

LOUGHBOROUGH BUILDING SOCIETY

Pillar 3 Disclosures as at 31 October 2019

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Note: These Pillar 3 disclosures have been prepared solely for the purposes of compliance with the Capital Requirements Directive. The information contained therein as to the capital requirements and management of risk does not constitute any form of financial statement and shall not be solely relied upon by anyone in making judgement on the Society. There is no requirement for the disclosures to be externally audited.

Introduction

1. This document provides information on the capital strength of the Society and its approach to risk management. The Society seeks to ensure that it protects the interests of members and other stakeholders by holding sufficient capital at all times.
2. The European Union Capital Requirements Directive and Capital Requirements Regulations came into force from 1 January 2014 and have the objective of ensuring that banks, building societies and investment firms hold adequate capital to provide security for members and depositors. The regulations are collectively known as CRD IV. The Prudential Regulation Authority (PRA) is the prudential regulator of Loughborough Building Society ("The Society") and is responsible for implementing CRD IV in the UK. The Society has adopted the Standardised Approach for Credit risk and the Basic Indicator Approach for Operational risk.
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.
 - Pillar 2: Internal capital adequacy assessment process (ICAAP) and supervisory review and evaluation process (SREP). The Board of the Society undertakes an assessment of all of the key risks facing the Society and additionally performs stress testing of those risks to establish a level of additional capital to be held under Pillar 2.
 - Pillar 3: This document deals with the requirements under Pillar 3 (disclosure) concerning the risks faced by the Society and a description of the capital held. This information is provided in accordance with the Rules laid down in Capital Requirements Regulations and in the FCA handbook, BIPRU, section 11. The requirements under Pillar 3 are designed to promote market discipline through the disclosure of information about risk exposures and risk management processes.
4. The Board approves the Society's ICAAP annually, using the level of Individual Capital Guidance (ICG) and regulatory buffers advised by the PRA as the minimum capital requirement.
5. The Society's assessment of capital indicates that it has adequate resources to meet the PRA and CRD IV regulatory buffers as at 31 October 2019 and over the three year strategic planning period.
6. The figures quoted in this disclosure have been drawn from the Society's Annual Report and Accounts as at 31 October 2019, unless otherwise stated.

Risk Management Objectives and Policies

7. The Board Risk Committee, consisting solely of non-executive directors, is responsible for determining a framework for risk management including governance structure, risk appetite and risk policy, which is subject to approval by the Board. The Executive Directors are responsible for operating and monitoring risk management and internal control processes. The Society has adopted a "three lines of defence" approach to the identification and management of risk as follows:

First line	Day-to-day management of risk by department managers. This encompasses ownership and accountability for directly assessing, controlling and mitigating risks.
Second line	Oversight of the risk framework by the Society's Risk and Compliance function. This includes oversight of the implementation of effective risk management practices by operational management; adherence to Policies and the Board's risk appetite; provision of guidance and support to the business and independent reporting to the Risk Committee.
Third line	Independent assurance as to the effectiveness of the Society's risk governance framework, systems and controls by the Internal Audit function.

The Society uses a Risk Register to assess the likelihood and impact of its key risks. This is reviewed annually by the Board and by the Risk Committee, and by the Risk function and risk owners on a quarterly basis. It is updated to reflect new or evolving risks and changes in controls and control effectiveness assessments. The Risk Register forms a base for the identification of key 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 structural risks on both sides of the balance sheet. The Board Audit and Compliance Committee, consisting solely of non-executives, considers the adequacy of internal controls, the Compliance function, Internal Audit function and the evaluation of related risks. The system of internal control is designed to enable the Society to achieve its corporate objectives within a managed risk profile, rather than to eliminate risk. The Board Risk Committee considers all other risks including lending risks.
9. The Society has a Management Assets and Liabilities Committee, (MALCO), consisting of executive directors and senior management. MALCO meets monthly and is responsible for reviewing risks on both sides of the balance sheet and making recommendations to ALCO.
10. The Society's Internal Audit function provides independent assurance to the Board, through the Audit and Compliance Committee, regarding the effectiveness of internal controls.
11. The principal business and financial risks to which the Society is exposed are credit, market, liquidity, regulatory, strategic, operational, conduct and reputational, these are detailed in sections 12 to 22 below. Full details regarding the financial risks and instruments used by the Society are given in the Annual Report and Accounts 2019, Note 25, Financial Instruments.
12. 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 Credit Policy of the Society and monitoring the arrears profile. The ALCO monitors exposure to treasury counterparties as detailed in section 43 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 credit 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.
13. The Society is predominantly a residential mortgage lender, and 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.
14. Product type concentrations also exist in the Society's mortgage balances. These are monitored regularly by the Board to ensure that credit policy limits are not exceeded. All concentrations are managed within limits which the Board believes are appropriate to current economic conditions and Society objectives.
15. The Board has ensured that the Society ICAAP makes provision for additional capital to be available to cover any downturn in house prices or increased mortgage losses.
16. 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's balance sheet together with appropriate hedging contracts with external counterparties, as permitted under the Board's Financial Risk Management Policy. Interest rate risk is considered more fully in sections 44 to 49 below. The Society does not undertake any treasury transactions of a speculative nature.
17. 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.
18. Regulatory Risk considers the risk that the volume and complexity of regulatory issues may impact on the Society's ability to compete over time. Executive and management staff are kept informed of regulatory changes through regular update communications. The three lines of defence model also provides oversight,

challenge and assurance as to how the Society meets regulatory requirements.

19. [Strategic Risk](#) is the risk that the Society is exposed to external factors. These are considered by the Board as part of the corporate planning process and regularly throughout the year, ensuring that the Society makes an adequate amount of profit and maintains sufficient capital.
20. [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, key supplier failure and external events. Line managers are responsible for assessing the operational risks and associated controls which are relevant to their areas and this is reflected in the Risk Register. Management information includes a review of the Society's performance against key operational risk indicators. The Society has in place a range of insurance policies to cover operational risks including loss of systems, site disruption or crime. There is also a Business Continuity Plan and a Liquidity Contingency Plan to ensure that risks of disruptions to the Society's business can be mitigated by appropriate management actions. Within operational risk, cyber risk is a key area. Appropriate measures are in place, including penetration testing, to mitigate cyber related risks and ensure that the Society is secure.
21. [Conduct risk](#) – is the risk that the Society does not treat its customers fairly and provides inappropriate products for customers. The Board has an approved Conduct Risk Appetite Statement and a Conduct Policy which applies to all staff and seeks to ensure that customers are treated fairly across the entire life cycle of customer relationships. The Conduct Risk Dashboard provides management information on the Society's performance with regard to Conduct Risk and this is reviewed quarterly by the Board and on a monthly basis by the senior management team.
22. [Reputational risk](#) – as a deposit taking institution, it is essential that the Society safeguards its members' funds to ensure that events do not arise which could damage its reputation and lead to a loss of public confidence. The Society manages this risk by the preparation of a detailed Corporate Plan with regular review by MALCO, ALCO and the Board.
23. 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 structural balance sheet exposures and the use of financial instruments for risk management purposes.
24. 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 ICG requirement issued by the PRA.

Capital Resources

25. Total Society capital resources at 31 October 2019, amount to £22.9m. Under the Own Funds definition in the CRD this is made up of Common Equity Tier 1 capital comprising general reserves and other reserves, less a deduction for intangible assets. Tier 2 capital is made up of general credit adjustments; the collective impairment provision.
26. [Table 1](#) provides details of the positive and negative components of capital within the Society.

TABLE 1	Society
Common Equity Tier 1 capital resources	£m
Gross (accumulated profits held as general reserves)	23.3
Available for sale reserve	-
Deduction (intangible assets – IT software)	(0.8)
Net Tier 1 capital resources	22.5
Tier 2 capital resources	
Gross (collective provision for bad and doubtful debts)	0.4
Net Tier 2 capital resources	0.4
Total capital resources	
Gross	23.7
Deduction	(0.8)
Net Total capital resources	22.9

Capital Adequacy Assessment

27. 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.
28. The Corporate Plan has regard to the Society ICAAP submission and in particular the Board's risk appetite for different business activities and risks.
29. The Society's 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 in the plan.
30. In order to produce a detailed capital plan, the Society's ICAAP includes calculations of the capital resources requirement each year using the standardised approach for credit risk and the basic indicator approach for operational risk.
31. 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.
32. 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.
33. [Table 2](#) provides details of the calculation of capital resource requirements within the Society as at 31 October 2019, covering both liquidity and mortgage exposures.

TABLE 2			
CAPITAL RESOURCES REQUIREMENT	SOCIETY		
	Exposure £m	Risk weighted assets value £m	Minimum capital required £m
Credit risk			
<i>Treasury assets</i>			
Central government	38.5	-	-
Credit institutions	20.5	5.7	0.4
Total treasury assets	59.0	5.7	0.4
<i>Loans & advances to customers</i>			
Non-residential & business - performing loans	5.1	5.1	0.4
Non-residential & business - past due loans	0.1	0.1	-
Residential use - performing loans	248.5	88.2	7.1
Residential use - past due loans	1.5	1.5	0.1
Total loans & advances to customers	255.2	94.9	7.6
<i>Other exposures</i>			
Fixed and other assets	3.0	2.3	0.2
Interest rate derivatives	0.1	-	-
Mortgage commitments	20.5	3.6	0.3
Total other exposures	23.6	5.9	0.5
Credit risk - capital resources required	337.8	106.5	8.5
Operational risk - capital resources required		9.5	0.8
Society total capital resources required		116.0	9.3

34. Table 3 gives a reconciliation between the total exposures as shown in Table 2 and Total Assets as reported in the Society's Annual Report and Accounts.

TABLE 3	
Reconciliation of Total Exposures to Total Assets per Accounts	£m
Total credit risk exposures per Table 2	337.8
Less: collective loss provision not deducted	(0.3)
Less: off balance sheet items	(20.5)
Less: EIR/hedging balances	0.9
Total Assets per Report & Accounts at 31 October 2019	317.9

Leverage Ratio

35. CRD IV introduced a non-risk based leverage ratio which became mandatory from 1 January 2018. The minimum requirement for all banks and building societies is 3%. The leverage ratio measures Tier 1 capital as a percentage of on and off balance sheet assets. The Society's leverage ratio was 6.7% at 31 October 2019 and is expected to be around 7.0% throughout the period of the Corporate Plan. The following tables show the calculation of the leverage ratio.

TABLE LR Sum	
Summary reconciliation of accounting records and leverage ratio exposures	£m
Total assets per published financial statements	317.9
Adjustments for derivative financial instruments	0.0
Adjustments for off-balance sheet items	20.5
Asset amounts deducted in determining Tier 1 capital	(0.8)
Other adjustments	(0.6)
Leverage ratio exposures	337.0

TABLE LR Spl	
Split of on balance sheet exposures (excluding derivatives)	£m
Exposures treated as sovereigns	38.5
Institutions	20.5
Secured by mortgages on immovable properties	253.3
Exposures in default	1.6
Other exposures (e.g. equity, securitisations and other non-credit obligation assets)	3.1
EU-3 Banking book exposures	317.3
Trading book exposures	-
EU-1 Total on-balance sheet exposures (excluding derivatives)	317.3

TABLE LR Com	
Leverage ratio common disclosure	£m
On-balance sheet items (excluding derivatives and SFTs but including collateral)	317.3
Asset amounts deducted in determining Tier 1 capital	(0.8)
Total on-balance sheet exposures (excluding derivatives and SFTs)	316.5
Total derivative exposures	0.0
Total off-balance sheet exposures	20.5
Total Exposures	337.0
Tier 1 Capital	22.5
Leverage ratio	6.68%

Credit Risk - Mortgages

36. 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.

37. A geographical analysis of Society mortgage exposures is as follows:

TABLE 4						
Society	Non-residential			Residential		
	Performing £m	Past Due £m	Total £m	Performing £m	Past Due £m	Total £m
Geographical region						
North	-	-	-	6.8	-	6.8
Yorkshire & Humberside	-	-	-	21.2	-	21.2
North West	-	-	-	21.3	-	21.3
East Midlands	4.6	0.1	4.7	109.7	2.0	111.7
West Midlands	0.3	-	0.3	20.6	0.1	20.7
East Anglia	-	-	-	5.0	-	5.0
South East	0.2	-	0.2	29.3	-	29.3
Greater London	-	-	-	9.8	-	9.8
South West	-	-	-	15.6	0.1	15.7
Wales	-	-	-	9.2	-	9.2
Less: Individual loss provisions	-	-	-	-	(0.8)	(0.8)
Total included in Table 2	5.1	0.1	5.2	248.5	1.4	249.9
Less: Collective loss provisions			(0.2)			(0.1)
Total per Report and Accounts			5.0			249.8

38. A residual maturity analysis of Loans and Advances to customers is provided at Note 14 of the Annual Report and Accounts 2019. The following caveat is added: "The maturity analysis is based on contractual maturity not expected redemption levels".

Impairment allowance

39. The Society's accounting policy in relation to the impairment allowance for loans and advances is set out in full at Note 1, accounting policies, to the Annual Report and Accounts 2019.

40. Full details of the movement on impairment allowance are provided at Note 15 to the Annual Report and Accounts 2019.

41. For capital adequacy purposes, collective provisions are regarded as Tier 2 capital (Table 1 above). Summarised details of the individual impairment provision movements during the year to 31 October 2019 are given in Table 5:

TABLE 5				
Individual impairment provisions - 2019	Brought forward £m	Written Off £m	Movement £m	Carried Forward £m
Society				
Non-residential	0.2	0.2	-	-
Residential	0.6	-	0.2	0.8
Total	0.8	0.2	0.2	0.8

42. Individual provisions of £0.8m have been used to adjust downwards the value of risk-weighted mortgage assets in the capital adequacy calculations.

Credit Risk - Treasury

43. 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 Fitch short term F1 and long term A. Other investments are only made on agreement of ALCO. Treasury deposits are also made with unrated building societies.

44. Policy limits and counterparties are regularly reviewed by the Society's MALCO and by the Board ALCO, with formal policy approval being made at Board level. The Society receives regular counterparty rating amendments from its Treasury advisors and limits may be suspended following adverse downgrades.

45. The following table shows the breakdown of liquid assets by maturity and rating at 31 October 2019 under the standardised approach. There were no liquid assets with maturity of more than one year.

Table 6		3 months to	Total
Rating	Maturity less than 3m £m	1 year £m	£m
Cash and balances at the Bank of England	38.5	-	38.5
AAA to AA-	-	-	-
A+ to A-	2.9	3.9	6.8
BBB+ and below	-	1.5	1.5
Unrated Building Societies	2.7	9.5	12.2
TOTAL	44.1	14.9	59.0

Derivatives

46. In addition to the exposures above that relate to liquid assets, the Society has exposures relating to derivative instruments. The Society uses derivative instruments to hedge its exposure to interest rate risk (interest rate swaps). Counterparty credit risk includes the risk that the derivatives counterparty will default on the transaction. All of the Society's derivatives are bilateral and conducted over-the-counter (OTC).

47. Under the CRR, credit institutions and investment firms are required to hold additional own funds due to Credit Valuation Adjustment (CVA) risk arising from the OTC derivatives. The charge is applicable to derivatives not subject to centralised clearing.

48. An overview of the CVA capital requirement is detailed below:

TABLE 7	Asset £'000	Risk Weighted Asset £'000	Capital required (£'000)
CVA Risk	-	13.3	1.1

Interest Rate Risk

49. Interest rate risk is referred to under the heading of Market Risk, in paragraph 16 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;
- Fixed rate mortgage lending; and,
- Fixed rate treasury investments.

50. Interest rate risk is managed by utilising natural hedges on the balance sheet and by effecting interest rate swaps with external counterparties.

51. The interest rate risk on savings and mortgage products is reviewed on a regular basis and hedging action taken as appropriate.

52. The Society's balance sheet is tested against Board gap limits on a monthly basis for the effects of a 2% parallel shift in interest rates.

53. Basis risk is reported to the MALCO, ALCO and the Board and is managed within the limits stated in the Financial Risk Management Policy.

54. Interest rate risk limits are an expression of the Board's risk appetite and are reviewed as part of updating the Society ICAAP.

Liquidity Risk

55. Liquidity risk is the risk that the Society will be unable to meet its financial obligations as they fall due as a result of imbalances in the cash flow of its activities either in stressed or business as usual conditions. This risk is managed through adherence to the Board policies for both Liquidity and Financial Risk Management, for which MALCO is responsible. Day to day responsibility for the management of the risk lies with the Finance Director.

56. Liquidity stress testing is carried out on a monthly basis to ensure the Society can withstand normal and stressed outflows. The key regulatory metric for measuring short term (30 day) liquidity risk is the liquidity coverage ratio (LCR) which compares the potential cash flows under a prescribed set of assumptions with the value of high quality liquid assets held as a Liquidity Buffer. The LCR must exceed 100%.

57. Table 8 shows the main components of the LCR calculation on an average basis for each quarter, based on the previous twelve month positions. The regulatory minimum requirement for the LCR is 100% and at 31 October 2019 the Society's LCR was 192%.

TABLE 8	Quarter Ended 31 Jan 2019	Quarter Ended 30 Apr 2019	Quarter Ended 31 Jul 2019	Quarter Ended 31 Oct 2019
Liquidity Buffer £m	38.8	32.9	37.2	39.2
Total Net Cash Outflows £m	14.1	15.7	17.3	20.2
Liquidity Coverage Ratio %	275%	209%	214%	194%

Operational Risk

58. Operational risk is the risk of loss arising from inadequate or failed internal processes, people and systems, or from external events. The Society operates a robust control environment to mitigate operational losses, including the maintenance of insurance policies.
59. A Business Continuity Plan and disaster recovery process is in place to ensure that disruptions to the Society's business can be appropriately managed.
60. The Society's operational risk capital requirement is calculated (under the Basic Indicator Approach) as 15% of the Society's average net income over the previous 3 years.

TABLE 9	Year Ended 31 Oct 2017	Year Ended 31 Oct 2018	Year Ended 31 Oct 2019	3 Year Average	Capital Requirement (15%)
Net Income (£'000)	4,810	5,122	5,240	5,058	759

Asset Encumbrance

61. The Society joined the Term Funding Scheme in January 2018 and the Index Long-Term Repo Scheme in July 2019 which required collateral in the form of mortgage loans to be lodged with the Bank. The funding received totalled £16.3m and allows the Society to reduce its funding costs and the rates charged to borrowers. The loans remain fully owned and operated by the Society but they are reported as encumbered.
62. The information in Table 10 is required to be disclosed based on median values of at least quarterly data on a rolling basis over the previous twelve months. As such, the results may not be directly comparable to other information provided in this disclosure or the Annual Report and Accounts.

TABLE 10	Encumbered Assets		Unencumbered Assets	
	Carrying Amount £'000	Fair Value £'000	Carrying Amount £'000	Fair Value £'000
Loans on demand	-	-	41,356	-
Debt securities	-	-	8,538	8,578
Loans and advance other than loans on demand	29,587	-	221,555	-
Other assets	-	-	3,127	-
Assets of the reporting institution	29,587		274,576	

Remuneration Policies and Practices

63. A risk arises if the Society's remuneration policies and practices could result in staff being rewarded for decisions inconsistent with the Board's risk appetite. It is therefore the Society's policy on remuneration to seek to ensure that its remuneration decisions are in line with effective risk management.
64. The Society seeks to ensure that its remuneration decisions are in line with its business strategy and long-term objectives, and consistent with the Society's current financial condition and future prospects. It also seeks to establish an appropriate balance between the fixed and variable elements of remuneration, although this balance will vary depending on the seniority and nature of an individual's employment. Performance measures used to calculate variable remuneration are therefore adjusted to take account of current or potential risks to the business and are consistent with the need to retain a strong capital base.

Variable remuneration is not paid unless it is sustainable within the Society's overall financial position. Guaranteed incentive payments do not form part of any remuneration package and all incentive schemes are non-contractual.

65. The Board has identified that those staff whose professional activities have a material impact on the Society's risk profile are the three Executive Directors: the Chief Executive Officer, Operations Director and Finance Director.
66. Information concerning the mandate of the Board Staff and Remuneration Committee and the decision making process used in determining the remuneration policy of the Executive Directors, and information on the link between pay and performance, is contained in the Directors' Remuneration Report in the Society's Annual Report and Accounts 2019 and the Summary Financial Statement 2019. The total remuneration of the Executive Directors in respect of the year ended 31 October 2019 was £414,000.
67. The Staff and Remuneration Committee is also responsible for determining the terms and conditions for all other management and staff of the Society.

[Country-by-country reporting](#)

68. The country-by-country disclosures as required by Article 89 of the Capital Requirements Directive IV (CRD IV) are disclosed in the Society's Annual Report and Accounts.

[Conclusion](#)

69. This disclosure document, prepared annually in accordance with the requirements of CRR Articles 431 to 455, 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.
70. 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](#).