Cumberland Building Society

Pillar 3 Disclosure

31 March 2017

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1. 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.

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', as follows:

Pillar 1	Minimum capital requirements, using defined formulae
Pillar 2	The Internal Capital Adequacy Assessment Process (ICAAP) undertaken by the Society, and the Supervisory Review and Evaluation Process (SREP) undertaken by the 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.

This document has been prepared to meet the disclosure requirements of CRD IV as presented in Part Eight of Regulation (EU) No. 575/2013.

All figures within this document are correct at 31 March 2017 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). 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.

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

2. Overview of Risk Management and RWA

Bank Risk Management Approach

(a) <u>Business Model</u>

Cumberland Building Society aims to be the natural choice for mortgages, current accounts and savings and a leading provider of other retail financial services in its operating area, while continuing to be an independent mutual building society.

To achieve this aim, the Cumberland offers a wide range of financial services, principally through its branch offices, and delivers long term benefits to members through the provision of competitive products combined with excellent customer service.

The Cumberland Group, which principally consists of the Society along with subsidiaries which provide services to customers as set out below, aims to achieve sufficient profit to maintain its capital strength to safeguard the interests of members.

The Cumberland's strategic objectives include, as well as maintaining a strong capital position, achieving a suitable balance between profitability and the growth of the business, and the fair treatment of members with in particular, the maintenance of a fair balance between the interests of investing and borrowing members, both existing and new.

The Society's business model is derived from the key elements of its strategy above.

The Board regards as essential, the establishment of direct relationships with members, and the deepening of these relationships through the provision of a wide range of services and excellent customer service. This is supported by:

- a strong branch network; the Society's branch operating area consists of Cumbria (with 26 branches), Dumfries and Galloway (5 branches), North Lancashire (with branches in Preston and Lancaster) and West Northumberland (a branch in Haltwhistle, with an area deemed to extend east to Hexham);
- a customer service centre within its Head Office in Carlisle, and
- a strong commitment to developing internet and mobile banking services for members as technology advances.

Therefore, as well as the traditional building society products such as residential mortgages and savings, the Group also operates:

- a full current account service, with cheque book, overdraft facilities, chip and PIN-enabled Visa debit cards for point of sale purchase and ATM transactions (with contactless cards being issued), the operation of 20 cash machines connected to the Link network, internet banking for both personal and business customers, a mobile app for personal customers and a mobile app for business customers was launched in May 2017;
- a commercial lending operation, focussed primarily on owner-occupied guest houses and hotels, holiday let and buy to let properties, with the majority of its lending located within the branch operating area and in particular, the Lake District;

- an estate agency and lettings and management service, through Cumberland Estate Agents Limited;
- motor vehicle finance, through Borderway Finance Limited;
- financial advice, through Cumberland Financial Services Limited.

The Board considers that the concentration on relationships with local customers has been a source of strength for many years and is committed to continuing to develop this approach.

The large majority of residential lending has been undertaken through the Society's branches or its estate agency and within the branch operating area, and this will continue to be the case as it is fundamental to the Society's mission. However, since 2012, additional residential lending has been undertaken in partnership with a limited number of carefully selected introducers, and as virtually all of this lending has been undertaken outside the branch operating area, it has broadened the geographical distribution of the mortgage book.

The Society is very strongly funded by its savings and current account members together with local business customers, with for many years, very little funding having been obtained from the financial markets, although since 2012, drawings have been made from the Government's Funding for Lending Scheme (FLS) to supplement this. With very limited exceptions, the Society does not offer savings and current accounts to those living outside of its branch operating area.
The Group is very committed to developing its digital services over the next few years, by building on those which are already offered, such as internet and mobile banking, as it regards this as vital in ensuring that it continues to provide the services that members want.

As part of the monetary stimulation package announced on 4 August 2016, the Bank of England issued a market notice announcing the new Term Funding Scheme (TFS). The TFS is designed to encourage participants to pass on cuts in Base Rate to borrowers. The Society will participate in TFS during the drawdown window up to 28 February 2018 with a term of up to 4 years from date of draw down.

(b) 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 exposed to credit risk in respect of either mortgage customers or Treasury counterparties being unable to meet their obligations as they become due.

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, during 2012-13 the Society began to accept introduced residential mortgage business, almost all located outside of the branch operating area, from a very 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 and Board 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 four 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 an Executive Director, two Executive Directors or by members of the Commercial Credit Committee.
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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 Assets & Liabilities Committee (ALCO) 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 ratings (Moody's); 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) Market Risk

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

The balance sheet is stress tested on a monthly basis to inform the ALCO and the Board of the effects on the Society's economic value and net interest income of interest rates rising or falling, by applying an instantaneous parallel movement of 200 basis points to the interest rate curve. ALCO is also provided with the impact of non-parallel changes in the yield curve.

Quarterly, the Board assesses the Society's position in relation to its net interest margin, including sources of basis risk, and considers the exposure to a series of negative but credible scenarios in relation to it.

ii) Liquidity Risk

Liquidity risk is the risk that the Society will be unable to meet its commitments when they fall due. The ALCO assists the Society's management and the Board to manage this risk. Responsibility for the daily management of the risk, including the monitoring of both retail and wholesale funding, lies with the Treasurer, within the prudent frameworks of the Individual Liquidity Adequacy Assessment Process (ILAAP) and the Financial Risk Management Policy. 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 FLS 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 14.89% of share and deposit liabilities at 31 March 2017, but out of a total of £305 million, £190 million was related to drawdowns from the FLS, and over £90 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 or external events. The Group Operational Risk Policy sets out the Group's approach to the management of operational risk.

Whilst line management is responsible for identifying and managing operational risks, this is carried out using an agreed framework and methodology and with the assistance of the Group Risk function, with quarterly reporting to the Executive Risk Management Committee (ERMC) 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 ERMC on a quarterly basis to review the Society's performance in this area, covering specific issues that have arisen and relevant management information. The ERMC 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 EMRC, 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.

(c) 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.

Board Audit Committee (BAC)

The BAC is a Committee of the Board and the Committee's primary duties are:

- To review and challenge where necessary, critical accounting policies, any changes to them and any significant estimates and judgements made by management
- To satisfy the Board on the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non-financial risk in relation to the Society's existing and future business and related capital requirements
- To satisfy the Board that weaknesses in control are being corrected
- To review and challenge where necessary, the clarity and completeness of disclosures made in the Annual Report and Accounts and Annual Review booklet
- To evaluate the performance of the Internal Audit function on a regular basis, its independence and the adequacy of Internal Audit resources
- To review and approve the preparation and supervision of Internal Audit's plan and programme of work
- To assess the External Audit function
- To recommend to the Board annually the re-appointment, or in the event of a vacancy, the appointment, remuneration and terms of engagement of External Auditors

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

The minutes of BAC meetings are supplied to the following Board Meeting.

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

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. 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 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 remaining three non-executive directors, the four executive directors, the Head of Internal Audit, the Head of Risk and the Group Compliance Manager 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.

The minutes of BRC meetings are supplied to the following Board Meeting.

Other Committees

Assets and Liabilities Committee (ALCO)

The ALCO is responsible for oversight and consideration of the following key risks:

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

The Committee meets monthly 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 BRC and Board, as appropriate. Minutes of the monthly ALCO meeting are provided to the following Board Meeting.

Membership of ALCO includes the Executive Directors, a Non-Executive Director, the Treasurer, the Head of Risk, Group Risk Manager and Financial Controller. Attendees include a rotational Non-Executive Director, other members of the Executive, the Head of Internal Audit, the Treasury and Finance Accountant and the Financial Risk Analyst. An operational ALCO meeting is held at least every two weeks to assess the pricing of mortgage and savings products and consider the management of interest rate risk.

A Liquidity Management Committee (LMC) consisting of the Finance Director, Treasurer and Group Risk Manager meets every fortnight 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 ALCO.

Executive Risk Management Committee (ERMC)

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 and any emerging trends within the book.

In relation to operational risk the committee reviews risk incident dashboards from management. These include root cause analysis, an explanation of which controls broke down and action taken or planned to address the issue, with Line 2 (the Risk function) providing a report to include a summary of the key incidents reported, any trends or themes identified and year to date financial impact.

In relation to conduct and regulatory risk the ERMC 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 reviews external events that relate to conduct risk, such as Financial Conduct Authority (FCA) enforcement action and fines, Financial Ombudsman Service rulings, thematic reviews, letters and speeches from the FCA and PRA, and 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.

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. At above a certain value, applications are referred to the Board for approval. All Committee meetings are attended by a member of the Risk function.

Three Lines of Defence

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

In the first line of defence, risk management is primarily the responsibility of all management and staff of the Society. 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 required 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 Head of Risk 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 BAC and reports to the Chief Executive for day-to-day management. The BAC 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:

Line	**Activity**	**Responsibility**
Board	Establishes culture and values Defines risk appetite and strategy Approves frameworks, methodologies, policies and roles and responsibilities	Board
1	Ownership of day to day risk management Compliance with relevant regulation and legislation Identifies, manages and mitigates risks faced by the Society Defines and operates controls and limits Assesses key risk indicators and market conditions Produces management information and reports on risk	Line Management
2	Facilitate the design and development of the overall risk management framework and associated policies Oversight, monitoring and reporting of key risks Oversight, monitoring and reporting against risk appetite Monitor business as usual adherence to framework Monitor and report on regulatory compliance 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 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.

(d) <u>Risk measurement and reporting</u>

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.

An Asset and Liability management information system and associated models are used within Treasury to manage, model and measure key risks such as interest rate risk, basis risk and concentration risk. Other models allow forward looking margin risk scenarios to be run in order to assess the impact of different interest rate movements on net interest income. Exposures against policy triggers and limits are provided monthly to ALCO and reported to the next Board meeting.

A forward looking three year financial plan is produced quarterly 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 ERMC 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 ERMC to BRC and the Board.

(e) <u>Stress Testing</u>

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 margin risk, interest rate risk and liquidity risk
- Pension obligation costs
- Reverse stress testing

The results of these stress tests feed into the ICAAP and the corporate planning process and inform the Society’s risk appetite statements and measures.

Residential and Commercial mortgage stress tests are undertaken twice yearly 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 ALCO 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 sets 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.

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

The results of the analysis allow management and the Board to examine the effects of margin risk against the policy limit and, if necessary, provide sufficient lead time for corrective action to be taken.

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.

(f) <u>Risk Mitigation</u>

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 the ALCO.

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 ERMC 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 ALCO 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 ALCO 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.

Financial Risk Management Policy 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 ERMC, BRC and Board.

(g) Overview of Risk Weighted Assets

The following two tables show the Group's exposures, both on and off balance sheet, the risk weighted assets in relation to each, and the capital required at 8.0%, at 31 March 2017 and 2016. The Society's definition of default is when payments are 90 days or more past due, and includes unauthorised current account overdrafts.

31 March 2017 – all figures in £000s

Asset Class	Exposures, both on and off balance sheet	Risk weighted assets	Capital requirement at 8.0%
Sovereigns and their central banks	159,667	0	0
Banks	142,894	35,807	2,865
Residential property (FSRP)	1,727,181	599,078	47,926
Commercial real estate (FSOL)	157,015	120,608	9,649
Equity - Visa Inc. preference shares	3,263	3,263	261
Past-due loans	3,936	4,042	323
Other assets	58,946	48,751	3,900
Credit valuation adjustment		989	79
Counterparty credit risk		1,932	155
Operational risk		68,782	5,503
Total	2,252,902	883,252	70,661

31 March 2016 – all figures in £000s

Asset Class	Exposures, both on and off balance sheet	Risk weighted assets	Capital requirement at 8.0%
Sovereigns and their central banks	195,693	0	0
Banks	96,316	27,279	2,182
Residential property (FSRP)	1,630,444	561,481	44,918
Commercial real estate (FSOL)	160,841	127,628	10,210
VISA cash receipt anticipated	3,369	674	54
Past-due loans	3,029	3,074	246
Other assets	52,050	43,227	3,458
Credit valuation adjustment		1,076	86
Counterparty credit risk		3,298	264
Operational risk		61,460	4,917
Total	2,141,742	829,196	66,335

The table on the following page shows further detail with respect to exposures by asset classes and risk weights.

Standardised approach – exposures by asset classes and risk weights

All figures in £000s

		a	b		c	d		e	f	g	h	i	j
	Risk Weight	0%	15%	17.5%	20%	35%	37.5%	50%	75%	100%	150%	Others	Total credit exposures amount (post CCF and post-CRM)
	Asset Class												
1	Sovereigns and their central banks	159,667	-	-	-	-	-	-	-	-	-	-	159,667
4	Banks	1,858	-	-	115,695	-	-	25,341	-	-	-	-	142,894
8	Secured by residential property	-	-	5,077	-	1,701,445	90	-	14,484	-	6,085	-	1,727,181
9	Secured by commercial real estate	-	-	-	-	-	-	878	-	156,137	-	-	157,015
10	VISA Inc. preference shares	-	-	-	-	-	-	-	-	3,263	-	-	3,263
11	Past-due loans	-	-	-	-	-	-	-	-	3,153	651	132	3,936
13	Other assets	3,215	1,329	-	-	-	646	-	21,788	31,968		-	58,946
14	Total	164,740	1,329	5,077	115,695	1,701,445	736	26,219	36,272	194,521	6,736	132	2,252,902

Note: within the 35% column, are £208 million of FSRP loans and in the 100% column, £149 million of FSOL loans, which are to SME's, and to which have been applied the SME factor of 76.19% available for the calculation of their risk weighting under the standardised approach, as set out in Article 501 of the Capital Requirements Regulation.

(h) Own Funds

The capital resources of the Group at 31 March 2017 totalled £153.831 million.

This consists predominantly of common equity tier 1 capital of £152.234 million, which is the Group's general reserves (accumulated profits) of £151.538 million and the available for sale reserve of £0.696 million. The Society's CET1 ratio at 31 March 2017 was 17.24%.

In addition, there is upper Tier 2 capital of £1.597 million, which is the Group's collective provision for bad and doubtful debts.

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, on pages 17, 18 and 26 of the Annual Report and Accounts.

The Society considers additional capital add ons through the ICAAP process.

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

(i) 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.

These include a Capital Conservation Buffer of 2.5% of risk weighted assets and a Counter-Cyclical Capital Buffer of up to 2.5% of risk weighted assets which can be applied by the regulator when macroeconomic conditions dictate. In addition, globally systemically important banks are expected to hold a buffer of up to 2.5%, but this is not applicable to the Group.

As shown above, the available Common Equity Tier 1 capital at 31 March 2017 was £152.234 million, and the total risk weighted assets for the Society were £883.252 million, leading to a capital requirement at 8.0% of £70.661 million.

As the Group currently has £83.170 million of capital in excess of minimum capital requirements this is regarded as being more than sufficient to meet any future capital buffer requirements. The capital buffers are to be implemented gradually through to 2019. The Group's three year plan forecasts that the Society's capital position will strengthen over this time period and that Basel III capital requirements will continue to be met with a robust margin.

3. Credit Risk

General qualitative information about credit risk

a) <u>Business Model and Credit Risk</u>

The Society's business model was described in Section 2 of this document and this section provides further detail in relation to credit risk.

Flowing from the business model, 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 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) <u>Lending fully secured on residential property</u>

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 the minimum short-term credit rating from Moody's, 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.

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 ALCO and Board monthly.

b) Credit Risk Management

Primary responsibility for credit risk management and control rests with Line 1 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, Line 1 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 Line 1 “back office” oversight of front office Treasury activities and compliance with Financial Risk Management Policy and the Risk function provides independent Line 2 oversight of what the “back office” does.

Mortgage arrears and current account overdraft management and collections activity is all handled within Line 1.

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 Lines 2 and 3, and Line 1, 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 Executive management 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 reporting Executive each month. Residential mortgage arrears performance is reviewed monthly by the reporting Executive and quarterly by the Board. Commercial mortgage cases in arrears are reported to the Board on a monthly basis.

On a quarterly basis a comprehensive schedule of exposures against lending limits for both residential and commercial mortgages is considered by the ERMC and reported to the BRC and Board. The results of credit risk review work by the Risk function is reported to the 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 reporting 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 on a monthly basis to the ALCO and Board. ALCO 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, EMRC, 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

All figures in £000s

		a
1	Defaulted loans and debt securities at end of the previous reporting period	3,029
2	Loans and debt securities that have defaulted since the last reporting period	2,862
3	Returned to non-defaulted status	1,387
4	Amounts recovered on sale / written off	525
5	Other changes	(43)
6	Defaulted loans and debt securities at end of the reporting period (1+2-3-4+5)	3,936

No debt securities were in default at any point during the year ended 31 March 2017.

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. Specific provision is made against those loans and advances which are considered to be impaired. In considering the specific 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 in contained in note 13 on page 26 of the Annual Report and Accounts.

The residual maturity of loan exposures is provided in note 25 on page 34 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 on pages 37 to 39 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

1. Loans Fully Secured on Residential Property – geographical analysis

All figures in £000s	Performing	Past due 90 days	Total	%
North West	967,404	1,633	969,037	56.2%
Scotland	177,646	1,334	178,980	10.4%
London	159,973	-	159,973	9.3%
South East	156,346	-	156,346	9.1%
South West	112,017	-	112,017	6.5%
East of England	30,226	-	30,226	1.8%
Yorkshire & Humberside	37,667	-	37,667	2.2%
North East	24,937	12	24,949	1.4%
West Midlands	19,595	-	19,595	1.1%
Wales	18,746	-	18,746	1.1%
East Midlands	16,882	-	16,882	1.0%
Total	1,721,439	2,979	1,724,418	100.0%
% performing / not performing	99.8%	0.2%	100.0%	

2. Loans Fully Secured on Land – geographical analysis

All figures in £000s	Performing	Past due 90 days	Total	%
North West	87,808	272	88,080	56.1%
South West	22,831	-	22,831	14.5%
Yorkshire & Humberside	14,504	88	14,592	9.3%
Scotland	9,304	470	9,774	6.2%
Wales	6,444	-	6,444	4.1%
South East	6,492	-	6,492	4.1%
East Midlands	2,558	-	2,558	1.6%
East of England	1,525	-	1,525	1.0%
West Midlands	2,436	-	2,436	1.6%
North East	1,651	-	1,651	1.1%
London	584	-	584	0.4%
Total	156,137	830	156,967	100.0%
% performing / not performing	99.5%	0.5%	100.0%	

3. 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	% share
Guesthouses	35,104	7,827	9,262	11,411	63,604	40.7%
Hotels	24,754	2,338	7,357	11,300	45,749	29.3%
Investment Properties	13,383	2,284	2,768	8,357	26,792	17.1%
Public Houses/ Restaurants	6,028	824	977	2,016	9,845	6.3%
Retail outlets	1,642	854	165	110	2,771	1.8%
Professionals' premises	725	0	89	17	831	0.5%
Others	1,255	46	1,746	3,717	6,764	4.3%
Total	82,891	14,173	22,364	36,928	156,356	100.0%
% share	53.0%	9.1%	14.3%	23.6%	100.0%	

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.

4. Ageing analysis of past-due accounts

All figures in £000s

	Loans FSRP	Loans FSOL	Total
3-4 months	242	343	585
4-5 months	689	-	689
5-6 months	48	-	48
6-7 months	208	-	208
7-8 months	45	-	45
8-9 months	1,399	88	1,487
9-10 months	97	-	-
10-11 months	-	-	-
11-12 months	-	127	127
Over 12 months	251	272	523
Total	2,979	830	3,809

Note: unauthorised current account overdrafts at 31 March 2017 totalled £128,000, with specific 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 Moody's credit ratings to assess the credit quality of its rated wholesale counterparties to assess the creditworthiness of its unsecured exposures. At 31 March 2017, 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 Moody's ratings onto the relevant risk buckets.

4. 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 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 their interest rate swaps by up to two years to 21 June 2019.
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 two tables on the following page 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)	821	4,189	5,010	1,932

Credit valuation adjustment (CVA) capital charge

All figures in £000s

	EAD post-CRM	RWA
All portfolios subject to the Standardised CVA capital charge	5,010	989
Total subject to the CVA capital charge	5,010	989

5. Operational Risk

The Group calculates its operational risk capital requirement using the 'basic indicator approach'. At 31 March 2017, the risk weighted assets relating to operational risk were £68.78 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.

6. Interest Rate Risk in the Banking Book (IRRBB)

IRRBB covers the risks which arise through holding assets and liabilities with different interest rate characteristics. For the Group, this principally arises as a result of offering mortgage and savings products with fixed rates of interest. So for example, if the fixed rate mortgages are funded by variable rate savings, and the rates on the latter increase, then the Group's net income would be reduced.

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 dashboard circulated to the Board and executives, and fortnightly to the operational ALCO meeting. An interest rate risk gap analysis report which measures the exposure of the Society's economic value to IRRBB is produced monthly and reviewed by ALCO; the report is also reviewed quarterly by the Board. A net interest income gap analysis to measure changes in earnings over a 2 year horizon to enhance the measurement and control of interest rate risk is also produced monthly and reviewed by ALCO, and quarterly by 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 equity reserves and profit and loss. The results of this analysis conducted on 31 March 2017 show, for the Group:

	+200 bps	-200 bps
	£ 000	£ 000
Impact on equity	(1,957)	2,214

reserves		
Impact on income and expenditure	(2,217)	2,217

7. Leverage Ratio

Basel III introduces 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 must be 3% but the leverage ratio will not become a binding component until 1 January 2018. The Society is already well in excess of this requirement. The ratio and its components are disclosed in more detail below.

Leverage Ratio		31 March 2017 (£000)	31 March 2016 (£000)
Exposure			
	Balance Sheet Exposure	2,241,977	2,130,278
	Netted Derivative Adjustment	5,007	4,685
	Mortgage Pipeline	88,544	57,998
	Other Committed Facilities	331,303	282,861
Leverage Ratio Exposure		2,666,831	2,475,822
Group Tier 1 Capital		152,234	142,943
Leverage Ratio		5.71%	5.77%

8. Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)

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. Two of these are the LCR and the NSFR, which at 31 March 2017 stood at 216% and 138% respectively.

9. Remuneration Code Disclosures

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

The remuneration of the executive directors and other members of senior management is determined by the Remuneration Committee, which consists of its chair Michael Hulme and the other non-executive directors.

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.

Remuneration Code Staff

The Remuneration Committee has determined that as at 31 March 2017, the four Executive Directors, six other executives, nine other members of senior management and the seven non-executive directors are designated as being Code staff and 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.

Executive directors

Further information on the mandate of the Remuneration Committee and its decision making process in determining the remuneration policy for the executive directors, is contained in the Report on Directors' Remuneration within the Group's Annual Report and Accounts for the year ended 31 March 2017.

Aggregate information on the remuneration of the four executive directors is given below (fixed remuneration includes pension contributions made by the Society on behalf of the employees, and the value of taxable benefits):

	£
Fixed remuneration	807,192
Variable remuneration	118,854

Total	926,046

Other members of senior management and those involved in control functions

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

Aggregate information on the remuneration of these 16 staff during the year to 31 March 2017, of which 2 joined the business this year, one was promoted to a position within this category during the year, and two left the business, is given below:

	£
Fixed remuneration	1,112,322
Variable remuneration	101,226

Total	1,213,548

Non-executive directors

The remuneration of the nine non-executive directors who served during 2016-17 (one of whom was appointed during the year, one of whom retired at 5 July 2016 and one of whom retired at 23 September 2016) comprised only of fees and, other than that of the Chairman, is reviewed and agreed annually by the Board. The remuneration of the Society's Chairman is determined by the Remuneration Committee, 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 (all fixed) during the year, was £261,738.

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.

10. Conclusion

This Pillar 3 disclosure document 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 a Society Board-approved policy document entitled “CRD Pillar 3 Disclosure Policy”, which is appended to this document.

During the year ended 31 March 2017, 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 John Kidd, Finance Director, Cumberland Building Society, Cumberland House, Cooper Way, Parkhouse, Carlisle, CA3 0JF, or to john.kidd@cumberland.co.uk.

Appendix 1

Cumberland Building Society - Pillar 3 Disclosure Policy

This policy sets out the Cumberland Building Society's approach to the disclosure requirements of Pillar 3 as set down in Article 431 of the CRR, Part Eight.

Banks and building societies are required to publish their Pillar 3 report concurrently with their year end financial report.

The Group will prepare both quantitative and qualitative information in accordance with the disclosure requirements, the Pillar 3 report will be published on the Society's website at www.cumberland.co.uk.

The policy is based on the Group's adoption of the standardised approach to credit risk and basic indicator approach to operational risk.

The Pillar 3 report will be 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 will be calculated through the quarterly Corep process and subject to the internal controls and review process currently in place. The information will be prepared by line 1 and with respect to the risk management framework aspects, by line 2, with oversight and review by line 2 and line 3.

The Pillar 3 report will be reviewed at the Audit Committee for onward recommendation to the Board for approval.

In accordance with the requirements, the Group will disclose (but not necessarily limited to) the list below:

- the Group's main activities, strategy and all significant risks
- how senior management and the board of directors internally assess and manage risks and strategy
- information relating to its risk management framework and risk governance structure
- information relating to its exposure to credit risk by asset class, the geographic distribution and industry of exposures
- information relating to credit quality of assets, its amounts of and movements in defaulted exposures, including the accounting definitions of 'past due', 'impaired' and 'defaulted'
- information on counterparty credit risk and the main characteristics of counterparty credit risk management
- the details of the nominated external credit assessment institution

- information relating to its operational risk exposure calculated in accordance with the basic indicator approach

- the nature of interest rate risk, including key assumptions and frequency of measurement, and the measures used to assess it

- information as required on the Society's remuneration policy, performance metrics, fixed and variable remuneration awarded during the financial year and design characteristics of the remuneration system

In accordance with the requirements of Article 435 in Part Eight of the CRR the Society's management body are satisfied that the risk arrangements in place at the Society are adequate for the overall risk profile of the Society.

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