Cumberland Building Society

Basel 2 Pillar 3 Disclosure

31 March 2011

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1. Introduction

The Capital Requirements Directive (CRD) was issued by the European Union in order to implement the Basel 2 accord, and set out a new framework for capital adequacy for building societies and banks, governing the amount of capital they must hold in order to provide security for members, depositors and shareholders.

In the UK, the Society's regulator the Financial Services Authority (FSA) is responsible for the implementation of the CRD, which consists of three main elements, known as 'Pillars', as follows:

Pillar 1	Minimum capital requirements, using defined formulae
Pillar 2	The Internal Capital Adequacy Assessment Process (ICAAP) undertaken by the Society, and the Supervisory Review and Evaluation Process (SREP) undertaken by the FSA
Pillar 3	Disclosure of key information on risk exposures and risk management processes, as set out in this document and as required by chapter 11 of the BIPRU section of the FSA Handbook.

All figures within this document are correct at 31 March 2011 unless otherwise stated and cover the Cumberland Building Society Group, which consists of Cumberland Building Society and its trading subsidiaries (Cumberland Estate Agents Limited, Cumberland Financial Services Limited, Cumberland Property Services Limited and Cumberland Homes Limited).

2. Risk Management Framework, Policies and Objectives

a) Board and Committee Structure

The Board is responsible for ensuring that effective systems and controls are in place for risk management. In order to achieve this, the Board and senior management have established the following committees which enable the consideration of specific areas of risk management in more detail than would be possible within Board Meetings.

Audit and Risk Committee

This monitors internal controls, financial reporting, risk management and regulatory compliance matters, reviews the work of the Internal Audit and Compliance functions, assesses their effectiveness, and considers the appointment of the external auditor.

It consists of four non-executive directors and meets at least five times a year. The four executive directors, the Head of Internal Audit, the Group Compliance Manager and a representative from the external auditors also attend Committee meetings by invitation to assist in its deliberations.

A report giving details of the matters covered by it, and the minutes of its meetings, are supplied to the following Board Meeting.

Through this Committee, the Group Internal Audit function provides independent assurance to the Board of the effectiveness of the system of internal control.

The Committee receives reports from the Risk Management Committee, the Information Security Committee and the Fraud Prevention Committee.

Residential Mortgages Credit Committee

This considers the detailed provisions controlling the Society's approach to residential mortgage lending contained within the Lending Policy Statement in the light of the Society's risk appetite for such lending, and accordingly the relevant section of the Risk Appetite Statement, and makes recommendations on these to the Board for approval.

As required by the Lending Policy Statement, it also reviews and decides upon specific residential loan applications.

It consists of the executive directors and the General Manager and meets on a regular basis as required.

Commercial Mortgages Credit Committee

This considers the detailed provisions controlling the Society's approach to commercial mortgage lending (principally fully secured on land, but it may also consider residential buy to let cases which are handled by the 'Cumberland Business' Department) contained within the Lending Policy Statement in the light of the Society's risk appetite for such lending, and accordingly the relevant section of the Risk Appetite Statement, and makes recommendations on these to the Board for approval.

As required by the Lending Policy Statement, it also reviews and decides upon specific commercial loan applications.

It consists of the executive directors and the General Manager and meets on a regular basis as required.

Assets and Liabilities Committee (ALCO)

This is responsible for considering and monitoring balance sheet structure, interest rate and liquidity risk management and credit risk with respect to treasury counterparties.

Its main meeting each month considers relevant information with respect to all of the above, and considers on a regular basis the Individual Liquidity Adequacy Assessment and liquidity stress testing. On an annual basis it reviews the Treasury Policy Statement and the Treasury sections of the Risk Appetite Statement, and makes recommendations on these to the Board. The Board receive the minutes of this meeting and a report summarising the key issues arising each month.

Shorter ALCO meetings are held each week to assess the pricing and management of interest rate risk of fixed rate mortgage and savings products.

It consists of the executive directors, the General Manager, the Treasurer, and on an annually rotating basis, a non-executive director attends the main monthly meeting.

Risk Management Committee

This considers the Group's approach to operational risk, consists of the executive directors with the Head of Internal Audit attending as an observer, and meets quarterly. It considers reports from all business areas on their operational risk management during the quarter and whether there have been changes in their risk profiles. All heads of business areas appear before the Committee each year to enable discussion on the risk management of their areas.

On an annual basis it considers the Group Operational Risk Policy and the operational risk section of the Risk Appetite Statement, and makes recommendations on these to the Audit and Risk Committee, which receives a quarterly report summarising key issues arising from the Committee.

b) Principal Risks

The principal risks facing the Group and the procedures put in place to manage them, are described below. The Group seeks to manage all of the risks that arise from its operations, and the ways in which this is achieved include the production of key risk-related information, forecasting and stress testing, and the use of the Board and management committees as set out above.

Credit Risk

The Group is exposed to credit risk in respect of either mortgage customers or treasury counterparties being unable to meet their obligations as they become due.

i) Residential Mortgages

The Lending Policy Statement considers the definition, basis of exposure, importance, appetite (together with the rationale for it), and the Society's objective in relation to the relevant aspects of residential lending credit risk; i.e. security, counterparty, concentration and residual risks.

This is reviewed annually, or on a more frequent basis if there are changes to the operating environment. Lending mandates are strictly controlled and all applications are reviewed by the specialist residential mortgage underwriting team. Applications outside individuals' mandates are considered by the Residential Mortgages Credit Committee.

The Society's long established approach of obtaining its residential mortgage business direct, via face to face interviews with customers in its branches or by telephone, rather than through third parties, is regarded as a key factor in mitigating its residential mortgages credit risk. The Society has not undertaken any 'sub-prime' or 'self-certification' mortgage lending or purchased mortgages originated by other firms.

As a result, the Society's residential lending exhibits a strong concentration within its branch operating area of Cumbria, Dumfriesshire, north Lancashire and west Northumberland. This is monitored by the Board each quarter, with a detailed assessment being produced on an annual basis and included as an appendix in the Society's ICAAP. However, research has shown that customers value the 'local' nature of the Society and its branch network, and the Society's detailed knowledge of its operating area, when combined with its direct approach to residential lending, is regarded as a strength in ensuring the quality of its lending. This is strongly reflected in the Society's arrears performance when compared with national statistics. Overall, the Society regards this concentration in a positive manner, as a focus and a demonstration of the strength of its regional franchise.

Mortgage indemnity guarantee (excess of loss) insurance is used to mitigate risk as appropriate.

ii) Commercial mortgages

Commercial mortgages credit risk is controlled by the Lending Policy Statement in a similar manner as for residential mortgages, although the Society's specialist commercial lending managers produce detailed appraisals of each application, and all applications are considered by at least two members of the Commercial Mortgages Credit Committee.

Whilst there is a concentration of commercial lending within the Society's branch operating area, and with respect to tourism in the Lake District, this is less pronounced than for residential lending, and the Board monitors the geographical and sectoral compositions of the book twice a year.

iii) Treasury

The ALCO is responsible for recommending limits on Treasury counterparties for approval by the Board, and these are set out in the Treasury Policy Statement and reviewed annually or more frequently if appropriate. The list of counterparties consists of those which meet or exceed minimum rating agency (Moody's) ratings or are other building societies. Information on rated counterparties is reviewed in detail by the Committee when it believes that this is appropriate. The permitted credit limit for counterparties includes where appropriate exposure in respect of the credit risk weighted amount of derivative financial instruments.

Market Risk

The primary market risk faced by the Group is interest rate risk. This is the risk of fluctuations in interest rates and changes in the value of derivative contracts (interest rate swaps) impacting upon the value of the Group's assets and liabilities. The ALCO assists management and the Board to manage that risk.

Interest rate risk is managed by utilising natural matches of assets and liabilities on the balance sheet and by effecting interest rate swaps with external counterparties. The interest rate risk on fixed rate savings and mortgages is reviewed by the Treasurer daily, and on at least a weekly basis (depending upon business flows) by ALCO, and hedging action taken as appropriate.

The balance sheet is stress tested on a monthly basis to inform the ALCO and the Board of the effects on income or costs of interest rates rising or falling, by applying an instantaneous parallel movement of 200 basis points to the interest rate curve.

Liquidity Risk

Liquidity risk is the risk of failing to meet demands and commitments to provide funds to customers and other third parties. The ALCO assists the Society's management and the Board to manage this risk. Responsibility for the daily management of the risk, including the monitoring of both retail and wholesale funding, lies with the Treasurer, within the prudent frameworks of the Individual Liquidity Adequacy Assessment and Treasury Policy Statement. Monthly, the balance sheet is stress tested to confirm that the Group can withstand normal and extreme cash outflows.

In addition, the Society's savings and current account balances are higher than its mortgage balances and it has a relatively low level of wholesale funding compared to its peers (with its proportion of shares and other borrowings not in the form of shares held by individuals, at 4.97% of share and deposit liabilities at 31 March 2011). This means that the Society's dependence upon the financial markets for funding is relatively limited.

Operational Risk

Operational risk is the risk of loss arising from inadequate or failed internal processes or systems, human error or external events. The Group Operational Risk Policy sets out the Group's approach to the management of operational risk.

Whilst line management is responsible for identifying and managing operational risks, this is carried out using an agreed framework and methodology, with quarterly reporting to the Risk Management Committee.

Various other Board-approved policies, e.g. the Group Information Security Policy, and the Health and Safety Policy, reinforce the Group Operational Risk Policy in specific areas.

The Society maintains appropriate insurance cover for high impact events, which is reviewed on at least an annual basis.

Business Risk

The Society's Board of Directors is responsible for the management of its business risk. Business risk is the risk that the Society fails to be successful in terms of both its financial performance and the levels of its business activity.

For a mutual building society, this covers the risks of failing to meet the requirements of its members in relation to their needs for financial services, of failing to retain them, and of failing to attract new members. It also necessitates balancing the interests of the two principal sets of existing members, borrowers and savers, in relation to each other, and in relation to new members, so far as is possible given the trends in the wider market. Business risk encompasses strategic and reputational risks. Each quarter, the Risk Management Committee considers formally, as an individual agenda item, the Society's key strategic and commercial risks.

Pension Obligation Risk

The Society operates a defined benefit scheme (the Cumberland Building Society Pension and Assurance Scheme), together with three defined contribution schemes.

Pension liability risk attaches to the defined benefit scheme, in respect of a series of risks, including the potentially volatile course of the financial markets, the level of inflation and the effects of increasing life expectancy of scheme members. The scheme has been closed to new members since 2001 and the rate of accrual was reduced in 2007, to mitigate this risk.

Following a stress test of the assumptions relating to the scheme, the Society holds an additional amount of capital under Pillar 2 in recognition of this risk.

Residual Risk

The Board recognises that there are residual risks inherent in the operations of any business, which may not be identified specifically. Accordingly, the Board has resolved that the Society should operate with a buffer of capital in excess of the regulatory requirement.

3. Capital Resources

The capital resources of the Group at 31 March 2011 totalled £112.501 million.

This consists predominantly of core Tier 1 capital of £108.472 million, which is the Group's reserves (accumulated profits).

In addition, there is upper Tier 2 capital of £4.029 million, which is the Group's general provisions for bad and doubtful debts of £3.728 million, and investment property reserve of £0.301 million.

The Group has no need for remunerated capital and therefore has no subordinated debt or permanent interest bearing shares. There are no deductions required in respect of any of the Group's capital resources.

4. Capital Adequacy Assessment

The Group maintains a three year financial forecasting and strategic planning framework which is reviewed by the Society's Board on an annual basis. The three year financial plan enables a forecast of the Group's capital and its regulatory capital resources requirement to be made, and this is a key element of the Group's ICAAP. The Corporate Plan is produced with reference to the ICAAP, and both reflect the Board's risk appetite in relation to the Group's operations, thus integrating the capital adequacy position and forecasts into business strategy.

The ICAAP contains calculations of the capital resources requirement as at the most recent financial year end, with forecasts for the following three years, using the standardised approach for credit risk and the basic indicator approach for operational risk.

Under the standardised approach for credit risk, the Group 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, as required under Pillar 1.

With respect to the basic indicator approach for operational risk, the Group 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.

The ICAAP also includes assessments of the capital adequacy position under stressed scenarios in order to ensure that this will be satisfactory in such circumstances.

Table 1 provides details of the calculation of the capital resources requirements of the Group as at 31 March 2011.

Table 1 – Group Capital Resources Requirement, 31 March 2011

Credit Risk Category	Asset £m	Risk weighted asset value £m	Minimum capital required £m
Treasury Assets			
Central government and central banks	95.12	0.00	0.00
Regional government and local authorities	0.00	0.00	0.00
Credit institutions	261.56	82.53	6.60
Cash	2.66	0.00	0.00
Off balance sheet - derivative contracts		1.22	0.10
Total Treasury Assets	359.34	83.75	6.70
Loans and advances to customers			
Residential:			
Performing loans	1,002.15	375.82	30.07
Past due loans	3.68	4.05	0.32
Commitments	3.99	0.90	0.07
Non-residential / business:			
Performing loans	148.40	148.40	11.87
Past due loans	1.07	1.60	0.13
Commitments	1.51	0.76	0.06
Unsecured current account overdrafts:			
Performing loans	2.08	1.56	0.12
Past due loans	0.14	0.21	0.02
Commitments	2.22	0.33	0.03
Total loans and advances to customers	1,165.24	533.63	42.69
Fixed and other assets	15.01	15.01	1.20
Total credit risk exposures and capital resources required	1,539.59	632.39	50.57
Operational risk capital requirement		47.00	3.76
Group total capital resources required		**679.39**	**54.35**

The total asset value of £1,539.59 million contained in the table above, reconciles to the total assets figure in the Group's balance sheet in the Annual Report and Accounts for the year ended 31 March 2011 (which is also available at www.cumberland.co.uk) as follows:

	£m
Asset amount as above:	1,539.59
Less:	
Loan commitments	(7.72)
General and specific provisions	(5.05)
Deferred mortgage indemnity guarantee income	(0.05)

Total – as per Annual Report and Accounts	1,526.77

5. Credit Risk

This section gives more information with respect to the Group's credit risk exposures with respect to residential lending, commercial (fully secured on land) lending, and treasury assets.

The Group regards as 'past due' any mortgage or loan account where more than three monthly repayments have not been made at the accounting date.

Residential mortgages

A geographical analysis of the Society's residential mortgage book as at 31 March 2011 is provided in Table 2 below, based on the division between the Society's branch operating area and elsewhere in the UK. The Society's branch operating area covers Cumbria, Dumfriesshire (i.e. the districts of Annandale and Eskdale and Nithsdale), parts of north Lancashire (in relation to the Preston branch and northwards to the border with Cumbria), and west Northumberland (in relation to the Haltwhistle branch) and 87.2% of the residential mortgage book is located within this. Combined, around 600,000 people live in Cumbria and Dumfriesshire.

Table 2 – Residential mortgage balances at 31 March 2011, split by geography and whether performing or past due.

	Performing £m	Past due £m	Total £m
Branch operating area	874.03	2.77	876.80
Other UK	128.12	0.91	129.03
Total	1,002.15	3.68	1,005.83

A residual maturity analysis of loans and advances to customers (both secured on residential property and on land) is provided in note 10 of the Annual Report and Accounts for the year ended 31 March 2011, but the actual experience of repayments may differ from that, as many loans and advances are repaid early.

Commercial Mortgages

As discussed in section 2 above the Group's commercial (fully secured on land) mortgage lending is not so concentrated within the branch operating area, and therefore a different geographical analysis is appropriate, as shown in Table 3 below.

Table 3 – Commercial (FSOL) mortgage balances at 31 March 2011, split by geography and whether performing or past due.

	Performing £m	Past due £m	Total £m
Branch operating area	81.19	0.93	82.12
York/Yorkshire Dales	11.35	-	11.35
South/South West	12.03	-	12.03
Other UK	43.83	0.14	43.97
Total	148.40	1.07	149.47

Provisions

The Group's accounting policy in relation to provisions for loans and advances is set out in note 1(j) to the Annual Report and Accounts for the year ended 31 March 2011.

Table 4 below shows the Group's general and specific provisions for bad and doubtful debts at 31 March 2011 and a year earlier, with the charge for the year.

Table 4 – General and specific provisions for bad and doubtful debts

	Loans fully secured on residential property £000	Loans fully secured on land £000	Current account overdrafts £000	Total £000
At 1 April 2010				
General provision	1,690	1,998	40	3,978
Specific provision	-	199	56	255
Written off in year				
Specific provision	(25)	(116)	(3)	(144)
Charge in year				
General provision	-	(250)	-	(250)
Specific provision	236	962	8	1,206
At 31 March 2011				
General provision	1,690	1,998	40	3,728
Specific provision	211	1,045	61	1,317

Treasury assets

The Group has nominated Moody’s Investor Services as its external credit assessment institution. Moody’s ratings are applied to Group liquidity exposures in order to establish their risk weighted value for capital adequacy purposes, in line with the standardised approach using credit quality steps as set out in BIPRU chapter 3.

Unrated exposures are restricted to UK building societies which have not obtained a Moody’s rating and are considered to be of high standing.

Using the above, the Society’s liquid assets counterparties at 31 March 2011 were rated as shown in Table 5 below, together with their residual maturity:

Table 5 – Counterparty ratings and residual maturities of liquid assets at 31 March 2011

	Up to 3 months	3 - 6 months	6 to 12 months	1 - 5 years	Total
	£m	£m	£m	£m	£m
Moody's credit rating:					
Sovereign - Aaa	48.18	14.98	22.67	9.29	95.12
Aa3	140.55	5.07	5.01	-	150.63
A2	10.02	-	-	-	10.02
A3	5.01	8.07	3.02	-	16.10
Baa1	-	3.03	-	-	3.03
Baa2	20.02	4.04	-	-	24.06
Unrated building societies	36.09	13.09	8.54	-	57.72
Cash	2.66	-	-	-	2.66
Total	262.53	48.28	39.24	9.29	359.34

The balances in the Baa1 and Baa2 categories are all rated building societies.

6. FSA Remuneration Code Disclosures

The Society's objective in setting remuneration policies is to ensure that they are in line with its business strategy, risk appetite and long term objectives, and that remuneration is set at a level to retain and attract individuals of the calibre necessary to operate an organisation such as the Society.

The remuneration of the executive directors and other members of senior management is determined by the Remuneration Committee, which consists of its chairman Richard Atkinson and two other non-executive directors, Simon Berry and David Clarke.

The terms of reference of the Committee are available on the Society's website, www.cumberland.co.uk and include the following as part of its mandate:

To take into account, when determining the remuneration policy, all relevant factors to ensure that Executive Directors and senior management are provided with appropriate incentives to encourage enhanced performance, in keeping with the Society's risk appetite, and are, in a fair and responsible manner, rewarded for their individual contributions to the Society's success, and for the Society's overall performance.

In setting remuneration, the Committee takes account of fees and salaries payable and other benefits provided to executive directors and other senior management of building societies that are similar in size and complexity to the Cumberland, and other organizations as are believed relevant. Periodically, a report may be commissioned from external consultants to assist in this process.

The Committee believes that variable remuneration, comprising of incentive schemes relating to financial and business performance, are an appropriate part of a balanced remuneration package. The general approach to this however, has been to set variable remuneration at relatively modest levels, being mindful of the context of the Society's operating area and its status as a mutual organisation, but also, the need for robust risk management in order to ensure that the outcomes achieved are beneficial to the organisation over the long term.

The scheme for 2010-11 involved an overall assessment of the Society's performance with respect to profitability, management expenses, residential mortgage growth, savings funds inflow, growth in current account balances and numbers of accounts, and the provision of excellent customer service, via process improvements, customer satisfaction questionnaires and data on complaints.

The scheme for 2011-12 involves targets in relation to residential mortgage balances, the stock of current accounts and the performance of branches in relation to customer service, underpinned by a series of scheme 'gateways' which must be achieved in order for any incentives to be payable, involving an appropriate level of Society operating profit, whether administrative expenses exceed budget, and the level of residential mortgage and share balances.

Both schemes involve the results of one year at a time, are non-contractual, and payment has been or will be made shortly after the year end. All payments are at the absolute discretion of the Remuneration Committee, and no elements of variable remuneration are guaranteed.

Remuneration Code Staff

The Board have determined that as at 31 March 2011, the four executive directors, three other executives and 10 other members of senior management reporting directly to executive directors, including those involved in control functions, are designated as being subject to the FSA Remuneration Code, as set out in SYSC 19A. Since that date, two other members of staff have moved within this definition.

It is believed that other senior members of staff do not affect the risk profile of the firm in the way that the Code staff listed above do, as they report directly into them and are constrained in their actions by their operating mandates as defined in the Group's documented policies and procedures.

Executive directors

Further information on the mandate of the Remuneration Committee and its decision making process in determining the remuneration policy for the executive directors, is contained in the Report on Directors' Remuneration within the Group's Annual Report and Accounts for the year ended 31 March 2011.

Aggregate information on the remuneration of the four executive directors is given below:

	£
Fixed remuneration	603,852
Variable remuneration	26,103

Total	629,955

Other members of senior management and those involved in control functions

The Remuneration Committee is also responsible for determining the terms and conditions of other staff designated as being subject to the Remuneration Code, after consultation with the Chief Executive.

Aggregate information on the remuneration of these 13 staff is given below:

	£
Fixed remuneration	792,114
Variable remuneration	18,110

Total	810,224

In both cases fixed remuneration includes pension contributions made by the Society on behalf of the employees, and the value of taxable benefits.

7. Conclusion

This Pillar 3 disclosure document has been prepared in accordance with the requirements of BIPRU chapter 11, as appropriate for a firm of the size and complexity of Cumberland Building Society and in line with a Society Board-approved policy document entitled "CRD Pillar 3 Disclosure Policy".

In the event that a user of this disclosure document should require further information, application should be made in writing to John Kidd, Finance Director and Secretary, Cumberland Building Society, Cumberland House, Castle Street, Carlisle, CA3 8RX, or to john.kidd@cumberland.co.uk.