to customers</b>	<b>204.4</b>
Total residential exposures for capital adequacy purposes	187.9
Total non-residential exposures for capital adequacy purposes	16.5
<b>Society capital adequacy value of loans and advances to customers</b>	<b>204.4</b>
Adjustments to reflect different reporting requirements and timing differences	-
<b>Reconciled value of loans and advances to customers</b>	<b>204.4</b>

36. A geographical analysis of Society exposures, shown in table 3, is given in [Table 5, below](#):

<b>TABLE 5</b>						
<b>Society</b>	<b>Non-residential</b>			<b>Residential</b>		
	Performing £m	Past Due £m	Total £m	Performing £m	Past Due £m	Total £m
North	-	-	-	3.1	-	3.1
Yorkshire & Humberside	-	-	-	8.3	0.1	8.4
North West	0.4	-	0.4	10.2	0.0	10.2
East Midlands	13.8	0.5	14.3	109.3	2.2	111.5
West Midlands	1.3	-	1.3	10.4	0.1	10.5
East Anglia	0.1	-	0.1	6.0	0.2	6.2
South East	0.3	0.1	0.4	18.9	0.2	19.1
Greater London	-	-	-	5.3	0.2	5.5
South West	-	-	-	9.9	-	9.9
Wales	-	-	-	3.5	-	3.5
<b>Total</b>	<b>15.9</b>	<b>0.6</b>	<b>16.5</b>	<b>184.9</b>	<b>3.0</b>	<b>187.9</b>

37. A residual maturity analysis of Loans and Advances to customers is provided at Note 12 of the Annual Report and Accounts 2009. The following caveat is added: 'This maturity analysis assumes that loans and advances run for their full, agreed term. In practice, mortgage loans seldom continue to the agreed maturity date and, therefore, the actual repayment profile is likely to be significantly different from that disclosed'.

## Provisions

38. The Society's accounting policy in relation to the provision for loans and advances is recited in full at Note 1, accounting policies, to the Annual Report and Accounts 2009.

39. Full details of the movements on provisions for bad and doubtful mortgage debts are provided at Note 11 to the Annual Report and Accounts 2009.

40. For capital adequacy purposes, general provisions are regarded as Tier 2 capital (Table 1 above). Summarised details of the specific provision movements during 2009 are given in [Table 6](#):

<b>TABLE 6</b>				
<b>Specific Provisions - 2009</b>	<b>Brought forward £m</b>	<b>Written Off £m</b>	<b>Movement £m</b>	<b>Carried Forward £m</b>
<b>Society</b>				
Non-residential	-	-	0.1	0.1
Residential	0.1	0.1	0.1	0.1
<b>Total</b>	<b>0.1</b>	<b>0.1</b>	<b>0.2</b>	<b>0.2</b>

41. Specific provisions of £0.2m have been utilised to adjust downwards the value of residential risk-weighted assets in the capital adequacy calculations.

## Credit Risk-Treasury

42. The purpose of the treasury credit risk policy is to ensure that the Society operates to obtain the best possible return, within prudent limits in respect of counterparties in terms of both amount invested and counterparty rating.

Investments in banks and building societies are held purely for liquidity purposes. The minimum policy ratings are generally short term F1 and long term A-, although treasury deposits are also made with unrated building societies.

Policy limits and counterparties are regularly reviewed by the Board Assets and Liabilities Committee, with formal policy approval being made at Board level. The Society receives regular counterparty grading amendments from its Treasury advisors and limits may be suspended following adverse downgrades.

The following table shows the breakdown of liquid assets by maturity and rating at 31 October 2009

under the standardised approach.

Table 7	Maturity less than 3m £m	3 months to 1 year £m	Over 1 year £m	Total £m
Rating				
AAA to AA-	36.16	8.80	3.25	48.21
A+ to A-	2.30	0.00	1.90	4.20
BBB+ and below	0.00	0.00	0.00	0.00
Unrated Building Societies	15.50	5.00	0.00	20.50
<b>TOTAL</b>	<b>53.96</b>	<b>13.80</b>	<b>5.15</b>	<b>72.91</b>

## Interest Rate Risk

43. Interest rate risk is referred to under the heading of Market Risk, in section 15 of this disclosure document. The main activities undertaken by the Society that give rise to interest rate risk are as follows:
- Management of the investment of capital and other non-interest bearing liabilities;
  - Issue of fixed rate savings products;
  - Fixed rate wholesale funding taken by the Finance department;
  - Fixed rate mortgage and other lending; and,
  - Fixed rate investments by the Finance department.
44. Interest rate risk is managed by utilising natural hedges on the balance sheet and by effecting interest rate swaps with external counterparties.
45. The interest rate risk on savings and mortgage products is reviewed on a regular basis and hedging action taken as appropriate.
46. The Society balance sheet is tested against Board gap limits on a monthly basis for the effects of a 3% parallel shift in interest rates, after the appropriate adjustment of capital allocations.
47. Interest rate risk limits are an expression of the Board's risk appetite and are reviewed annually as an integral part of updating the Society ICAAP.

## Conclusion

48. This disclosure document, prepared in accordance with the requirements of BIPRU 11, as interpreted for the Society, is intended to provide background information on the Society's approach to risk management. It also provides asset information and capital calculations under Pillar 1. The disclosures are published within 4 months of the Society's financial year end and are updated annually.
49. In the event that a user of this disclosure document requires further explanation on the disclosures given, application should be made, in writing, to the [Finance Director at Loughborough Building Society, 6 High Street, Loughborough, Leicestershire LE11 2QB](#).

# Appendix to Loughborough Building Society Pillar 3 Disclosure Document

## BIPRU 11 - Disclosure Policy (CRD Pillar 3)

### Introduction

1. This policy covers the operations of the Loughborough Building Society and codifies the disclosure requirements of CRD Pillar 3, as set down in [BIPRU 11](#) and as relevant to the scale of operations of the Society.
2. This policy has been approved by [the Board](#) of the Society and is subject to [annual review](#) by that Board.
3. This policy is made on the basis that the Society has adopted the [standardised approach](#) to credit risk and the [basic indicator approach](#) to operational risk and that no other approaches are appropriate.

### Frequency of Publication of Disclosures

4. The Society has a [limited scale of operations and range of activities](#) with over 90% of its commercial asset exposures represented by loans fully secured on residential properties. The Society's business is transacted [wholly in the United Kingdom](#) and [substantially in one financial sector](#).
5. There is [no participation in international financial markets](#) or payment, settlement and clearing systems, other than as a client of providers of such systems.
6. In view of the scope and lack of complexity of the Society's business and in accordance with BIPRU 11.4.4, the Board has decided that disclosures shall be published [annually](#).

### Location of Disclosures

7. Disclosures will be published on the Society's web-site in a downloadable file entitled "[Loughborough Pillar 3 Disclosures](#)" (supply link here).
8. Details of the disclosure was given in the Directors Report of the Society's [2009 Annual Report and Accounts](#).

### Materiality

9. The Society will regard information as material if its omission or misstatement could change or influence the decision of a user relying on the information for the purpose of making economic decisions.

### Confidentiality

10. The Society will consider the ownership and confidentiality of all information prior to publication.

### Disclosures

11. The Society will disclose information relating to its [risk management objectives and policies](#) for each separate category of material risk, including:
  - The strategies and processes to manage those risks;
  - The scope and nature of risk reporting and measurement systems; and,
  - The policies for hedging and mitigating risk, and the strategies and processes for monitoring the continuing effectiveness of hedges and mitigants.

12. The Society will disclose the following information in relation to its [capital resources](#):
  - A summary of the main features of all capital resources;
  - Details of tiers one and two capital resources with separate disclosure of positive and negative items;
  - Details of total capital resources, net of regulatory deductions
  
13. The Society will disclose the following information in relation to [its credit risk, operational risk and concentration risk, and the overall Pillar 2 rule](#):
  - A summary of the approach to assessing the adequacy of its internal capital to support current and future activities;
  - 8% of the risk weighted exposure amounts for each of the standardised credit risk exposure classes;
  - The operational risk capital requirement.
  
14. The Society will disclose the following information in relation to its [exposure to credit risk](#):
  - Accounting definitions of 'past due' and 'impaired' exposures, together with the amounts of such exposures;
  - Details of the approaches and methods used to determine value adjustments and provisions together with the amounts of and movements in value adjustments and provisions;
  - Details of the total amounts of exposures by material exposure class;
  - The geographic distribution of exposures by material exposure class;
  - A residual maturity analysis of exposures by material exposure class.
  
15. The Society will disclose the following information in relation to [interest rate risk](#):
  - The nature of interest rate risk, including key assumptions and frequency of measurement;
  - The measures used to assess interest rate risk.