

# **BUCKINGHAMSHIRE BUILDING SOCIETY**

## **Pillar 3 Disclosure Document**

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## 1. Introduction

The legislative framework, the Capital Requirements Directive (CRD), commonly referred to as Basel 2, governing how much capital all banks and building societies must hold to protect their members, depositors and shareholders, was introduced by the European Union from the beginning of 2007. In the UK this has been implemented by our regulator, the Financial Services Authority (FSA).

Buckinghamshire Building Society's aim is to ensure the protection of our members' savings by having sufficient capital even during a significant economic downturn.

The new framework is not concerned just about the Society's capital requirement, but it also requires disclosure of key pieces of information, such as risk exposure and the risk assessment process.

Below are the 3 main "Pillars" which make up the Capital Requirements Directive.

Pillar 1	Minimum capital requirements
Pillar 2	Assessment of capital requirements by the Firm and FSA
Pillar 3	Disclosure

Pillar 1 assessment is based on a formulaic risk based capital calculation focussing particularly on credit and operational risks to determine the Capital Resources Requirement. The Board of Buckinghamshire Building Society has then undertaken a bottom up assessment of all of the risks facing the Society and has established the amounts of additional capital that it believes needs to set aside under Pillar 2. As part of this process the Society has undertaken stress tests to determine whether it could maintain capital adequacy in a severe economic downturn.

This policy document deals with the requirements laid down for Pillar 3 (disclosure) and the information provided here is in accordance to the rules laid out in the FSA handbook BIPRU Chapter 11.

This disclosure document has been prepared by the Buckinghamshire Building Society on a non-consolidated basis given that there are no subsidiaries or associated entities:

FSA Number 206022

All figures within this document are correct **as at 31 December 2008** unless stated otherwise.

## **2. Risk Management Policies and Objectives**

Buckinghamshire Building 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 mortgages and savings the Society also uses wholesale financial instruments to invest liquid asset balances and raise wholesale funding and to manage the interest rate risks arising from its operations.

The Society looks to manage all the risks that arise from its operations, the main risks within its business being credit risk, market risk (including interest rate risk), liquidity risk and operational risk.

The ways in which we manage these risks include using forecasting and stress test models to help guide our business strategies; producing key risk information and indicators to measure and monitor performance; and using management and board committees to monitor and control specific risks.

### **Credit Risk**

Credit risk refers to the potential risk that arises from customers (or counterparties) failing to meet their obligations as they fall due. Credit risk arises primarily from loans to our retail customers, loans to our commercial mortgage customers and from liquid assets held by the Treasury department. The Board are responsible for reviewing the Group's lending policy and to assist in this process the management monitor on a daily basis the exposures in accordance with this policy, including exposure to individual counterparties and sector concentration. The Mortgage Manager recommends lending policy for approval by the full Society board and reports on a monthly basis. The executive management are responsible for recommending limits on Treasury counterparties, country exposures and types of financial instruments which require approval by the Society's Board.

### **Market Risk**

Market risk is the risk that the value of, or income arising from, the Society's assets and liabilities varies as a result of changes in interest rates or exchange rates. This incorporates a range of risks but the principal element is interest rate risk.

Interest rate risk arises from imperfect matching of different interest rate features, re-pricing dates and maturities of mortgages, savings and wholesale products. The Society manages this exposure on a continuing basis, within limits set by the Board using a combination of on and off-balance sheet instruments.

The sensitivity to changes in interest rates impacts on the following activities:

1. Management of the investment of reserves and other net non-interest bearing liabilities.
2. Fixed rate savings products and fixed rate funding.
3. Fixed and capped rate mortgage lending and fixed rate Treasury lending.

Interest rate swaps and caps are used to manage the above risks. In addition swaps are used to manage a risk arising from a net exposure to an interest rate basis type e.g. base rate or LIBOR. The Society also monitors prepayment levels on fixed rate mortgages and ensures that the Early Repayment Charge is consistent with the interest rate risk exposure.

The Society uses a parallel shift in interest rates of 2% to assess interest rate shock and to establish risk appetite. In addition internal scenario and stress tests are run for non parallel interest rate movements.

## **Liquidity Risk**

The Society's liquidity policy is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding in order to retain full public confidence in the solvency of the Society and to enable it to meet its financial obligations. This is achieved through maintaining a prudent level of liquid assets, through wholesale funding and through management control of the growth of the business.

The Society maintains assets in liquid form in such proportion and composition as will at all times enable it to meet its liabilities as they arise (including any unexpected adverse cash flow).

## **Operational Risk**

Operational risk is the risk of loss arising from failed or inadequate internal processes or systems, human error or other external factors. The risk is managed by individual business areas that have responsibility for putting in place appropriate controls for their business. Each area of the business has appointed a "risk leader" who co-ordinates control and risk assessments on a regular basis. This is led by the Society's Risk Manager. Regular reporting of risks takes place through to the Executive, Audit Committee and Board.

In order to ensure we have sufficient capital to cover some of these operational risks the Society maintains a range of insurance policies to cover eventualities such as business interruption, loss of computer systems, crime etc.

To monitor its operational risks the Society uses a piece of software, which allows a value, a likelihood and an impact (together with a reduction in impact from application of the control) to be assigned to each risk. This allows us to establish a residual risk remaining after operation of controls for each business component.

## **Business Risk**

Business risk is the risk that the Society may not be able to carry out its business plan or its desired strategy and could therefore suffer losses if its income falls.

It is a risk that every business faces, however, the Society looks to mitigate this risk by having a diverse range of products so that its income source is not reliant on one product or one area of its business.

## **Concentration Risk**

Where a firm's exposure to a single borrower or several borrowers within the same group of companies is large, it risks larger losses should the borrower default. Concentration risk is concerned mainly with the fact that in some cases these losses may be sufficient to threaten the solvency of a firm.

However, concentration risk need not just be in the form of large loans to single borrowers, it could include a concentration of "high risk" or high LTV loans, niche lending such as buy-to-lets or industry / sector concentrations.

The Society monitors all of these areas carefully to ensure that we do not lend more than appropriate for our position and size. In addition we have limits on specific areas, such as where payments are linked to rental income on the property securing the loan.

The Society, as a local building society, will by implication have a geographic concentration in our core lending area. We manage this risk carefully by having business strategies that aim to maintain a good balance of lending across the British Isles excluding Scotland and Northern Ireland and monitor our exposure by region on a regular basis.

We also take account of concentration risk within our models by having higher economic stresses where geographic concentration risk has been identified. In our case this means that for residential exposures in Buckinghamshire, Greater London and South East generally we hold slightly more capital and measure by implication the relatively greater reductions in asset values in this region than would otherwise be the case.

### **Pension Obligation Risk**

The Society in the past maintained a defined benefit scheme for key executive management. The scheme is now closed and has no obligation to the future accrual of service cost because the members have either retired or if still currently employed, a legally binding settlement has been reached with the individual concerned. Therefore no amount of additional capital is required to be set aside.

### **Residual Risk**

The process considered whether there was any necessity to include a capital allocation for risks that are not currently foreseen or measured by our models within our holding. Given the general level of mitigants of all the other identified risks including those under operational risk where a particularly rigorous assessment had been undertaken the level of residual was relatively small and it was concluded that no additional capital for residual risk was necessary. This position is reinforced in that we maintain a level of capital in excess of the minimum required by the FSA.

### 3. Main Board and Division of Delegated Powers to Committee

#### **Audit and Compliance Committee**

**Composition:** Three non-executive directors under the chairmanship of any non executive director, other than the Chairman of the Board.

**Main Functions:** The Audit Committee monitors the integrity of the Society's Financial Statements and any formal announcements. The Committee also reviews the Society's internal financial controls and risk management systems, as well as the effectiveness of the Society's Internal Audit function. It ensures the Society runs compliantly in accordance with requirements and standards of the regulatory system and any codes of practice.

It will approve the annual Compliance Monitoring Plan, and assess the resources and skills of those involved in it.

**Frequency:** The Committee meets on a quarterly basis with additional meetings held to deal with specific issues such as the ICAAP document. Meetings may also be convened during the monthly Board meetings.

#### **Remuneration Committee**

**Composition:** Will comprise of either the Chairman or Vice-Chairman and two other non-executive directors.

**Main Functions:** The remuneration Committee reviews and effects appropriate remuneration levels for executive, staff and non-executive directors. It monitors and recommends the remuneration package of staff and directors with regard to their duties, responsibilities and performance. It also considers all benefits, holiday entitlement, bonus schemes, pension arrangements and contracts of employment issues.

**Frequency:** Meetings shall be held annually at such determined by the Committee. It also reports at the June Board meeting, the recommendations of Management for all staff.

#### **Finance Committee**

**Composition:** Will comprise of any two non-executive directors, with at least one being the Chairman, Vice Chairman or Audit and Compliance Committee Chairman and any one of the following members of management: Chief Executive, Head of Finance, General Manager, Compliance Officer, and Society Secretary.

**Main Functions:** The Finance Committee will review and monitor treasury performance, approve new treasury counterparties, agree parameters for hedging instruments, monitor and approve committed funding lines, monitor gap analysis and set limits, approve terms and limits for products.

**Frequency:** The Committee will meet as required, and are held as necessary.

#### **Nomination Committee**

**Composition:** All serving non-executive directors.

**Main Functions:** Responsible to identify and nominate candidates for approval of the Board to fill vacancies as they arise. Review existing skills, knowledge and experience of Board members. Give full consideration to succession planning and make recommendations, taking into account challenges and opportunities being faced, and what skills and expertise are needed in the

future. Regularly review the structure, size and composition of the Board, and review the leadership needs of the Society.

**Frequency:** The Nomination Committee meets as required and at an appropriate time to consider Board appointments as and when they arise.

### **Key Reports**

There are a variety of reports produced to help senior management and delegated Committees monitor the Society's risks, however, the main reports are:

- Credit reporting of the overall mortgage portfolio, stress tests and focussed reporting on key credit risk areas.
- Report showing the liquidity and capital employed in the business and back office Treasury operations.
- Risk Management Framework, covering risk and related mitigants' details controls and key risk indicator levels.

#### 4. Capital Resources

The Capital Resources of the Group are calculated under Pillar 1 of the Capital Requirements Directive. The Capital Resources are comprised of:

- General Reserves accumulated by the Society, representing Tier 1 Capital
- Revaluation and provisions, included in Tier 2 Capital

Tier 1 and 2 Capital Resources have been set out in the table below

<b><u>Capital Resources Breakdown</u></b>	£'000s	£'000s
Profit and Loss and other Reserves	8,831	
<b>Total Tier 1 Capital</b>		<b>8,831</b>
Revaluation Reserve	894	
General Provisions	<u>215</u>	
<b>Total Tier 2 Capital</b>		<b><u>1,109</u></b>
<b>Total Capital</b>		<b>9,940</b>

Total Society assets at the above date are £160.09m

## **5. Capital Resources Integrated into Business Strategy**

Buckinghamshire Building Society aims to maintain sufficient capital resources to allow it to make advances and provide other financial services. In order to maintain this capital the Society needs to generate and retain profits that will add to the general reserves, the main sources of capital.

### **Strategy and Planning**

The 3 year Strategic Plan and Annual Operating Plan process establishes risk appetites for business lines being developed by the Society and for each of the risk categories.

The Society ensures it has sufficient financial and non-financial resource to meet the Strategic Plan objectives.

### **Capital Adequacy Assessment Process**

In addition to the Strategic Plan and Operating Plan we have an Internal capital Adequacy Assessment Process (ICAAP), which focuses on ensuring capital resources of the Society are sufficient to support its plan both in normal and stressed conditions.

This process involves reviewing all business areas with estimates for capital allocation across the Strategic Plan period. The Board can then agree (with input from the results of the Society stress models) the economic scenarios to be used in calculating capital requirements.

Finally the Board approves the capital assessment taking into account any areas where they may feel the models and internal assessments do not adequately capture the full risk exposure and holding extra capital where appropriate.

### **Lending & Business Decisions**

The Society translates its overall risk appetite for credit risk into individual lending limits controlling the exposures to be taken on by the Society. The performance against these limits is monitored monthly and reviewed at least annually. In addition, the Society credit risk is stress tested by type of business and the results reflected in business decisions.

### **Pricing**

Our pricing models also include capital assessment by products. Pricing models are in use for all mortgages launched. Pricing models provide guidance as to the level of interest rates required to ensure an appropriate level of return is achieved.

## 6. Risk Weighted Exposure Amounts & Operational Risk Capital

The assets of the Group are allocated risk based amounts in line with the “Standardised Approach” under the Capital Requirements Directive. In addition an evaluation of capital required to cover Operational Risk is calculated under the “Basic Indicator Approach” and determined by reference to the net income of the Group averaged over the previous 3 years.

	Asset	Risk Weighted Asset	Capital
	£'000s	£'000s	£'000s
<b>Treasury Assets</b>			
Cash balances held	68	0	0
Claims or contingent claims on central governments or central banks	0	0	0
Claims or contingent claims on regional governments or local authorities	0	0	0
Claims or contingent claims on institutions	44,941	9,824	786
SWAPs held duration of 1 year or more	22,500	113	9
<b>Total Treasury Assets</b>	<b>67,509</b>	<b>9,937</b>	<b>795</b>
<b>Loans &amp; Advances to Customers</b>			
Claims or contingent claims on Corporate	0	0	0
Claims or contingent claims secured on real estate property	112,646	46,454	3,716
Past due items	1,139	1,153	92
Retentions	721	361	29
<b>Total Loans &amp; Advances to Customers</b>	<b>114,506</b>	<b>47,968</b>	<b>3,837</b>
<b>Other Assets</b>			
Debtors and Prepayments	83	83	7
Fixed Assets	1,542	1,542	123
<b>Total Other Assets</b>	<b>1,625</b>	<b>1,625</b>	<b>130</b>
<b>Total Credit Risk Exposures</b>	<b>183,640</b>	<b>59,530</b>	<b>4,762</b>
<b>Operational risk Capital Requirement</b>			<b>321</b>

In addition the Society holds capital of £0.168 Million retentions against loans offered not completed, off balance sheet financial instruments and other assets.

### Counterparty Credit Risk

The purpose of the Society’s counterparty Treasury Risk Management Policy is to ensure that the Society can obtain the best possible return whilst operating within prudent limits in respect of counterparties.

The methodology for establishing counterparty limits involves consideration of the background rating information and balance sheet data relevant to the counterparty. The minimum rating required under Fitch ratings are:

- Short term facilities up to and including one year in maturity: lending bank to have a short term credit rating of at least F1;
- Facilities over one year and up to and including 5 years in maturity: lending bank to have a long term credit rating of at least A

Replacement values of outstanding hedging instruments are calculated and counterparty limits are adjusted to reflect an off-balance sheet exposure.

New limits are approved and existing limits removed only on the recommendation of the Finance Committee to the Board. All limits are reviewed at least quarterly by the Society Secretary, any changes being recommended to the Board as appropriate. The Head of Finance prepares a submission for the approval of new, or the removal of existing counterparties. Limits may be suspended by Treasury Department pending removal in the events of adverse market intelligence. No dealing will take place with counterparties which do not have a pre-approved limit. Where appropriate, exposure to counterparties is monitored on a consolidated basis.

7. Geographical exposure of loan book showing "Past Due" (Loans > 3 months in arrears), performing and total split by category for the Buckinghamshire Building Society as at 31<sup>st</sup> December 2008

Buckinghamshire Building Society			
Geographic Region	Residential Mortgages		
	Past Due £'000s	Performing £'000s	Total £'000s
Outer South East	229.73	11,863.52	12,093.25
Greater London		11,050.71	11,050.71
Outer Metropolitan	701.67	45,801.86	46,503.53
East Anglia		907.81	907.81
South West		6,009.32	6,009.32
West Midlands		1,400.62	1,400.62
East Midlands		2,199.38	2,199.38
North West		809.06	809.06
Yorkshire and Humberside		1,172.96	1,172.96
North		1,023.80	1,023.80
Wales		915.25	915.25
Unspecified		44.82	44.82
<b>Total</b>	<b>931.40</b>	<b>83,199.11</b>	<b>84,130.51</b>
Residential Buy to Let Mortgages			
Geographic Region	Past Due £'000s	Performing £'000s	Total £'000s
Outer South East		2,063.05	2,063.05
Greater London	160.67	7,148.04	7,308.71
Outer Metropolitan		8,073.26	8,073.26
East Anglia		223.74	223.74
South West		2,486.46	2,486.46
West Midlands		111.30	111.30
East Midlands		371.57	371.57
North West		269.21	269.21
Yorkshire and Humberside		293.83	293.83
North		217.04	217.04
Wales	47.24	41.26	88.50
Unspecified			
<b>Total</b>	<b>207.91</b>	<b>21,298.76</b>	<b>21,506.67</b>
Commercial			
Geographic Region	Past Due £'000s	Performing £'000s	Total £'000s
Outer South East		1,006.37	1,006.37
Greater London		1,926.25	1,926.25
Outer Metropolitan		4,055.63	4,055.63
East Anglia		159.09	159.09
South West			
West Midlands			
East Midlands			
North West			
Yorkshire and Humberside			
North		139.88	139.88
Wales			
Unspecified		860.54	860.54
<b>Total</b>		<b>8,147.76</b>	<b>8,147.76</b>

\* Past Due amounts relate to overall mortgage balances not the amount in arrears

## 8. Provisions

Provisions for losses are based upon an appraisal of loans, advances and other assets. Specific provisions are made in respect of properties in possession and in respect of mortgage accounts 2.5% of balance in arrears at that date and against other assets where book value exceeds the estimated realisable value.

The provision on each account represents the amount required to reduce the outstanding balance of the asset to its expected realisable value, by using industry recognised house price indices, and adjusting for costs of realisation, other recoveries and the probability of possession.

General provisions are made where it is considered that there is impairment in the value of assets at the year-end that is not already covered by specific provisions.

The amount shown in our income and expenditure account represents the actual losses incurred and the net change in provisions. Interest that is considered to be irrecoverable on advances secured on repossessed properties is excluded from income from the date of repossession.

The general provisions made at the year-end represent the Directors' assessment of the potential losses which, although not yet specifically identified as relating to payment arrears, are known from experience to exist in the Group's loan portfolio.

These provisions have been deducted from the appropriate asset values shown in the balance sheet with the exception of customer claims which are shown within other creditors.

Both the balance sheet and the provisions of liabilities can be found in the 2008 Annual Report and Accounts.

## 9. Breakdown of Treasury Assets under the Standardised Approach

Fitch Ratings Services	Maturity of Treasury Investment			
	<3 months £'000s	3 months to 1 year £'000s	> 1 year £'000s	Total £'000s
AAA to AA-	28,792	1,767		30,559
A+ to A-	2,532	1,010		3,542
BBB+ to BBB-				
BB+ to BB-				
B+ to B-				
CCC+ and below				
Unrated Building Societies / Local Government	8,055	2,785		10,840
<b>Total</b>	<b>38,377</b>	<b>5,562</b>		<b>44,941</b>

## 10. Conclusion

This disclosure document is intended to provide background information on the Society's approach to risk management as related to maintaining and preserving the capital position of the Society. It also provides asset information and capital calculations under Pillar 1.

In the event that a user of this document has comments or requires further information then they are requested to contact Michael Simpson, Head of Finance at:

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