

Furness Building Society

Pillar 3 Disclosure Document

As at 31 December 2010



Always with your interest at heart

Contents	Page
1. Introduction	3
2. Risk Management Policies and Objectives	4
3. Main Board and Committee Structure	7
4. Capital Resources	9
5. Capital Resources and Corporate Planning	9
6. Risk Weighted Exposures and Operational Risk Capital	10
7. Past Due (Loans $\geq$ 3 months in arrears) Exposure by Graphical Region as at 31 December 2010	12
8. Provisions	13
9. Breakdown of Treasury Assets under the Standardised Approach	13
10. Conclusion	14

## 1. Introduction

The European Union introduced the legislative framework known as the Capital Requirements Directive (CRD) commonly known as Basel 2 that governs how much capital all banks and building societies must hold to protect their members, depositors and shareholders. In the UK the Financial Services Authority (FSA) is responsible for ensuring that the banks and building societies that it regulates have implemented the CRD.

To protect its members' savings, Furness Building Society aims to maintain adequate capital to cover a significant economic downturn. This includes holding sufficient capital to cover the activities of its wholly owned subsidiaries and in particular, those that are trading i.e. Furness Mortgage Services Limited (FMSL) and Furness Independent Financial Advisers Limited (Furness Independent). FMSL acquired mortgage books in prior years and as borrowers from a subsidiary company, these borrowers do not qualify for membership of the Society. Furness Independent provides independent financial advice to those Society members who express a preference for this service and also to non-Society members. References hereafter to the Group include these three entities.

The 3 main "Pillars" that make up the CRD are as follows:

Pillar 1 Minimum capital requirements

Pillar 2 Assessment of capital requirements by the firm and the FSA

Pillar 3 Disclosure

Under Pillar 1 the Group has followed the Standardised Approach permitted by the CRD when calculating the minimum capital requirement. This involves applying a defined risk based capital calculation to produce the Group's credit and operational risks. As required by Pillar 2 the Society's Board has then performed a thorough assessment of the risks that the Group is exposed to and has calculated the additional amount of capital that it considers necessary to cover these risks. This assessment process included stress testing to ensure that the Group could maintain adequate capital in the event of a severe economic downturn.

This document deals with the requirements laid down for Pillar 3 (disclosure) and the information provided herein is in accordance with the rules laid down in the FSA handbook BIPRU Chapter 11. All figures within this document are stated as at **31 December 2010** unless otherwise indicated.

The document will be updated on at least an annual basis and is published as soon as practically possible after the Society's Annual Report and Accounts have been accepted at the Annual General Meeting which is held each April.

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

Furness Building Society is primarily a producer and retailer of financial products, mainly in the form of mortgages and savings. These products give rise to a financial asset or liability and are termed financial instruments. As well as mortgages and savings, the Group uses wholesale financial instruments to invest in liquid assets and raise wholesale funding and to manage the interest rate risks arising from its operations.

The Board has an established risk management framework for the Group that is proportionate to both the size of the Group and the risks to which it is exposed. This framework enables the Group to identify, monitor, control and report on the key risks faced by the Group.

As a mutual building society which is run for the benefit of its members, the Board has a risk appetite which has this responsibility as its primary focus.

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

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

### **Credit Risk**

Credit risk refers to the potential risk that arises from customers (or counterparties) failing to meet their obligations as they fall due. Credit risk arises primarily from loans to our retail customers, loans to commercial mortgage customers and from liquid asset investments held by the Treasury department. The Society's Credit Risk Committee is responsible for reviewing the Group's retail lending policy and recommends changes to the Society's Board of Directors. The Board monitors exposures in accordance with this policy including concentration to individual retail counterparties and sector concentration. The Assets and Liabilities Committee (ALCO) is responsible for recommending limits on Treasury counterparties, country exposures and types of financial instruments for approval by the Board of Directors. The full ALCO committee meets on a monthly basis with management ALCO meetings also taking place between these meetings.

### **Market Risk**

Adverse movements in market variables such as interest rates, prices etc. pose a risk to the Group's financial position and constitute market risk. Because the Society does not operate a trading book it does not have a Pillar 1 requirement for this risk. The Group is however affected by interest rate risk.

Interest rate risk arises from imperfect matching of different interest rate features, re-pricing dates and maturities of mortgages, savings and wholesale products. The Society's ALCO monitors and manages this exposure on an ongoing basis using a combination of on and off-balance sheet instruments. The following activities are affected by changes to interest rates:

- Fixed and capped rate mortgage lending and fixed rate treasury lending
- Fixed rate savings products and fixed rate treasury funding
- Management of the investment of reserves and other net non-interest bearing liabilities

Interest rate swaps and caps are used to manage these risks. In addition, the risks arising from a net exposure to interest basis risk such as the base rate or LIBOR are managed by setting product limits and having products with the same basis on the opposite side of the balance sheet. The prepayment risks associated with fixed rate mortgages are managed through the use of early repayment charges.

The Society's interest rate related risk appetite is measured against the impact of a parallel shift in interest rates of 2%.

## **Liquidity risk**

The Society's liquidity policy has been developed to ensure that the Group is able to meet known and also any unforeseen financial obligations as they fall due. This is achieved by maintaining an appropriate level of liquid assets and by having access to additional sources of funds through the wholesale market. Liquidity is maintained at a level that ensures public confidence in the solvency of the Group. A significant proportion of the Society's liquid assets are held in the form of instruments such as treasury bills or government guaranteed CDs to give guaranteed access to funds at short notice in addition to amounts held in a Bank of England reserve account, call accounts and short term deposits.

## **Operational Risk**

The risk of loss arising from failed or inadequate internal processes or systems, human error or other external factors constitute operational risk. Each of the key risk areas within the Group are owned by a manager who reports directly to an executive. These managers are responsible for devising appropriate controls to mitigate the risks in their area of responsibility and these controls are considered by the executive to whom the manager reports and where appropriate, by the Group's Management Risk Committee which comprises the Society's three Executive Directors, the Group Secretary and the Risk Manager.

The Society's Risk Manager maintains the risk database and works with the Group's staff to embed a clear awareness of risks and how to address them. The Group measures its risks before and after the application of appropriate controls and ultimately, the Board are responsible for deciding on whether they accept the residual risk that exists after the application of these controls.

## **Business Risk**

The Society considers that Business and Strategic risks are inextricably linked and recognises that in an adverse macroeconomic environment it may be unable to achieve its corporate plan objectives due to earnings volatility and additional costs. The Society has a well developed corporate planning process which involves the Board of Directors and senior management team who consider the potential impact of negative scenarios such as a margin squeeze.

## **Concentration Risk**

As a regional building society, the Society is considered to face concentration risk because its activities and those of its subsidiaries are highly concentrated in residential lending and/or associated products and services funded predominantly by retail investments. Concentration risk is concerned mainly with the fact that in extremis, the losses resulting from certain concentrations may be sufficient to threaten the solvency of the Group.

The following types of concentration risk are considered to affect the Society and are monitored and managed by the Board to ensure that we do not lend more than is appropriate for our position/size; Geographic, Employment, Funding, Large Exposures and Product Type.

We take account of geographic concentration risk when undertaking stress testing and model the impact of dramatic falls in property prices in the North West area where a high proportion of our mortgage balances are situated and hold an appropriate level of capital to cover the impact of recessionary conditions. The Society regularly monitors its geographic concentration risk and adjusts its lending strategy where appropriate.

The Society has a low proportion of its total lending in the form of commercial mortgages and monitors the amount of this type of lending on a regular basis to ensure that the quality and quantity remain within the Society's risk appetite.

## **Pension Liability Risk**

Although the Society closed its final salary pension scheme to new members in 2000 it is still exposed to those existing and former members of staff who remain members of the scheme. While the scheme remains open to these members, there remains a risk that the scheme's assets may be insufficient to cover the benefits due to them.

The Society's Board of Directors agreed a schedule of contributions over a six year period to close the pre-tax deficit that existed at the date of the last triennial actuarial review of the pension scheme which was performed as at 6 April 2008.

## Residual Risk

The Board holds capital to cover events that can be anticipated with a reasonable degree of certainty and also holds adequate capital to cope with scenarios that result in stressed conditions. In addition, the level of capital held by the Group covers unforeseen events that are not modeled by the Society and this is comfortably in excess of the minimum required by the FSA.

## Conduct Risk

The Society must ensure that it conducts dealings with its customers in a manner that is fair and is in their interests and the Board is ultimately responsible for the fair treatment of customers. The Society has a Treating Customers Fairly Committee which is chaired by the Chief Executive with staff from many levels and areas of the Society represented. The Committee meets monthly and considers related regulatory developments, the outcomes from customer complaints and receives feedback from staff and customers. Conduct risk key performance indicators, which cover marketing, product development, terms and conditions and staff training and awareness, are considered by the Board on a quarterly basis. The Society has a training and competence scheme which reviews the knowledge, ability and compliance levels of the mortgage and insurance sales teams on an ongoing basis.

### 3. Main Board and Committee Structure

The Society's Board of Directors currently comprises 3 executive directors and 6 non-executive directors with the two subsidiary companies each having a Board of Directors which comprises 2 of the Society's executive directors and 2 of its non-executive directors.

From a risk management perspective there are 3 Board appointed committees that report directly to the Board and these are the Board Risk Committee, Audit Committee and the Assets and Liabilities Committee (ALCO). In addition, the Group's Management Risk Committee is chaired by the Chief Executive and reports to the Board Risk Committee as does the Credit Risk Committee that comprises members of the senior management team including the executive with line responsibility for the underwriting function.

#### Audit Committee

**Composition:** 3 non-executive directors

**Main Functions:** The Committee's main role is to review the effectiveness of the Group's systems of internal control and risk management process. Other functions of the committee include;

- to review the internal and external audit processes
- to consider external and internal audit reports
- to consider compliance with regulatory and legal requirements

- to consider financial reports including the Society's Annual Report and Accounts
- to approve and monitor the annual internal audit plan

The Audit Committee meets on a quarterly basis, with an additional meeting being held each February to deal with the Annual Report and Accounts.

### **Assets and Liabilities Committee (ALCO)**

**Composition:** Two non-executive directors, Chief Executive, Deputy Chief Executive, Finance Director, Treasurer and Mortgage Controller with the Group Secretary and Financial Controller as observers.

**Main Functions:** The Committee is an executive decision making committee whose decisions and recommendations are reported to the Board on a monthly basis. The principal objective of the committee is to identify, control and manage the operational, structural, funding, basis, counterparty and settlement risks inherent in the Group's balance sheet with particular regard to the impact on the Group's capital position. The Committee is responsible for reviewing the Society's treasury activity and the current and proposed strategy and limits for liquidity, wholesale funding and hedging activities. In addition the Committee is responsible for ensuring that the Group complies with Society and Regulatory limits. The full Committee receives a variety of reports to enable it to discharge the above mentioned responsibilities and meets at a minimum on a monthly basis and more frequently when necessary. A management ALCO comprising members of the Society's senior management team meets between the meetings of the full committee to address operational matters that are then reported to the full committee. This management committee has been invaluable during the prevailing period of general economic uncertainty.

### **Board Risk Committee**

**Composition:** 2 non-executive directors, Finance Director and Group Secretary with the Chairman of the Board and Chief Executive as observers.

**Main Functions:** The Committee's main purpose is to provide assurance and make recommendations to the Board on the management/mitigation of risks. The Committee reviews the risks and controls identified by the Audit Committee, the Assets and Liabilities Committee (ALCO), the Group's Management Risk Committee and the Credit Risk Committee. It challenges their assessments where appropriate and determines whether they consider that the main risks have been identified and whether they have been adequately mitigated. The Board Risk Committee consider and recommend the risk appetite of the Group to the Board along with what it considers the Group's Top risks to be and these are then monitored and controlled using the risk management framework detailed in this document.

#### 4. Capital Resources

The Group's capital resources are calculated in accordance with the regulations specified in the Capital Requirements Directive. This calculation takes into account the capital required for the Society and all of its active subsidiaries. There are currently no known impediments that would prevent the transfer of capital resources from Furness Building Society to these subsidiaries should the need arise.

Total Group assets at 31 December 2010 were £813.5M of which £9.47M relate to the mortgage assets of Furness Mortgage Services Limited.

At 31 December 2010 the Group's Capital Resources totalled £60.275M and comprised:

- £55.313M of Tier 1 Capital in the form of General Reserves
- £4.962M of Tier 2 Capital in the form of Subordinated Debt
- £1.270M of Tier 2 Capital in the form of mortgage related general provisions

As the title suggests, the rights of the issuers of Tier 2 capital are subordinated to the claims of the Society's depositors, creditors and investing members.

#### 5. Capital Resources and Corporate Planning

The Group's main source of capital is from retained profits which are added to the General Reserves that have accumulated since the Society's formation in 1865.

It is essential that the Group maintains sufficient capital to support its ongoing activities and this requirement is an integral part of the Group's corporate planning process. The Society's corporate plan projects forward three years and takes into account the need to have and maintain adequate capital and non-financial resources to support both existing activities and new ventures that the Group may be contemplating.

In addition to the corporate planning process the Group is required to undertake an Internal Capital Adequacy Assessment Process (ICAAP) which is a formal process that calculates the Group's capital requirement in normal and stressed conditions and these two processes are obviously very closely linked.

The ICAAP involves reviewing all of the Group's business activities and calculating the capital required to support them.

The credit risk related capital requirement for various types of mortgage lending and treasury related investments has a major influence on the Group's appetite for such exposures with limits being established and monitored on a regular basis for each type of credit exposure. The Group undertakes regular stress testing of each major credit risk component with the results of this testing influencing business decisions on an ongoing basis.

The Society's mortgage pricing process takes into account the amount of capital required to support different types of mortgage lending.

## 6. Risk Weighted Exposures and Operational Risk Capital

The Group applies the 'Standardised Approach' to Credit Risk as specified by the Capital Requirements Directive which entails the application of agreed risk weights to each asset class to produce risk weighted assets for which the capital requirement is then calculated. Additionally, the Group uses the 'Basic Indicator Approach' to evaluate the additional capital required to cover the Operational Risk associated with the Group's activities. The resulting capital requirements at 31 December 2010 are detailed below:

Position at 31 December 2010	Asset £000	Risk Weighted Assets £000	Capital £000
<b>Treasury Assets</b>			
Claims or contingent claims on central governments or central banks	79,328	0	0
Claims or contingent claims on regional governments or local authorities			
Claims or contingent claims on institutions	115,743	23,057	1,845
<b>Total Treasury Assets</b>	<b>195,071</b>	<b>23,057</b>	<b>1,845</b>
<b>Loans and Advances to Customers</b>			
Claims or contingent claims secured on real estate property	609,393	230,107	18,408
Past due items	5,528	6,217	497
<b>Total Loans and Advances to Customers</b>	<b>614,921</b>	<b>236,324</b>	<b>18,905</b>
<b>Total Credit Risk Exposures</b>	<b>809,992</b>	<b>259,381</b>	<b>20,750</b>
<b>Operational Risk Capital Requirement</b>			<b>1,529</b>

The Society's capital requirement relating to offered but not completed mortgages, off balance sheet financial instruments and other assets was £0.940M.

### Counterparty Credit Risk

The Society is exposed to counterparty credit risk in relation to its liquid asset investments which are invested with banks, building societies and local authorities. Whilst the achievement of a satisfactory rate of return on these investments is a consideration, it is of secondary importance relative to the need to ensure that the investments are held with reputable institutions that have a very high probability of repaying the investment at maturity.

The ALCO are responsible for recommending to the Board which counterparties should be included on the authorised counterparty list and what the maximum exposure should be for each counterparty. The ALCO take into account the ratings assigned to an entity by the Fitch, the Moody's and the Standard and Poors credit rating agencies, and also consider any other pertinent data that is considered to relate to the creditworthiness of each entity. Additional research is undertaken by the treasury department that ensured that the Society was not exposed to the Icelandic Banks or Bradford and Bingley plc.

Virtually all of the Society's investments are short term in nature being invested for 12 months or less, with the majority having maturities of 3 months or less. For an investment of this type to be made with a rated entity it must have a short term Fitch rating of at least F1. Fitch describes an F1 rated entity as follows: 'Highest credit quality. Indicates the strongest capacity for timely payment of financial commitments; may have an added "+" to denote any exceptionally strong credit feature.' In addition to these ratings, when deciding on individual counterparty credit limits the ALCO take into account the support rating which indicates the likelihood of support being forthcoming in the event of the entity experiencing difficulties. The Society restricts investment with unrated entities to other building societies which are highly regulated and to local authorities which are considered to be quasi-government.

On the rare occasions that the Society arranges an investment for a period in excess of a year, where rated, the entity must possess a Fitch international long term rating of at least A which they define as: 'High credit quality. 'A' ratings denote expectations of low credit risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.' At 31 December 2010, the Society had investments totalling £5M with rated entities with maturities in excess of one year.

The Society takes into account both on and off-balance sheet exposures when calculating outstanding counterparty credit exposures. The Society's executive management team can reduce an existing credit limit or remove a counterparty completely from the authorised counterparty list without convening a full ALCO meeting with the action being reported to the next full meeting. However, for a counterparty to be added to the authorised counterparty list or to have its credit limit increased this must be considered by the full ALCO who will make a recommendation for consideration by the Society's Board of Directors. No transactions will be undertaken with a new counterparty until the Board have authorised the credit limit for each entity.

There were no direct foreign counterparty exposures as at 31 December 2010.

## 7. Past Due (Loans >= 3 months in arrears) Exposure by Geographical Region as at 31/12/2010

FBS Residential Mortgages (Excl BTL) AS AT 31 December 2010			
Geographic Region	Past Due(£000's)	Performing (£000's)	Total (£000's)
1 Scotland	83	13,606	13,689
2 Northern Ireland	0	0	0
3 North West	2,526	291,473	293,999
4 North East	473	47,572	48,045
5 East Anglia	0	12,903	12,903
6 East Midlands	135	14,543	14,678
7 Midlands	117	17,507	17,624
8 North Wales & Cheshire	40	24,793	24,833
9 Marches	0	0	0
10 South Wales & Gloucestershir	29	9,865	9,894
11 South West	0	12,913	12,913
13 South East	0	9,405	9,405
14 London	0	10,174	10,174
15 Thames Valley	0	13,706	13,706
16 Home Counties	0	18,522	18,522
<b>Total</b>	<b>3,403</b>	<b>496,982</b>	<b>500,385</b>

FBS Residential Buy To Let Mortgages as at 31 December 2010			
Geographic Region	Past Due(£000's)	Performing (£000's)	Total (£000's)
1 Scotland	0	1,050	1,050
2 Northern Ireland	0	0	0
3 North West	1,796	53,705	55,501
4 North East	0	6,513	6,513
5 East Anglia	0	1,331	1,331
6 East Midlands	0	1,186	1,186
7 Midlands	0	2,350	2,350
8 North Wales & Cheshire	0	4,885	4,885
9 Marches	0	0	0
10 South Wales & Gloucestershir	0	1,251	1,251
11 South West	84	2,105	2,189
13 South East	0	1,288	1,288
14 London	0	2,915	2,915
15 Thames Valley	0	567	567
16 Home Counties	0	2,466	2,466
<b>Total</b>	<b>1,880</b>	<b>81,612</b>	<b>83,492</b>

FBS Commercial Mortgages as at 31 December 2010			
Geographic Region	Past Due(£000's)	Performing (£000's)	Total (£000's)
1 Scotland	0	2,252	2,252
2 Northern Ireland	0	0	0
3 North West	245	18,549	18,794
4 North East	0	175	175
5 East Anglia	0	0	0
6 East Midlands	0	0	0
7 Midlands	0	139	139
8 North Wales & Cheshire	0	140	140
9 Marches	0	0	0
10 South Wales & Gloucestershir	0	0	0
11 South West	0	0	0
13 South East	0	0	0
14 London	0	0	0
15 Thames Valley	0	0	0
16 Home Counties	0	0	0
<b>Total</b>	<b>245</b>	<b>21,255</b>	<b>21,500</b>
<b>Grand Total</b>	<b>5,528</b>	<b>599,849</b>	<b>605,377</b>
<b>Percentage</b>	<b>0.91%</b>	<b>99.09%</b>	<b>100.00%</b>

## 8. Provisions

Management determines the Group's loss provisions following an appraisal of all outstanding mortgages, liquid asset investments and other assets.

Specific provisions are established for all mortgages which are 3 months or more in arrear or where the mortgaged property has been taken into possession. In respect of loans which are 3 months or more in arrears but where the property has not been taken into possession, the directors, in accordance with recommended practice, apply a factor to take into account the probability of the cases resulting in repossession when calculating the specific provision to be made.

A general provision is made against advances not specifically identified above in order to reflect potential losses which, in the opinion of the directors, may eventually be realised, having regard to the Group's experience and the general economic conditions.

These mortgage related provisions have been deducted from the associated asset values shown in the balance sheet with the exception of the provision for potential customer claims which are shown in the balance sheet under the caption 'Provisions for liabilities'. At the 31 December 2010 the Group did not have any provisions relating to the Group's liquid asset investments.

The balance sheet and the relating provision for liabilities can be found in the Group's 2010 Annual Report and Accounts.

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

Fitch Ratings Services	Maturity of Treasury Investment			Total
	< 3 months	3 months to 1 year	> 1 year	
	£000	£000	£000	£000
AAA TO AA-	126,726	45,833	5,000	177,559
A+ to A-	11,500	3,000	0	14,500
BBB+ to BBB-	2,000	12	0	2,012
BB+ to BB-	0	0	0	0
B+ to B-	0	0	0	0
CCC+ and below	0	0	0	0
Unrated Building Societies/Local Government	1,000	0	0	1,000
Total	141,226	48,845	5,000	195,071

## 10. Conclusion

The foregoing information provides both a description of the Group's risk management approach and identifies the key areas that have the most impact on the calculation of the Group's capital requirement Pillars 1 and 2 of the CRD.

Should a user of this document require clarification of any part of the document they are requested to contact Brian Ryninks, Finance Director, at [brian.ryninks@furness-bs.co.uk](mailto:brian.ryninks@furness-bs.co.uk)