The Cumberland

# Pillar 3 Disclosure – 31 March 2019

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*Final dated 29 May 2019*

## 1. **Overview**

(a) Introduction

The European Union implemented the Basel II accord in 2007 through the Capital Requirements Directive (CRD), setting out a 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.

From January 2014, the Basel III capital accord, which is being implemented by the EU via ‘Capital Requirements Directive IV’ (CRD 4) and the Capital Requirements Regulation (CRR), became effective.

(b) Overview of Basel III

In the UK the Society’s regulator, the Prudential Regulation Authority (PRA), is responsible for the implementation of the CRD, which consists of three main elements, known as ‘Pillars’:

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 PRA, which assess whether additional capital should be held for those risks not covered under Pillar 1.

Pillar 3 Disclosure of key information on capital, risk exposures and risk management processes.

(c) Basis of preparation

This document has been prepared to meet the disclosure requirements of CRD IV as presented in Part Eight of Regulation (EU) No. 575/2013. These requirements are usually referred to simply as “Pillar 3”.

The Group has prepared the templates specified by the CRR and associated regulations except where they do not apply, and in these instances a note has been included giving the reasons. This applies in particular to the disclosure requirements around IFRS9 and around securitisation, discussed below. In each table included in this document the Group has completed the rows and columns which apply to its business and has omitted any rows or columns which would otherwise be blank.

All figures within this document are as at 31 March 2019 unless otherwise stated and cover the Cumberland Building Society Group, which consists of Cumberland Building Society and its trading subsidiaries (Borderway Finance Limited, Cumberland Estate Agents Limited, Cumberland Financial Services Limited, Cumberland Property Services Limited and Cumberland Homes Limited). For prudential purposes the Group presents its consolidated position as above.

There are no current or foreseen material practical or legal impediments to the transfer of own funds or repayment of liabilities among the parent undertaking and its subsidiaries. All figures in tables are in thousands of pounds, unless stated otherwise.

The financial statements have been prepared under the historical cost convention, modified to include certain items at fair value, and in accordance with Financial Reporting Standard 102 (FRS 102) and International Accounting Standard 39 (IAS 39). The Society has not yet adopted IFRS 9 and so the disclosures required under Article 473 of the CRR have not been prepared.

The Society does not participate in securitisation activity, either as originator, facilitator or investor. As a result it does not calculate risk weighted assets in accordance with Part 3, Title 2 Chapter 5 of the CRR, or calculate its own funder requirements under Articles 337 or 228 of the CRR, and the disclosures required under Article 449 of the CRR have not been prepared.

Pillar 3 disclosures are prepared annually to 31 March and are published on the Society's website at the same time as the Annual Report and Accounts.

This document is not subject to external audit. It has though, as directed by the Board, been reviewed by Internal Audit and reviewed and approved by the Board.

The disclosures in this document are based on the CRD IV rules and fulfil the Group's obligations under Pillar 3.

(d) Key regulatory metrics

The key regulatory metrics for the Group are as follows.

| | | 2019 | 2018 |
|---|---|---|---|
| CET1 capital | Page 15 (note 1) | £185.1m | £173.3m |
| CET1 capital - % | | 17.7% | 16.0% |
| Total Regulatory capital | Page 15 | £186.7m | £174.9m |
| Total Risk Weighted Assets | Page 16 | £984.4m | £949.7m |
| Leverage exposure | Page 30 | £2,621m | £2,561m |
| Leverage ratio | | 7.06% | 6.77% |
| Liquidity Coverage Ratio - % | Page 30 | 252% | 220% |

Note 1 – total Tier 1 capital and CET1 capital are the same values.

(e) Verification

The Pillar 3 disclosures are subject to the same level of internal review and internal controls as the information provided for financial reporting. Much of the information required for disclosure in the Pillar 3 report is calculated through the quarterly COREP reporting process and subject to the internal controls and review process currently in place. The information is prepared and checked by line 1 with oversight and challenge by lines 2 and 3 as appropriate.

The Pillar 3 Disclosure document is reviewed by the Audit Committee for onward recommendation, and approved by the Board alongside the Annual Report and Accounts.

## 2. Overview of Risk Management

### (a) Risk appetite

The overall Risk Appetite is as follows

The Cumberland will only pursue a strategy that drives towards its vision, is consistent with the Society's values and does not exceed stated risk appetite and minimum required standards.

The Cumberland is a prudent business that ensures compliance with all applicable laws and regulations and maintains a robust control environment delivered through a consistently applied Risk Management Framework.

The chosen strategy has to be resilient enough to withstand severe but plausible stresses and allow the business to recover and minimise the detrimental impacts from unforeseen shocks.

The Risk Appetite is managed through a comprehensive Risk Appetite Framework and is reported to every Board Risk Committee. All the agreed measures are owned by individual members of the Senior Leadership Team with limits and Triggers agreed by Board

The Society has elected to omit disclosing key ratios and figures relating to its risk appetite, as they are considered to be proprietary information as per CRR article 432.

### (b) Risk Management framework

The Society applies a consistent approach to Risk Management through its Risk Management Framework.

The Society uses the best practice 3 lines of Defence approach, ensuring that risks are managed in the areas they are best understood (i.e. the business). A 2nd line of defence Risk team ensures consistency through the use of frameworks, tools and policies and provides independent oversight to the Board through Risk Reporting and the outputs and findings from the combined assurance plan. The 3rd line of defence, the internal audit function, provides independent assurance over all elements of the Society and helps ensure appropriate risk capabilities and approaches.

The Key Risk Frameworks component of the Risk Management Framework details how risk influences and is part of the overall Society strategy development.

A policy Framework is in place that determines the approach for setting minimum standards, with a Strategic Risk Policy detailing the minimum requirements for strategy setting and strategic considerations. This is complemented by a Risk Appetite Framework that determines the risk limits set by Board to act as guiderails under which the senior leadership team can deliver the strategy in a sustainable manner consistent with the values and working towards the overall vision and purpose.

In accordance with the requirements of Article 435 in Part Eight of the CRR the Society's senior leadership team are satisfied that the risk arrangements in place at the Society are adequate with regard to the Society's profile and strategy.

### (c) Principal Risks

The principal risks facing the Society and the procedures put in place to manage them are described below.

## Credit Risk

The Society is primarily exposed to credit risk in respect of either mortgage customers or Treasury counterparties being unable to meet their obligations as they become due. Credit risk also arises in the operations of Borderway Finance Limited, the Group's vehicle finance business, and in relation to current account overdrafts.

### i) Loans fully secured on residential property

The Residential Lending Policy Statement documents the Society's approach to and appetite for residential lending mortgage credit risk. Policy 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 a specialist residential mortgage underwriting team. Applications outside individuals' mandates are considered by the Residential Credit Committee.

The Society's principal focus in lending secured on residential property, is on owner occupier lending within its branch operating area on a direct basis. In addition however, since 2012-13 the Society has accepted introduced residential mortgage business, almost all located outside of the branch operating area, from a small number of partners. All introduced mortgage cases are restricted to a maximum loan to value ratio of 75%.

As a result of its long established approach, the Society's owner occupier residential lending exhibits a strong concentration within its branch operating area of Cumbria, Dumfries & Galloway, north Lancashire and west Northumberland. This is monitored by the Board Risk Committee each quarter, with a detailed assessment being produced on an annual basis and included as an appendix in the Society's ICAAP. 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.

The Society has increased its lending in the Buy to Let and Holiday Let markets during the last five years, which in addition to the introduced business channel referred to above, has reduced the geographical concentration within its mortgage book. Buy to let lending to corporate bodies and professional landlords is managed by the specialist Cumberland Business team. All Buy to Let and Holiday Let lending is restricted to a maximum loan to value ratio of 75%.

### ii) Loans fully secured on land

The Commercial Lending Policy Statement documents the Society's approach to, and appetite for, commercial lending credit risk, covering as well as loans fully secured on land, holiday and buy to let lending managed by the Cumberland Business department.

Policy is reviewed annually, or on a more frequent basis if there are changes to the operating environment. The Society's specialist commercial lending managers produce detailed appraisals of each application, and all applications are considered by either a specialist Commercial Underwriter or the Commercial Credit Committee.

Whilst there is a concentration of commercial lending within the Society's branch operating area, principally with respect to tourism in the Lake District, this is less pronounced than for owner occupier residential lending, and the Board monitors the geographical and sectoral compositions of the loan book that is fully secured on land.

### iii) Treasury

The Board Assets & Liabilities Committee (BALCO) is responsible for recommending credit limits on Treasury counterparties for approval by the Board, and these are set out in the Financial Risk Management Policy and reviewed annually or more frequently if appropriate. The list of counterparties consists of those which, on first inclusion, meet or exceed minimum credit rating agency rating; exposure limits are reconsidered following any change to the counterparty's credit rating. Credit exposure limits for building societies (rated and unrated) are reviewed annually following receipt of annual results. 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 replacement cost of derivative financial instruments.

## Financial Risk

### i) Interest Rate Risk in the Banking Book (IRRBB)

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 Group's earnings and capital. The BALCO assists management and the Board in managing the various elements of IRRBB. Interest rate risk is managed through matching assets and liabilities on the balance sheet with similar interest rate characteristics 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, with hedging action taken as appropriate, within parameters defined in the Financial Risk Management Policy (FRMP).

The balance sheet is stress tested on a monthly basis to calculate the potential impacts on the Society's Economic Value and Net Interest Income of a 200 basis parallel rise and fall in rates; the results are reported to BALCO and the Board. The impacts of non-parallel changes in the yield curve are also reported to BALCO.

### ii) Liquidity Risk

Liquidity risk is the risk that the Society will be unable to meet its commitments when they fall due. The BALCO 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 Process (ILAAP) and the FRMP. Monthly, the balance sheet is stress tested to confirm that the Group can withstand normal and extreme cash outflows.

The Society's savings and current account balances are marginally lower than its mortgage balances and excluding TFS funding, it has a relatively low level of wholesale funding compared to many of its peers. Its proportion of deposits and other borrowings not in the form of shares held by individuals, was 18.2% of share and deposit liabilities at 31 March 2019, but out of a total of £429 million, £290 million was related to drawdowns from the TFS (plus a further £70 million of FLS treasury bills held off balance sheet), and £107 million was from retail business customers, principally small and medium sized enterprises located within the Society's operating area. This means that the Society's dependence upon the financial markets for funding is currently relatively limited.

## Operational Risk

Operational risk is the risk of loss arising from inadequate or failed internal processes or systems, human error, external events or the underperformance or failure of third party suppliers. The Group Operational Risk Policy sets out the Group's approach to the management of operational risk, with the Third Party Relationship Policy covering the approach to the management of third party risk.

Whilst line management is responsible for identifying and managing operational risks, this is carried out using an agreed framework and methodology and with the assistance of the Risk function, with quarterly reporting to the Risk Management Committee (RMC) and the Board Risk Committee (BRC).

Various other Board-approved policies, e.g. the Group Information Security Policy, Money Laundering Policy Statement and Data Protection Policy Statement, reinforce the Group Operational Risk Policy in specific areas.

The Society maintains appropriate insurance cover which is reviewed on at least an annual basis.

The Group's operational risk capital charge is calculated using the 'basic indicator approach'.

**Conduct and Regulatory Risk**

Conduct and regulatory risks arise from the Group's conduct in its relationship with members and concerns the risk of failing to treat members fairly with resulting detriment to those members. Conduct and regulatory risk is considered by the RMC on a quarterly basis by reviewing the Society's performance in this area, covering specific issues that have arisen and relevant management information. The RMC reports to the BRC, which in turn reports to the Board.

**Strategic/Business Risk**

The Society's Board of Directors is responsible for the management of its strategic and business risks. 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 RMC, BRC and the Board consider formally, as an agenda item, the Society's key strategic and business 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 was closed to new members in 2000 and to future accrual at 31 March 2015.

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.

### (d) Risk Governance Structure

The Board is responsible for ensuring that effective systems and controls are in place for risk management. Governance is maintained through delegation of authority from the Board, down through the risk management hierarchy, supported by a committee based structure designed to ensure risk appetites, policies, procedures, controls and reporting are fully aligned with regulation, law, corporate governance and industry good practice.

The Board is ultimately responsible for setting the Society's risk appetite, approving the Risk Management Framework (RMF) and all key risk policies and ensuring that effective systems and controls are in place for risk management. To that end the Society's committee structure, policies, procedures and controls are designed to ensure that full coverage of the principal risk categories of credit risk, financial risk, operational risk, conduct and regulatory risk and strategic and business risk is reported, discussed, overseen and challenged at various levels across the Society, culminating in reporting to the Board.

**Audit Committee (AC)**

The AC is a Committee of the Board whose responsibilities include:

- Monitoring the integrity of the Group's financial reporting;
- Reporting to the Board on the appropriateness of the Group's accounting policies;
- Advising the Board on whether the Committee believes the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the necessary information for the Group's Members to assess the group's performance, business model and strategy;
- Oversight of the Group's system of internal control, including the work performed by the Internal Audit function;
- Monitoring the relationship between management and the external auditor;
- Monitoring the external auditor's adherence to the professional ethical standards expected of audit firms; and
- Overseeing the Group's whistleblowing arrangements.

The Committee consists of three non-executive directors and meets at least five times a year. The Chief Executive Officer, Chief Financial Officer, the Head of Internal Audit, the Chief Risk Officer and a representative from the external auditors also attend Committee meetings by invitation to assist in its deliberations.

The Committee Chair provides a report plus the AC minutes at the following Board meeting.

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

**Board Risk Committee (BRC)**

The BRC assists the Board in fulfilling its oversight responsibilities for risk management across the Society, including all subsidiaries and all principal risk categories (although BALCO covers Financial Risk in more detail). The BRC reports to the Board and will escalate any matter to the Board it deems appropriate. The Committee's primary duties are:

- To advise the Board on setting the Society's overall risk appetite and risk strategy
- To oversee the development and operation of the Society's Risk Management Framework
- To review and provide oversight of the effectiveness of the Group's compliance arrangements

- To provide oversight and challenge of the Group's significant risks and the controls in place to mitigate those risks
- To provide oversight of the Group's risk management arrangements to ensure that there is an appropriate risk culture and capability in place throughout the Society
- To review, challenge and recommend for approval to the Board the Society's key risk documents on at least an annual basis.
- To monitor compliance with Board approved risk appetite statements and limits to ensure the Society is not exposed to excessive risk

The Committee consists of four non-executive directors and meets at least four times a year. The Chief Executive Officer, Chief Financial Officer, Chief Risk Officer and the Head of Internal Audit also attend Committee meetings by invitation to assist in its deliberations.

The Committee receives reports and management information from the Risk function and the EMRC in order to monitor overall risk exposures against risk appetite and take account of current, emerging and potential risks.

## **Other Committees**

### Board Assets and Liabilities Committee (BALCO)

The BALCO, which took over this responsibility from ALCO during the year, is responsible for the oversight of capital and consideration of the following key risks:

- Liquidity risk
- Funding risk
- Interest rate risk, including
    - Basis risk
    - Margin risk
- Wholesale credit risk, including all treasury counterparty exposures

The Committee meets eight times a year to consider the above risks faced by the Society, along with balance sheet management and treasury controls, systems and policies, policy implementation, policy compliance and regulatory compliance. The Committee reviews a wide range of information relating to liquidity and funding exposures, profiles and limits and will recommend changes to policy and procedure to the Board as appropriate. Minutes of the BALCO meetings are provided to the following Board Meeting.

Membership of BALCO includes the Chief Executive Officer, Chief Financial Officer and two Non-Executive Directors. Attendees include the Head of Treasury, the Treasurer, the Chief Risk Officer and the Head of Internal Audit, with other Executives and Managers attending when appropriate. An operational review meeting, including attendees from Treasury, Finance, Risk and Audit, is held in those months in which there is no Board meeting, to give assurance that financial risk measures remain within risk appetite.

A Liquidity Management Committee (LMC) consisting of the Head of Treasury, Treasurer, Head of Finance and Product Development Manager meets monthly to review the Society's liquidity position against regulatory and policy requirements. The LMC considers forward-looking liquidity risk information and sets the short-term operational requirements for managing liquidity risk. Minutes of the LMC meetings are provided to BALCO.

### Risk Management Committee (RMC)

This Committee meets quarterly and reviews a range of information covering credit risk, operational risk, conduct and regulatory risk and strategic risk, and reports to the BRC.

In relation to credit risk the committee reviews on a quarterly basis, the composition of the book against statutory and internal limits, the performance of the book in terms of arrears and possessions, oversight of the underwriting and any emerging trends within the book.

In relation to operational risk the committee reviews an oversight assessment of the main operational risk categories, key risk and control performance, operational loss information, third party supplier performance and significant risk incident dashboards from management.

In relation to conduct and regulatory risk the RMC provides oversight of conduct risk across the business, reviews and challenges conduct risk management information, ensures management undertakes root cause analysis of conduct risk failings and appropriate mitigating actions. The Committee also considers forthcoming regulatory changes that will have conduct risk implications for the Society.

In relation to strategic risk the Committee reviews the Strategic Risk Register in order to assess the status of the significant risks to achievement of strategic objectives within the Corporate Plan. The Committee considers whether any significant risks have changed since the previous quarter and whether any mitigating actions are required or risk appetite in any area needs to be reviewed. The progress and suitability of the mitigating actions are also challenged by Risk.

**Residential Credit Committee**

This Committee meets to consider decisions on higher value residential mortgage applications that are outside the delegated mandate structure within the Underwriting team, or complex cases that require more detailed consideration. Above a certain value, subject to endorsement of the case by the Committee, applications are escalated to two non-executive directors for approval, with a summary of any such cases reported to the next Board meeting. All Committee meetings are attended by a member of the Risk function.

**Commercial Credit Committee**

This Committee meets to consider decisions on higher value commercial mortgage applications, holiday let applications and buy to let applications that are outside the delegated mandate structure within the Cumberland Business department. Above a certain value, applications are referred to the Board for approval. All Committee meetings are attended by a member of the Risk function.

## <u>Three Lines of Defence</u>

The Society's RMF utilises the three lines of defence model, which is recognised as an industry standard for risk management.

Risk management is primarily the responsibility of all management and staff of the Society who form the first line of defence. Management has a responsibility to identify risks to the business, understand how those risks might impact each area of the business and to establish effective controls or mitigating activities. Management also has a responsibility to comply with risk policies and the RMF.

In the second line of defence oversight is conducted to challenge managers and members of staff effectively in their performance of risk management activities. The second line Risk function designs and develops the overall risk management framework and monitors business as usual adherence to the framework, which includes regulatory compliance. The Chief Risk Officer has an independent reporting line directly to the Chairman of the BRC and reports to the Chief Executive for day-to-day management.

The third line of defence is provided by the Group's Internal Audit function, which is responsible for independently reviewing the effectiveness of the Society's risk management structure and adherence to processes. The Head of Internal Audit has an independent reporting line directly to the Chairman of the AC and reports to the Chief Executive for day-to-day management. The AC approves the work programme of Internal Audit and reviews reports on the results of the work performed. The three lines of defence model is shown in the following table (over):

| Line | Activity | Responsibility |
|---|---|---|
| Board | Establishes culture and values<br>Defines risk appetite and strategy<br>Approves frameworks, methodologies, policies and roles and responsibilities | Board |
| 1 | Ownership of day to day risk management<br>Compliance with relevant regulation and legislation<br>Identifies, manages and mitigates risks faced by the Society<br>Defines and operates controls and limits<br>Assesses key risk indicators and market conditions<br>Produces management information and reports on risk | Line Management |
| 2 | Facilitate the design and development of the overall risk management framework and associated policies<br>Oversight, monitoring and reporting of key risks<br>Oversight, monitoring and reporting against risk appetite<br>Monitor business as usual adherence to framework<br>Monitor and report on regulatory compliance<br>Monitoring and reporting on significant risks | Risk Management |
| 3 | Independent testing and verification of efficacy of Group's business model, controls, policies, processes and business line compliance<br>Assurance that the risk management framework is functioning as designed | Internal Audit |

Where considered necessary, the Group may use external specialists to support its Risk and Internal Audit functions through 'co-sourcing' in specific areas.

## (e) Risk measurement and reporting

The provision and reporting of comprehensive risk data is essential in allowing management and the Board to understand the Society's risks and how they are changing, and to assess risk on a forward looking basis. A broad range of management information and risk data is used to identify, assess, monitor, manage and report on risk.

Risk Appetite reporting provides accurate and timely information to the Board to help ensure that the Society does not deliver its strategy outside of the agreed risk parameters. As triggers are reached the Board will discuss the suitability of the current strategy and whether additional risk mitigants are required.

An Asset and Liability management information system and associated models are used within Treasury to manage, model and measure key risks including liquidity risk, funding risk and interest rate risk on the current and projected balance sheet. Exposures against trigger points and policy limits are provided to BALCO and reported to the next Board meeting.

A forward looking three year financial plan is produced to measure the impact of current performance, future plans and liquidity and funding assumptions on future profit and loss, balance sheet, capital resource requirements and key financial ratios. The results of the plan are reported to and discussed by the Board.

A comprehensive set of limits and trigger points is in place in relation to lending limits. Exposures against the limits and triggers points are reported to the BRC every quarter to measure performance against appetite and to consider the likely future trajectory of exposures against limits.

On a monthly basis details of commercial mortgage cases in arrears are reported to the Board, with the frequency for residential arrears performance reporting being quarterly.

Risk performance data relating to operational risk incidents and losses is reported every quarter to the RMC and BRC in order to measure performance against appetite. This information also allows management and the Board to evaluate whether controls are working effectively. Conduct and regulatory risk reporting also flows through RMC to BRC and the Board.

### (f) Stress Testing

The Society maintains a Stress Testing and Scenario Analysis Statement as an Appendix to the ICAAP. The statement covers the Society's stress testing methodologies in relation to:

- Scenario analyses covering margin compression, additional costs, weak or no business growth, and combinations of these
- Credit risk – residential mortgages
- Credit risk – commercial mortgages
- Combinations of the above, with management actions factored in
- Treasury – including interest rate risk, funding risk and liquidity risk
- Pension obligation costs
- Reverse stress testing

The results of these stress tests feed into the ICAAP, ILAAP, Recovery Plan and the corporate planning processes and inform the Society's risk appetite statements and measures.

Residential and Commercial mortgage stress tests are undertaken periodically to model the impact on the index-linked values of the properties in mortgage to the Society falling by agreed percentages. An assumed loss crystallisation rate is factored in for cases which are above 100% LTV in the stressed scenario after an addition of interest to allow for the time taken to sell the property. To this is added extra staff costs in order to arrive at an aggregate loss amount. Within the residential mortgage stress test, buy to let and holiday let portfolios are separately identified.

Specific additional stress tests are run where deemed appropriate, for example in relation to geography, sector or employer. Management also produce additional mortgage stress tests on the forward projections contained within the final year of the 3 year plan to further enhance the monitoring of such exposures in stress environments.

In risk management terms, the results of the mortgage stress tests inform the Society's capital position, allow management and the Board to evaluate if risk appetite is set appropriately and feed into the corporate planning process.

Liquidity stress tests are undertaken monthly and the results reported to BALCO and the Board. These stress tests are designed to highlight any shortfalls in the Society's liquidity holdings over a range of time horizons. Each of the tests incorporates assumptions for the run-off rates of retail and wholesale funding.

Reverse liquidity stress testing is also undertaken every quarter and assumes an increasing rate of outflow to further test resilience and identify areas of concern within the liquidity maturity profile.

The liquidity stress tests allow management and the Board to assess the impact of adverse scenarios upon liquidity and funding levels and are used in determining policy and contingency planning. The results of the tests are also used to further inform the Society's risk appetite, the framework of policy limits applied to Treasury positions and set the context for the risk assessments and contingency liquidity and funding plans within the ILAAP.

Interest rate risk scenarios are run monthly to model and evaluate the impact of a range of negative but credible changes in individual rate bases (including, for example, Base Rate and Libor) on net interest income.

The pension obligation stress test is undertaken annually by the Scheme Actuary and makes assumptions about discount rates, mortality rates, asset values and cash commutation.

A range of operational risk scenarios are created for the ICAAP covering a broad range of risks, with the potential financial impacts of these being assessed.

## (g) Risk Mitigation

The Society uses a number of strategies and processes to manage, hedge and mitigate risks arising from its business model.

In relation to residential mortgage credit risk the basic form of mitigation is to undertake a thorough assessment of the borrowers' ability to service the proposed mortgage at the initial pay rate and at a stressed rate. All mortgages are individually underwritten. All mortgage lending is supported by an appropriate form of valuation using either an independent firm of valuers, an indexed valuation for further advances or an Automated Valuation Model, which can be used on some lower risk cases as defined within Lending Policy. Borrowers are subject to mortgage conditions that impose obligations on both parties but provide the Society with rights to enforce its security should it need to.

For commercial lending credit risk a full assessment of the ability to service the proposed mortgage is undertaken and security is taken over the commercial property, along with as appropriate, collateral such as other property, a debenture over the company assets or other warranties. Commercial valuation firms are used to provide the Society with a valuation of the commercial premises. Standard commercial mortgage conditions, which impose obligations on both parties but provide the Society with rights to enforce its security should it need to, are supplemented by specific conditions prepared by external solicitors, where appropriate.

Treasury credit risk is mitigated by monitoring external credit ratings and the financial performance of unrated building societies.

Liquidity risk is mitigated by careful monitoring of the liquidity position by the Treasurer, and through relevant information provided to the LMC and BALCO.

Operational and conduct risks are mitigated through well defined and documented policies and procedures and thorough staff training. Risk and control registers are used to identify and capture significant risk and key controls and these are reviewed on an ongoing basis and in the light of experience. Risk performance is monitored quarterly and risk incident reports are submitted to the RMC and BRC on a quarterly basis. The risk function meets with senior managers on a regular basis to review incidents and discuss the control environment.

The Society is exposed to interest rate risks through offering fixed rate mortgage and savings products. Where possible, fixed rate mortgages and savings are matched against each other. Where this is not possible, the Society uses derivatives (interest rate swaps) to offset the interest rate risks arising from these products. The Society's hedging exposures are monitored daily in the Treasury department. The effectiveness of the Society's hedging approach is assessed monthly through calculating the full impact of an interest rate stress; the results of this are presented to BALCO and the Board.

The Group's agreements to enter derivatives transactions with counterparties are all documented through the International Swaps and Derivatives Association (ISDA) Master Agreement. In addition, the Group's agreements in respect of repurchase contracts are documented through the Global Master Repurchase Agreement (GMRA). Credit Support Annexes (CSA) are in place with all of the Group's ISDA and GMRA counterparties. These provide the legal basis for measuring the extent of any credit risk exposures and govern how cash is moved as collateral between the Group and the counterparty to offset these exposures, which arise as a result of movements in interest rates.

The Society monitors the continuing effectiveness of hedges and mitigants in a number of ways. Treasury positions are monitored on a daily and monthly basis and exposures are reported to BALCO and Board on a monthly basis. Treasury strategy is reviewed quarterly and this review will look at activities and developments in the last quarter and review what may be on the horizon in order to determine whether any changes are required to risk mitigation. The FRMP and counterparty financial strength are reviewed at least annually.

Strategic and business risk is mitigated through the identification, assessment, management and reporting of risks to the Society's objectives within the Corporate Plan. A Strategic Risk Register is maintained and reviewed by the RMC, BRC and Board.

## 3. Capital Resources

### Total capital resources

The capital resources of the Group at 31 March are set out below.

| | 2019 £000 | 2018 £000 |
|---|---|---|
| **Tier 1 Capital** | | |
| General reserves | 182,531 | 172,049 |
| Available for sale reserves | 2,602 | 1,233 |
| **Common Equity Tier 1 (CET1) capital and total Tier 1 Capital** | **185,133** | **173,282** |
| | | |
| **Tier 2 Capital** | | |
| Allowance for collective impairment | 1,616 | 1,641 |
| **Total Tier 2 Capital** | **1,616** | **1,641** |
| | | |
| **Total capital** | **186,749** | **174,923** |

These figures are as shown in the Group's Balance Sheet, Statement of Changes in Members' Interest and note 13, Provisions for bad and doubtful debts, in the Annual Report and Accounts to 31 March 2019. No reconciliation to the balance sheet is required.

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

There is no regulatory CET1 or Tier 2 capital in the form of capital instruments issued by the Group. For this reason the 'Capital main features' template and 'full terms and conditions' disclosures required by EU Regulation 1423/2013 have not been prepared.

The capital flows in the year to 31 March 2019 are set out below.

| | 2018 £000 |
|---|---|
| **CET1 capital at 31 March 2018** | **173,282** |
| Profit for the year to 31 March 2019 after taxation | 11,401 |
| Other comprehensive income / (expense) | |
| Gain on available for sale investment securities | 68 |
| Gain on equity share investment | 1,584 |
| Actuarial loss on retirement benefit obligations | (1,107) |
| Deferred tax relating to movements through OCI | (95) |
| | |
| **CET1 capital at 31 March 2019** | **185,133** |
| | |
| **Tier 2 capital at 31 March 2018** | **1,641** |
| Reduction in collective impairment | (25) |
| | |
| **Tier 2 capital at 31 March 2019** | **1,616** |
| | |
| **Total capital at 31 March 2019** | **186,749** |

## 4. Capital Adequacy

### (a) Minimum capital requirement

The Group's capital requirement under Pillar 1 is based on 8% of its Risk Weighted Assets for each of the applicable standardised credit risk exposure classes. Risk weightings are those applicable to the standardised approach. The following tables show the Group's exposures, the risk weighted assets in relation to each, and the capital required at 8.0%, at 31 March 2019 and 2018.

**31 March 2019 – all figures in £000s**

| Asset Class | Exposures on balance sheet | Risk weighted assets | Capital requirement at 8.0% |
|---|---|---|---|
| Sovereigns and their central banks | 270,023 | - | - |
| Banks | 192,328 | 66,236 | 5,299 |
| Residential property (FSRP) | 1,894,791 | 655,114 | 52,408 |
| Commercial real estate (FSOL) | 163,527 | 129,144 | 10,331 |
| Other loans | 24,346 | 18,804 | 1,504 |
| Past-due loans | 3,701 | 4,379 | 351 |
| Other assets | 22,591 | 21,844 | 1,747 |
| Equity - Visa Inc. preference shares | 5,497 | 5,497 | 440 |
| Credit valuation adjustment | - | 919 | 74 |
| Counterparty credit risk | - | 2,460 | 198 |
| **Total credit risk - standardised** | **2,576,804** | **904,397** | **72,352** |
| Operational risk | - | 80,028 | 6,402 |
| **Total** | **2,576,804** | **984,425** | **78,754** |

**31 March 2018 – all figures in £000s**

| Asset Class | Exposures on balance sheet | Risk weighted assets | Capital requirement at 8.0% |
|---|---|---|---|
| Sovereigns and their central banks | 291,097 | - | - |
| Banks | 148,949 | 43,308 | 3,465 |
| Residential property (FSRP) | 1,862,383 | 646,984 | 51,759 |
| Commercial real estate (FSOL) | 157,759 | 124,012 | 9,921 |
| Other loans | 23,308 | 17,894 | 1,431 |
| Past-due loans | 4,460 | 4,824 | 386 |
| Other assets | 27,768 | 28,553 | 2,284 |
| Equity - Visa Inc. preference shares | 3,913 | 3,913 | 313 |
| Credit valuation adjustment | - | 1,602 | 128 |
| Counterparty credit risk | - | 3,270 | 262 |
| **Total credit risk - standardised** | **2,519,637** | **874,360** | **69,949** |
| Operational risk | - | 75,294 | 6,023 |
| **Total** | **2,519,637** | **949,654** | **75,972** |

Lending figures in the tables above may be reconciled to those in note 12 of the Annual Report & Accounts for the year to 31 March 2019 as follows.

2019 - £000

| | FSRP | FSOL | Other |
|---|---|---|---|
| Exposures for risk weighting purposes | 1,894,791 | 163,527 | 24,346 |
| Past-due loans | 2,262 | 1,371 | 68 |
| Provisions | 522 | 1,176 | 91 |
| Fair value adjustments | (1,967) | (172) | - |
| Gross balances | 1,895,608 | 165,902 | 24,505 |

2018 - £000

| | FSRP | FSOL | Other |
|---|---|---|---|
| Exposures for risk weighting purposes | 1,862,383 | 157,759 | 23,308 |
| Past-due loans | 3,735 | 667 | 58 |
| Provisions | 551 | 1,579 | 86 |
| Fair value adjustments | 3,318 | 284 | - |
| Gross balances | 1,869,987 | 160,289 | 23,452 |

The average risk weightings by asset class in the year are shown in the table below. The figures shown are the arithmetic means for the five quarters ended 31 March 2018 to 31 March 2019 inclusive.

| Asset Class | Risk weighted assets £000 |
|---|---|
| Sovereigns and their central banks | - |
| Banks | 48,694 |
| Residential property (FSRP) | 651,747 |
| Commercial real estate (FSOL) | 125,469 |
| Other loans | 18,122 |
| Past-due loans | 4,884 |
| Other assets | 24,208 |
| Equity - Visa Inc. preference shares | 4,797 |
| Credit valuation adjustment | 1,273 |
| Counterparty credit risk | 3,148 |
| **Total credit risk - standardised** | **882,342** |
| Operational risk | 76,241 |
| **Total** | **958,583** |

**(b) Capital adequacy**

The table below shows the Group's Pillar 1 capital requirement for each key risk area under the standardised approach, expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes, at 31 March 2019. The table also shows the Group's capital resources, as set out in section 3, together with the excess over the minimum capital requirement.

| | 2019 £000 | 2018 £000 |
|---|---|---|
| Credit risk | | |
| Loans and advances to customers | 64,594 | 63,497 |
| Wholesale lending | 5,299 | 3,465 |
| Other items | 2,459 | 2,987 |
| Total credit risk | 72,352 | 69,949 |
| Operational risk | 6,402 | 6,023 |
| **Minimum capital requirement** | **78,754** | **75,972** |
| Pillar 2A capital requirement | 30,162 | 29,630 |
| **Total Pillar 1 and Pillar 2A** | **108,916** | **105,602** |
| **Capital resources** | **186,749** | **174,923** |
| **Excess of own funds over Pillar 1 and Pillar 2A requirement** | **77,833** | **69,321** |

**(c) Capital Buffers**

Basel III requires the use of common equity capital buffers to ensure that a firm has sufficient loss absorbing capital that provides a financial cushion against difficulties that might arise in times of stress. The Society is now required to hold sufficient Common Equity Tier 1 capital to meet the buffers described below.

The **Capital Conservation Buffer** (CCoB) is a requirement for all banks to build up an additional loss-absorbing capital cushion to improve their resilience to stresses. The CCoB was phased in over the three years to 1 January 2019 and is now at its final level of 2.5% of risk weighted assets.

The **Countercyclical buffer** (CCyB) is a buffer to provide a capital cushion to allow and compensate for procyclical effects. The CCyB may be varied by the regulator over time, to a maximum of 2.5% of risk weighted assets. At 31 March 2019 the CCyB was set at 1.0%.

The rate set for the CCyB may vary from country to country. All of the Group's credit risk exposures are UK-based, and the Group is required to hold capital of 1.0% against all of its risk weighted assets. The institution-specific CCyB at 31 March 2019 is as follows:

| | |
|---|---|
| Total risk exposure amount (£000) | 984,425 |
| Institution-specific CCyB | 1.0% |
| Institution-specific countercyclical buffer requirement (£000) | 9,844 |

The CCoB and the CCyB collectively form the CRD IV buffer.

The Group also holds a specific **PRA Supervisory buffer**, which is reduced by the CRD IV Buffer, where applicable, to ensure no duplication in capital requirements.

The Group is required to meet at least 56% of its Total Capital Requirement (TCR) by Common Equity Tier 1 in excess of the buffers noted above. The Group has met this requirement through the year ended 31 March 2019.

## 5. Credit Risk

### General qualitative information about credit risk

### a) Business Model and Credit Risk

The Society is exposed to credit risk in respect of:

- Lending fully secured on residential property (owner occupier, buy to let and holiday let)
- Lending fully secured on land
- Vehicle finance and unsecured personal lending
- Overdraft lending
- Treasury counterparties

Risk appetite statements have been set for each of the above sub-categories of credit risk. The Society's overall risk objective is to manage and control credit risk within defined exposures.

i) Lending fully secured on residential property

As a Building Society the Society must maintain a minimum of 75% of its business assets fully secured on residential property and a minimum of 65% on prime residential owner occupied assets. These, and other detailed lending limits and triggers are set by the Board based on the Society's risk appetite and objectives for residential lending. Management monitors these limits and reports them to the BRC on a quarterly basis.

The Society's approach is to make lending decisions which are sound, sustainable and take into account the borrower's willingness and ability to repay the amount borrowed. All cases are individually underwritten using credit reference data and a number of sources of evidence regarding the status of the borrower; the Society does not use automated credit scoring systems. A detailed Residential Lending Policy sets out the Society's lending criteria for different types of owner occupied and buy to let lending for those with no more than 3 mortgaged properties, along with the necessary evidence requirements and minimum level of approval required if a policy exception is sought. Policy criteria cover items such as income, security type, income and expenditure profile, credit history, acceptable security types, tenure and LTV. Specific criteria for types of lending include interest only, Buy to Let and introduced lending. Within policy there are criteria that cover responsible lending.

The criteria for holiday let lending, and for buy to let lending to corporate bodies and professional landlords, are covered in the Commercial Lending Policy Statement, which is discussed in the next section.

ii) Lending fully secured on land

The Society has detailed lending limits for commercial lending and these are set by the Board based on the Society's risk appetite and objectives for commercial lending. Management monitors a detailed set of limits and triggers relating to Commercial Lending and reports them to the BRC on a quarterly basis. The Commercial Lending Policy Statement covers loans fully secured on land and as stated in the section above, holiday let lending, buy to let lending to corporate bodies and professional landlords, and residential development lending, which are all managed by the specialist team of lending managers in the Cumberland Business department.

The Society's approach is to make lending decisions which are sound, sustainable and take into account the borrower's willingness and ability to repay the amount borrowed. For loans fully secured on land, in addition to the full assessment, a risk grading system is utilised that takes into account a number of criteria relating to the business itself such as financial performance and its ability to support the level of borrowing, the sector it is in and how the sector is performing and the skills and experience of those running the business. The system provides a risk score for the application, which is utilised as part of the decision making process.

The Society has specific lending criteria for the loans covered by the Commercial Lending Policy Statement, that include acceptable security, sector and borrower types and LTV limits.

iii) Vehicle Finance Lending

The Society has a vehicle finance subsidiary, Borderway Finance Limited (BFL), which has its own Lending Policy Statement. BFL's approach is to make lending decisions which are sound, sustainable and take into account the customer's willingness and ability to repay the amount borrowed. Every application is considered for affordability and an income and expenditure assessment is completed for all unsecured loan applications. Decisions are made on an individual basis by experienced underwriting staff.

Lending criteria cover items such as income, credit history, vehicle type, vehicle age and valuation and maximum loan term. Performance against the limits in BFL's lending policy is reported to BFL's Board on a quarterly basis and to the Society's Board in the event of any issues against limits.

iv) Overdraft Lending

The Society will provide personal and business customers with overdrafts on their accounts, subject to full underwriting of the request. In most cases, personal customers requesting an overdraft will be interviewed by a trained member of staff to establish the reason for the overdraft request and how and when the overdraft will be repaid. A mandate structure exists for the approval of overdrafts. Overdraft criteria include current credit history, account performance, funding profile and length of relationship. Requests are subject to a full assessment process, which generates a credit score.

Business current account overdrafts are offered on a secured and unsecured basis. Applications are assessed against a mixture of criteria that cover the individual customer(s) and the business, including the length of relationship with the business customer or entity, account performance, current credit history, recent financial information and the existence of tangible background assets. A mandate structure exists for the approval of overdrafts. Account performance is monitored and reviewed by management on a monthly basis and reported to Board every six months.

(v) Treasury Counterparties

Treasury credit risk is the risk of Treasury counterparties failing to meet their obligations to the Society. The Society's treasury counterparties are primarily banks and building societies. Exposures to wholesale (counterparty) credit risk are experienced through treasury investments, safe custody arrangements, repurchase agreements and derivative transactions.

Treasury investments are generally unsecured and give rise to exposure to the financial institution. The criteria for investments with unrated building societies include the size of the asset base, gross capital ratio, reserves, subordinated liabilities, subscribed capital and most recent and last 3 years' average profit and, where appropriate, the credit rating.

Criteria for exposure to banks include their minimum short-term credit rating, whether the bank is a globally systemic important bank (G-SIB), and the country of the bank and the condition of the country's economy.

Risk weights for Treasury exposures to institutions are based on external credit assessments provided by Moody's, which is recognised by the PRA as an eligible external credit assessment institution. Moody's credit assessments have been used for this purpose throughout the year.

Exposure limits to banks and building societies are based on an assessment of the above criteria. Limits are set for each institution and exposure against the limits is monitored daily by Treasury and reported to BALCO.

(vi) Summary of credit risk exposures

The Group's credit risk exposures at 31 March 2019 and 31 March 2018 is as follows.

| | 2019<br>£000 | 2018<br>£000 |
|---|---|---|
| Cash in hand and balances with the Bank of England | 270,023 | 291,097 |
| Wholesale lending | 193,695 | 156,468 |
| Loans and advances secured on immovable property | 2,061,951 | 2,024,545 |
| Other loans | 24,414 | 23,366 |
| Total credit risk | 2,550,083 | 2,495,476 |

The maturity profile of these exposures is shown in note 25 to the Annual Report and Accounts.

## b) Credit Risk Management

This section should be read in conjunction with section 1(f), which describes the Group's approach to credit risk mitigation.

Primary responsibility for credit risk management and control rests with first line management. There is an Underwriting section within Customer Services department which covers owner occupier and small portfolio buy to let lending. Within Cumberland Business, Business Lending Managers and senior management assess loans fully secured on land, holiday let and larger portfolio buy to let lending, as well as business overdraft requests. Mortgage cases are passed to the Underwriting section for final underwriting checks and approval. Where policy requires, mortgage cases will be authorised by the Residential or Commercial Credit Committee. Overdraft requests can be approved within Cumberland Business up to a defined limit. Senior management in BFL underwrite vehicle loans, the Current Account Services Team underwrite current account overdraft applications referred from branches (against defined criteria), and the Treasurer monitors the position with respect to the credit risk of treasury counterparties. In all cases, first line management is responsible for managing and controlling credit risk in line with the policies, procedures, controls and delegated authorities that have been ultimately agreed by the Board.

The Risk function provides independent oversight of mortgage credit risk by undertaking structured sampling of a number of cases each month, plus periodic reviews of tranches of mortgage lending or of specific parts of the mortgage book. The risk function also undertakes compliance reviews of mortgage lending, which includes some sampling of cases. Sampling of BFL loans is undertaken by the risk function on a monthly basis.

There is independent first line “back office” oversight of front office Treasury activities and compliance with FRMP, and the Risk function provides independent second line oversight of the “back office”.

Mortgage arrears and current account overdraft management and collections activity is all handled within the first line.

The Risk function, which includes compliance, liaises on a regular basis with Internal Audit in order to ensure that there is adequate oversight and assurance around credit risk activities. Internal Audit provides assurance that credit risk procedures and controls are implemented effectively within the management line through its programme of audit work and this process will involve testing of controls and some sampling of cases.

The above oversight and assurance work ensures there is regular dialogue between the first, second and third lines of defence regarding credit risk and credit risk management.

## c) <u>Credit Risk Reporting</u>

In order to achieve effective management and control, detailed management information is produced that allows the Senior Leadership Team to monitor performance and report to the BRC and Board where risk profile is nearing the risk appetite trigger points.

Performance of the mortgage book against key limits is reviewed by the relevant SLT member each month. Residential mortgage arrears performance is reviewed monthly by the relevant SLT member and quarterly by the Board. Commercial mortgage arrears are reported to the BRC.

On a quarterly basis a comprehensive schedule of exposures against lending limits for both residential and commercial mortgages is considered by the RMC as part of the Risk Appetite Reporting. The results of quarterly commercial, residential and Borderway Finance credit risk review work by Risk is reported to the RMC and BRC.

The BFL Lending Policy requires performance against lending limits to be reported to the BFL Board on a quarterly basis and to the Society’s Board in the event of any issues against limits.

Information on the performance of the overdraft book is reported to the responsible executive on a monthly basis and to the Board on a six monthly basis.

In relation to treasury credit risk a detailed breakdown of credit exposures is reported to BALCO and Board. BALCO will also review any changes in the credit rating of counterparties and the financial strength of unrated building societies in order to determine if any changes to exposure limits are required.

The range of credit risk reporting provided to individual executives, RMC, BRC and the Board is designed to ensure that credit risk and exposure is fully considered in order to ensure that the credit risk profile remains within appetite and that any emerging issues are identified so that appropriate action can be taken.

### Changes in stock of defaulted loans and debt securities

No debt securities were in default at any point during the year ended 31 March 2019. The table below relates purely to defaulted loans.

All figures in £000s

| | |
|---|---|
| Defaulted loans at end of the previous reporting period | 4,460 |
| Loans that have defaulted since the last reporting period | 2,459 |
| Returned to non-defaulted status | (3,413) |
| Other changes | 195 |
| Defaulted loans at end of the reporting period | 3,701 |

Movements in individual and collective provisions during the year are shown in note 13 of the Annual Report and Accounts.

Due to the low level of defaulted loans (less than 0.2% of the total loan books) and provisions (less than 0.1%) further analysis of these balances by sector has not been provided on the grounds of materiality.

**Additional disclosures related to the credit quality of assets**

This section provides additional information on the quality of the Society's mortgage assets.

**Qualitative Disclosures**

'Past due' exposures are defined as being at least 90 days in arrears, and are regarded as being in default.

Provisions are made to reduce the value of loans and advances to the amount which the directors consider is likely ultimately to be received.

Throughout the year and at the year end, individual assessments are made of all loans and advances on properties which are in possession or in arrears by three months or more. Individual provision is made against those loans and advances which are considered to be impaired. In considering the individual provision for impaired loans, account is taken of any discount which may be needed against the value of the property at the balance sheet date to agree a sale, the anticipated realisation costs and the amount recoverable under mortgage indemnity policies. It is recognised that not all accounts in arrears will result in possession and a factor is applied based on recent experience to reflect this probability when calculating the provision for accounts in arrears.

In addition, a collective impairment reduction is made against those loans and advances to customers where objective evidence, including forbearance measures taken to assist borrowers who are, or could be experiencing financial difficulty, indicates that it is likely that losses may ultimately be realised and thus a loss event has occurred. These factors take into account the Group's experience of default and delinquency rate, loss emergence periods, regional house price movements and adjustments to allow for forced sale values.

Loans and advances in the balance sheet are shown net of provisions, specific and collective. The charge or credit to the income and expenditure account comprises the movement in the provisions together with losses written off in the year.

All past due exposures are regarded as being impaired.

Information on provisions for bad and doubtful debts is contained in note 13 to the Annual Report and Accounts.

The residual maturity of loan exposures is provided in note 25 of the Annual Report and Accounts, although clearly in respect of mortgages, they are usually repaid well before their contractual maturity.

Information on credit risk on loans and advances to customers is provided in note 28 of the Annual Report and Accounts.

Restructured exposures are defined as those loans where there has been a restructuring that may result in a diminished financial obligation on the part of the borrower caused by material forgiveness, or postponement, of principal or interest by the Society. The Society has no such exposures.

## Quantitative Disclosures

### (a) Loans Fully Secured on Residential Property – geographical analysis

| All figures in £000s | Performing | Past due 90 days | Total | % |
|---|---|---|---|---|
| North West | 1,061,996 | 2,197 | 1,064,193 | 56.1% |
| Scotland | 208,726 | 38 | 208,764 | 11.0% |
| London | 151,109 | - | 151,109 | 8.0% |
| South East | 147,875 | - | 147,875 | 7.8% |
| South West | 146,944 | - | 146,944 | 7.7% |
| East of England | 44,788 | - | 44,788 | 2.4% |
| Yorkshire & Humberside | 33,435 | - | 33,435 | 1.8% |
| North East | 29,179 | - | 29,179 | 1.5% |
| West Midlands | 27,037 | - | 27,037 | 1.4% |
| Wales | 21,797 | 27 | 21,824 | 1.2% |
| East Midlands | 20,460 | - | 20,460 | 1.1% |
| Total | 1,893,346 | 2,262 | 1,895,608 | 100.0% |
| % performing / not performing | 99.9% | 0.1% | 100.0% | |

### (b) Loans Fully Secured on Land – geographical analysis

| All figures in £000s | Performing | Past due 90 days | Total | % |
|---|---|---|---|---|
| North West | 89,633 | 743 | 90,376 | 54.5% |
| South West | 22,466 | 543 | 23,009 | 13.9% |
| Yorkshire & Humberside | 14,948 | 85 | 15,033 | 9.1% |
| Scotland | 11,011 | - | 11,011 | 6.6% |
| Wales | 7,597 | - | 7,597 | 4.6% |
| South East | 6,114 | - | 6,114 | 3.7% |
| East Midlands | 4,498 | - | 4,498 | 2.7% |
| East of England | 3,454 | - | 3,454 | 2.1% |
| West Midlands | 2,273 | - | 2,273 | 1.4% |
| North East | 2,073 | - | 2,073 | 1.2% |
| London | 464 | - | 464 | 0.2% |
| Total | 164,531 | 1,371 | 165,902 | 100.00% |
| % performing / not performing | 99.2% | 0.8% | 100.0% | |

**(c) Loans fully secured on land – by sector and geography**

| All figures in £000s | Branch operating area | York/Y'shire Dales | S/SW England | Other | Total | |
|---|---|---|---|---|---|---|
| Guesthouses | 41,152 | 7,115 | 9,952 | 16,074 | 74,293 | 44.8% |
| Hotels | 19,747 | 1,919 | 6,427 | 9,487 | 37,580 | 22.6% |
| Investment Properties | 14,300 | 2,198 | 3,321 | 7,795 | 27,614 | 16.6% |
| Public Houses/ Restaurants | 5,955 | 671 | 665 | 1,315 | 8,606 | 5.2% |
| Retail outlets | 2,019 | 791 | - | 286 | 3,096 | 1.9% |
| Professionals' premises | 592 | - | 84 | - | 676 | 0.4% |
| Others | 2,701 | 2,340 | 2,561 | 6,435 | 14,037 | 8.5% |
| Total | 86,466 | 15,034 | 23,010 | 41,392 | 165,902 | |
| | 52.1% | 9.1% | 13.9% | 24.9% | | |

Note: the above table uses a different geographical split than the previous table, based on the Society's branch operating area, the two areas with the next highest amounts of lending, and then the rest of the UK.

**(d) Ageing analysis of past-due accounts**

All figures in £000s

| | Loans FSRP | Loans FSOL | Total |
|---|---|---|---|
| 3 to 6 months | 1,121 | 950 | 2,071 |
| 6 to 9 months | 195 | 264 | 459 |
| 9 to 12 months | 203 | 84 | 287 |
| Over 12 months | 743 | 73 | 816 |
| Total | 2,262 | 1,371 | 3,633 |

Note: unauthorised current account overdrafts at 31 March 2019 totalled £68,000, with individual provisions against these of £34,000.

**Qualitative disclosures on banks' use of external credit ratings under the standardised approach for credit risk**

The Society's uses published credit ratings to assess the credit quality of its rated wholesale counterparties to assess the creditworthiness of its unsecured exposures. At 31 March 2019, the Society had no secured credit exposures and no exposures subject to the Issuer versus issues assessment described in the Basel Framework.

The Standard mapping published in the CRR (EU 575/2013) is used to map the alphanumeric scale of the published ratings onto the relevant risk buckets.

## 6. Counterparty Credit Risk

### Qualitative disclosure related to counterparty credit risk

The Society uses derivative instruments to hedge its exposure to interest rate risk. Counterparty credit risk includes the risk that the derivatives counterparty will default on the transaction. All of the Society's derivatives at 31 March 2019 are bilateral and conducted over-the-counter (OTC).

All of the Society's derivatives transactions are governed by agreements based on documentation provided by the International Swaps and Derivatives Association (ISDA). Each of the ISDA agreements is supported by a Credit Support Annex (CSA). The CSAs govern the process of mitigating any credit risk that may result from the derivatives. This includes the frequency and method of valuing any credit risk exposure and the movement of margin collateral between the Society and the counterparty.

Wrong way risk occurs when the exposure to a counterparty is adversely correlated with the credit quality of that counterparty. Specific wrong way credit risk can occur where transactions are collateralised by related party securities. General wrong way credit risk can arise where the credit quality of the counterparty may be correlated with a macroeconomic factor which affects the value of derivative transactions, such as the impact of interest rate movements on derivatives or on securities held as collateral. The CSAs mitigate wrong way risk by ensuring that exposures on derivatives are regularly re-valued and are collateralised with cash.

Legislation introduced by the European Securities and Markets Association (ESMA) bring a requirement to clear OTC derivatives through a third party regulated institution (a central clearing counterparty - CCP) to reduce systemic and operating risk. This will also reduce counterparty credit risk. On 13 July 2016, the ESMA published revised legislation which proposes delaying the date by which "Category 3 Financial Counterparties", such as the Cumberland need to clear certain types of interest rate swaps by up to two years to 21 June 2019. At the date of issue of this report, Cumberland had put in place and was operating the processes required to clear the relevant derivatives.

The movement of collateral defined in the CSAs is based entirely on the market value of the swaps and does not include a factor for the Society's, or the counterparty's creditworthiness so a change in creditworthiness would not result in a change in the amount of collateral held. In any case, as the Society is an unrated institution, it is not subject to a potential ratings downgrade.

The Group does not use credit derivatives and so the disclosures required under Article 439 of the CRR have not been prepared.
The two tables following give details of the capital charges associated with treasury instruments counterparty credit risk.

### Analysis of counterparty credit risk (CCR) by approach

All figures in £000s

| | Replacement cost | Potential future exposure | EAD post-CRM | RWA |
|---|---:|---:|---:|---:|
| SA-CCR (for derivatives) | 1,915 | 4,245 | 6,160 | 2,460 |

### Credit valuation adjustment (CVA) capital charge

All figures in £000s

| | EAD post-CRM | RWA |
|---|---|---|
| All portfolios subject to the Standardised CVA capital charge | 6,160 | 919 |
| Total subject to the CVA capital charge | 6,160 | 919 |

The following table shows the total exposure and impact of netting specifically for derivatives. The mark to market values include accrued interest.

| | **31 Mar 19** | **31 Mar 18** |
|---|---|---|
| Swaps with positive MTM values | 1,915 | 10,801 |
| Swaps with negative MTM values | (4,623) | (5,338) |
| Collateral Posted | 2,730 | 370 |
| Collateral Held | 0 | (3,700) |
| **Net Credit Exposure** | **22** | **2,133** |

The breakdown of the credit ratings of the Group's Treasury exposures at 31 March are as follows.

| Credit quality step | 2019 £000 | 2018 £000 |
|---|---|---|
| Sovereign | 270,410 | 290,088 |
| 1 | 16,661 | 4,724 |
| 2 | 19,166 | 36,517 |
| 3 | 72,350 | 23,048 |
| 4 | 3,012 | - |
| 5 | - | 3,011 |
| Unrated | 61,707 | 54,611 |
| Total | 443,306 | 411,999 |
| Cash | 19,045 | 28,047 |
| Total on balance sheet | 462,351 | 440,046 |

Sovereign exposures include £3.727m (2018 - £2.117m) of cash ratio deposits which are not available for the Group's day to day operations and are included in Loans and Advances to Credit Institutions in the balance sheet.

The credit ratings used by the Group correspond to the following credit quality steps.

| Credit quality step | Moody's ratings |
|---|---|
| 1 | Aaa to Aa3 |
| 2 | A1 to A3 |
| 3 | Baa1 to Baa3 |
| 4 | Ba1 to Ba3 |
| 5 | B1 to B3 |

## 7. Operational Risk

The Group calculates its operational risk capital requirement using the ‘basic indicator approach’. At 31 March 2019, the risk weighted assets relating to operational risk were £80.0 million, based on the mean of its net income for the last three years. The Group’s approach to the management of operational risk is set out in section 2b) of this document.

## 8. Interest Rate Risk in the Banking Book (IRRBB)

IRRBB is the current or prospective risk to both the earnings and economic value of an institution arising from adverse movements in interest rates that affect interest rate sensitive instruments including gap risk, basis risk and option risk.

For the Group, this risk arises as a result of:

- Offering fixed rate mortgages and savings products to customers;
- Options, embedded in retail products, which allow customers flexibility in the rates they pay down their mortgage principal;
- Hedging fixed rate exposures to LIBOR and/or SONIA on the assumption that changes in LIBOR and SONIA will reflect changes in the Society’s funding costs; and
- The mismatch of the Group’s assets over its liabilities.

The Society manages its IRRBB exposures to ensure that they lie within the risk appetite framework approved by the Board. Day to day management of IRRBB is conducted in Treasury. Hedging exposure positions by product maturity are reported within a weekly dashboard circulated to the Board and Senior Leadership Team. Repricing risk gap analysis, which categorises the Society’s assets and liabilities by the term until they next reprice, is conducted monthly. This is used to measure the Society’s Economic Value (EV) and Net Interest Income (NII) exposures to repricing risk; the results are reported to BALCO and the Board.

Where possible, IRRBB is managed through matching fixed rate mortgages against fixed rate savings with similar maturity characteristics. Where this cannot be achieved, exposed positions are hedged using interest rate derivatives.

The analysis of IRRBB takes account of scheduled payments on fixed rate mortgages as well as unscheduled overpayments and early redemptions (referred to as prepayments) on mortgages and early withdrawals from fixed rate investments. At least quarterly, the average prepayments (for mortgages) and early withdrawals (for investments) are measured over the previous year and the results applied on a forward-looking basis. The analysis assumes that customers’ future prepayment and early withdrawal patterns will reflect recent performance. An amortisation profile is applied to mortgage hedges to take account of repayments and the expected level of prepayments. The Group does not apply behavioural characteristics to non-maturity deposits.

The output of the interest rate risk gap analysis is stressed to determine the potential impact of a +/- 200 bps parallel movement at all points on the yield curve on the Society’s interest rate risk to Economic Value and Net Interest Income. The results of this analysis conducted on 31 March 2019 show, for the Group:

| | +200 bps | -200 bps |
|---|---:|---:|
| Impact on Economic Value | (£0.940m) | £0.940m |
| Impact on Net Interest Income | £2.393m | (£2.453m) |

## 9. Leverage Ratio

Basel III introduced a non-risk based leverage ratio to complement the risk based capital requirements. The ratio shows tier 1 capital as a proportion of on and off balance sheet assets. The ratio does not apply risk-weighted factors to assets but acts as a primary constraint to building a firm's asset size to a level which is excessive in proportion to its capital base; the minimum level is 3.0%, and as shown in the table below, the Society is well in excess of this requirement.

| | 31-Mar-19 | 31-Mar-18 |
|---|---|---|
| **Exposure** | | |
| Balance Sheet Exposure | 2,576,804 | 2,519,637 |
| Adjustment for Derivative Financial Instruments | 4,794 | 3,282 |
| Off Balance Sheet Exposures | | |
| - Mortgage Pipeline (50% CCF) | 38,123 | 37,303 |
| - BFL Pipeline (50% CCF) | 189 | 256 |
| - Undrawn Overdrafts (10% CCF) | 834 | 838 |
| **Total Exposure** | 2,620,744 | 2,561,316 |
| **Total Tier 1 Capital** | 185,133 | 173,282 |
| **Leverage Ratio** | 7.06% | 6.77% |

During the year the leverage ratio increased to 7.06% (2018: 6.77%). This increase was due to the growth in Tier 1 capital (up by 6.8% in the year) which outpaced the increase in total exposure. The latter increased by 2.3% in the year. The Board is confident that the Society will continue to maintain leverage significantly above the minimum requirement of 3.0%.

The Group's leverage ratio has been significantly higher than the minimum level for several years. The off-balance sheet exposures remain relatively stable, and the Group has control over the two key elements, being the level of the mortgage pipeline and the use of derivatives. Derivatives are used only for risk management purposes – principally the management of interest rate risk – and the Group does not have a trading book.

## 10. Liquidity Coverage Ratio (LCR)

Summary details on liquidity risk are presented on page 5. The Society uses a suite of measures to monitor and manage liquidity and funding risks, the principal measure being the LCR. The following table shows the breakdown of the components of the LCR and have been calculated as a simple average of the three month end observations preceding each quarter end.

| | 12 Month Average Figures for Quarter Ending | | | |
|---|---|---|---|---|
| | 30-Jun-18 | 30-Sep-18 | 31-Dec-18 | 31-Mar-19 |
| **HQLA Buffer** | 332,042 | 345,504 | 359,402 | 363,736 |
| **Total Net Cash Outflows** | 149,563 | 145,531 | 146,566 | 144,144 |
| **Liquidity Coverage Ratio** | 222% | 237% | 245% | 252% |

## 11. Encumbrance

Encumbrance is defined as “pledging an asset or entering into any form of transaction to secure, collateralise or credit enhance any transaction from which it cannot be freely withdrawn.”

The majority of the Group’s encumbrance at 31 March 2019 relates to its access to market-wide facilities provided by the central bank, and which are secured against non-cash collateral, principally mortgage assets. The use of these facilities encumbers the assets pledged as collateral for the duration of the use of the facility and the counterparties are given the first charge over the assets which are encumbered.

To secure this funding, the Group has entered into legal agreements where financial assets are pledged as collateral to reduce counterparty exposure to the Group. The counterparties are assigned primary legal charge over the agreed collateral assets in the unlikely event of a default.

The Group makes use of interest rate swaps to mitigate its exposure to interest rate risk. Against the Group’s derivative liabilities cash collateral is pledged to counterparties in order to reduce their exposure to the Group; and similarly, cash collateral is received by the Group against its derivative assets to reduce the Group’s exposure to those counterparties. The cash collateral pledged is considered to be encumbered as it is no longer under the legal ownership or control of the Group. The movement of derivatives collateral is governed through the Credit Support Annex (CSA) agreements which the Group has in place with each of its derivatives counterparties.  Collateral posted is measured against counterparty mark-to-market values and may not reflect the Society's internal valuation of its financial instruments.

The Group’s encumbrance position at 31 March 2019 is shown in the following table.

**Encumbered and Unencumbered Assets**

| | Carrying amount of encumbered assets | Fair value of encumbered assets | Carrying amount of unencumbered assets | Fair value amount of unencumbered assets |
|---|---|---|---|---|
| Total assets of the reporting institution | 562,230 | | 2,014,574 | |
| Equity Instruments | | | 5,497 | 5,497 |
| Debt Securities | | | 64,182 | 64,182 |
| of which: issued by central governments | | | - | - |
| of which: issued by financial corporations | | | 64,182 | 64,182 |
| Other Assets | 562,230 | | 1,944,895 | |

Other assets include loans and advances (including mortgages) and other balance sheet items not listed above.

The collateral received by the Group at 31 March 2019 is as follows (over).

**Collateral Received**

| | Fair value of encumbered collateral received or own debt securities issued | Fair value of collateral received or own debt securities issued available for encumbrance |
|---|---|---|
| Collateral received by the reporting institution | | |
| Other Assets | Nil | Nil |

The Group's sources of encumbrance at 31 March 2019 are as follows.

**Sources of Encumbrance**

| | Matching liabilities, contingent liabilities or securities lent | Assets, collateral received and own debt securities issued other than covered bonds and ABSs encumbered |
|---|---|---|
| Carrying amount of selected financial liabilities | 360,000 | 562,230 |

## 12. Remuneration Code Disclosures

### (a) Introduction

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 PARC, which consists of its chair Michael Hulme and two other non-executive directors. The Committee met six times during the year ended 31 March 2019.

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 organisations 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, of the need for robust risk management in order to ensure that the outcomes achieved are beneficial to the organisation over the long term.

Variable remuneration schemes involve the results of one year at a time, are non-contractual, and payment is 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.

### (b) Remuneration Code Staff

PARC has determined that as at 31 March 2019, the one Executive Director, seven non-executive directors, five other members of the Senior Leadership Team and 13 others are designated as being Code staff in that they are 'material risk takers', and are thus subject to the FCA Remuneration Code and PRA Remuneration rules.

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.

### (c) Executive directors

Further information on the mandate of the PARC 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 2019.

Aggregate information on the remuneration of the four executive directors who served during the year (three of whom resigned during the year, on 30 April 2018, 22 June 2018 and 11 December 2018 respectively, and one of whom was appointed on 1 April 2018) is given below. Fixed remuneration includes pension contributions made by the Society on behalf of the employees, pension replacement amounts (which may be made, depending upon their individual circumstances) and the value of taxable benefits:

| | £000 |
|---|---|
| Fixed remuneration | 503 |
| Variable remuneration | 50 |
| | ----------- |
| Total | 553 |

**(d) Other members of senior management and those involved in control functions**

The PARC 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 19 staff during the year to 31 March 2019 is given below together with a breakdown of their costs by business area. Five of these staff joined and one left the business during the year, and one is no longer designated under the Code.

| | Fixed Remuneration £000 | Variable Remuneration | Total Remuneration |
|---|---|---|---|
| Operations | 744 | 77 | 821 |
| Support functions | 773 | 61 | 834 |
| Compliance (risk and audit) | 245 | 26 | 271 |
| | ---------- | ---------- | ---------- |
| Total | 1,762 | 164 | 1,926 |

**(e) Non-executive directors**

The remuneration of the eight non-executive directors who served during 2018-19 (one of whom was appointed on 1 June 2018 and one of whom resigned on 2 July 2018) comprised only of fees and, other than that of the Chairman, these are reviewed and agreed annually by the Board. The remuneration of the Society's Chairman is determined by the PARC, however he does not attend the sections of the meetings at which his remuneration is set and takes no part in the Committee's consideration of this matter. The total remuneration of the non-executive directors during the year, all of which was fixed, was £328,000.

**(f) Recruitment and Diversity**

The Group recognises the benefits that a diverse workforce can bring and is committed to a culture that attracts and retains talented people to deliver outstanding performance. Appointments are made on merit and against objective criteria, whilst still giving consideration to diversity in respect of gender and other characteristics.

### (g) Directors

A summary of the relevant experience of each of the executive and non-executive directors is given in the Annual Review booklet for the year ended 31 March 2019, which along with the Annual Report and Accounts, is available at www.cumberland.co.uk .

Details of other directorships held by the executive and non-executive directors is shown in the Annual Business Statement in the Annual Report and Accounts.

The policy regarding recruitment and diversity for selection of Directors is outlined in the Annual Report and Accounts.

## 13. Conclusion

This Pillar 3 disclosure document, which was approved by the Board on 4 June 2019, has been prepared in accordance with the requirements of CRD IV disclosure requirements of Part Eight of Regulation (EU) No. 575/2013, as appropriate for a firm of the size and complexity of Cumberland Building Society, and the Society Board-approved “CRD Pillar 3 Disclosure Policy”.

During the year ended 31 March 2019, the information received and reviewed by the Board and its committees provided assurance that the Society (Group) maintained an appropriate system of internal control and risk management and that there were no material breaches of controls or regulatory standards.

In the event that a user of this disclosure document should require further information, application should be made in writing to Richard Ellison, Chief Financial Officer, Cumberland Building Society, Cumberland House, Cooper Way, Parkhouse, Carlisle, CA3 0JF.

## Appendix – Glossary of abbreviations

| | |
|---|---|
| AC | Audit Committee |
| BALCO | Board Assets & Liabilities Committee |
| BCIT | Board Customer Innovation and Technology Committee |
| BFL | Borderway Finance Limited |
| BoE | Bank of England |
| BRC | Board Risk Committee |
| CCoB | Capital Conservation Buffer |
| CCP | Clearing Counterparty |
| CCR | Counterparty Credit Risk |
| CCyB | Counter-cyclical (capital) Buffer |
| CEO | Chief Executive Officer |
| CET1 | Common Equity Tier 1 (capital) |
| CFSL | Cumberland Financial Services Ltd |
| CLC | Credit Lending Committee |
| CRD | Capital Requirements Directive |
| CRR | Capital Requirements Regulation |
| CR–S A | Credit Risk Standardised Approach |
| CSA | Credit Support Annex |
| CVA | Credit Valuation Adjustment |
| ESMA | European Securities and Markets Association |
| EV | Economic Value |
| FCA | Financial Conduct Authority |
| FLS | Funding for Lending Scheme |
| FRMP | Financial Risk Management Policy |
| FSOL | Fully Secured on Land |
| FSRP | Fully Secured on Residential Property |
| FTE | Full Time Employee |
| GMRA | Global Master Repurchase Agreement |
| ICAAP | Internal Capital Adequacy Assessment Process |
| ILAAP | Individual Liquidity Adequacy Assessment Process |
| IRRBB | Interest Rate Risk in the Banking Book |
| ISDA | International Swaps and Derivatives Association |
| LCR | Liquidity Coverage Ratio |
| LMC | Liquidity Management Committee |
| MTM | Mark-to-Market |
| NII | Net Interest Income |
| NIM | Net Interest Margin |
| OLAR | Overall Liquidity Adequacy Rule |
| OTC | Over the Counter |
| PARC | People Remuneration & Culture Committee |
| PRA | Prudential Regulation Authority |
| RMC | Risk Management Committee |
| RMF | Risk Management Framework |
| RWA | Risk Weighted Assets |
| SLT | Senior Leadership Team |
| SREP | Supervisory Review and Evaluation Process |
| TCR | Total Capital Requirement |
| TFS | Term Funding Scheme |
| ToR | Terms of Reference |