



# Basel II Pillar 3 Disclosures

for the year ended 31 October 2010

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## 1. Overview

The Capital Requirements Directive (Basel II) introduced on 1 January 2007 sets out the rules regarding capital adequacy for banks and building societies, including the disclosure requirements (Pillar 3).

The rules within Basel II are categorised under three “pillars”:

**Pillar 1** sets out the minimum regulatory capital resources requirement which predominantly comprises credit risk and operational risk.

**Pillar 2** covers Management’s assessment of the additional capital resources required to cover the specific risks faced by the institution that are not covered by the minimum regulatory capital resources requirement set out under Pillar 1.

**Pillar 3** requires building societies and banks operating under the Basel II framework to disclose qualitative and quantitative information regarding their risk assessment process and capital resources, and hence their capital adequacy.

In addition to the assessment of capital requirements under Pillar 1 and 2 above, the Society’s overall capital requirement is also reviewed and agreed by the FSA under the Supervisory Review and Evaluation Process (SREP). Under this process the FSA set the Individual Capital Guidance (ICG) for the Society, which is the minimum amount of capital that the Society should hold.

This document has been prepared to meet the Pillar 3 disclosure requirements of Basel II. This document is based upon the Society’s Annual Report and Accounts for the year ended 31 October 2010, unless otherwise stated. These disclosures are issued on an annual basis as soon as practicable after the publication of the Society’s Annual Report and Accounts.

These disclosures are published on the Stafford Railway Building Society website ([www.srbs.co.uk](http://www.srbs.co.uk)). There is no requirement for the disclosures to be audited, however, some of the information within the disclosures also appear in the Society’s Annual Report and Accounts.

## 2. Risk Management Policies and Objectives

### Overview

The Society's primary aim is to put the safety and security of Members' deposits above everything else. This is achieved by appropriate management and minimisation of the risks arising from business activities.

The main risks we manage are :

- Credit risk
- Liquidity risk
- Operational risk
- Concentration risk
- Interest rate risk

### Risk Management Framework

The Society's Board has ultimate responsibility for developing an appropriate risk and control framework. Risk governance is provided through Board sub-committees.

In principle, each of the Board sub-committees fulfil a similar role, in that, operating under a Board delegated mandate, they provide a forum for the direction and challenge of Management whilst monitoring business performance and risk exposures. Each of the Board sub-committees are composed of Non-Executive Directors with other attendees being drawn from the Executive and Senior Management:

**Assets and Liabilities Committee (ALCO)**, which agrees and monitors liquidity, interest rate risk and credit risk as it relates to treasury counterparties and to mortgage lending.

**Audit Committee**, which has overall responsibility for reviewing the Society's internal controls and risk management systems, validating the integrity of the Society's financial statements and reviewing and approving the significant financial reporting issues and accounting policies/issues.

The Society's risk management framework is based on the best practice "3 lines of defence" model which is illustrated below.

<b>Line of defence</b>	<b>Activity</b>	<b>Responsibility</b>	<b>Governance</b>
1 <sup>st</sup>	Identification, assessment and management of risk through normal business operations	Management	Executive
2 <sup>nd</sup>	Policy   Controls   Identify, Assess, Monitor	Control Functions	Board Committees
3 <sup>rd</sup>	Independent assurance of the adequacy and effectiveness of control systems	Internal Audit	Audit Committee

### 3. Capital Resources

The Capital Resources of the Society are calculated under Pillar 1 of the Capital Requirements Directive.

The total Society assets at 31 October 2010 were £194 million.

The table below summarises the composition of regulatory capital for the Society as at 31 October 2010, together with prior year comparatives. During the year ended 31 October 2010, the Society complied with all of the externally imposed capital requirements to which they are subject.

<b>Capital Resources</b>	<b>As at 31/10/2010 £000's</b>	<b>As at 31/10/2009 £000's</b>
Tier 1 – General Reserves	£12,405	£11,135
Tier 2 – General Provisions	£164	£261
<b>Total Capital Resources</b>	<b>£12,569</b>	<b>£11,396</b>

#### Tier 1 Capital

These are the general reserves of the Society and represent an accumulation of after tax profits of the Society.

#### Tier 2 Capital

These are general provisions of the Society and therefore represent part of the Society's free capital.

## 4. Capital Adequacy

### Capital Management and Reporting

Capital is held to provide a cushion to absorb losses that may occur during the economic cycle. In assessing the adequacy of its capital, the Society considers its risk appetite, the material risk to which the Society is exposed and the appropriate management strategies for each of the Society's material risks.

The Society considers its overall capital requirement as part of its internal capital adequacy assessment process (ICAAP). In addition, the Board monitor the capital position of the Society on a monthly basis.

### Summary of Approach to Capital Adequacy Planning

The ICAAP document is produced annually, but it is reviewed on a quarterly basis so that it reflects relevant matters arising throughout the year. The ICAAP is the means by which the Society Ensures that :

- It has sufficient levels of capital resources to pursue the corporate objectives as set out in the Society's Corporate Plan in lights of the risks it faces; and
- It has sufficient capital resources to trade through a severe recession, if necessary by applying appropriate management actions.

In formulating the Society's Corporate Plan, the Society considers its overall objectives and evaluates these in light of its risk appetite.

### Minimum Capital Requirement (Pillar 1)

Under FSA rules (Pillar 1) a minimum level of capital must be held for credit risk and operational risk. The Society has adopted the standardised approach to calculate the minimum regulatory capital resource requirement for credit risk and operational risk.

The following table shows the Society's overall minimum capital requirement for credit risk under the standardised approach at 31 October 2010 (expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes). Details of the standardised approach to the calculation of regulatory requirements are contained in the FSA handbook. The evaluation of capital required to cover operational risk is calculated under the "Basic Indicator Approach" and determined by reference to the net income of the Society averaged over the previous 3 years.

	Exposure £000's	Risk Weighted Exposure £000's	Capital Required £000's
<b>Liquidity</b>			
Cash	22	0	0
Credit Institutions	42,218	10,252	820
Gilt Edged securities	10,644	0	0
<b>Total liquidity</b>	<b>52,884</b>	<b>10,252</b>	<b>820</b>
<b>Loans and advances to customers</b>			
Residential – performing loans	135,386	47,906	3,832
Non – residential – performing loans	4,388	4,388	351
Past Due Items	531	542	44
<b>Total Loans and advances to customers</b>	<b>140,305</b>	<b>52,836</b>	<b>4,227</b>
<b>Other exposures</b>			
Fixed and other assets	769	769	61
<b>Total other exposures</b>	<b>769</b>	<b>769</b>	<b>61</b>
			-----
<b>Total credit risk exposures</b>	<b>193,958</b>	<b>63,857</b>	<b>5,108</b>
<b>Market risk *</b>			<b>0</b>
<b>Operational Risk Capital Requirement</b>			<b>419</b>
			-----
<b>Total Pillar 1 capital requirement</b>			<b>5,527</b>
<b>Total capital available</b>			<b>12,569</b>
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<b>Excess of capital over minimum capital requirement under Pillar 1</b>			<b>7,042</b>
			=====
* Market risk is the risk arising due to adverse market movements. The Society has no trading book and therefore consequently no market risk.			

## 5. Credit Risk

### Overview

Credit risk is the risk that a borrower or counterparty to a contract will not be able to meet their obligations as they fall due. For this Society this normally means the risk that a borrower will not repay their mortgage loan, or that a financial institution will not repay funds invested by the Society in that institution.

### Mortgage credit risk

The Society continues to be engaged in lending activity, primarily on residential property. The Society's current lending policy is in accordance with its risk appetite which has been established by the Board, and has produced an inherently low risk mortgage book.

The Society has strong Management controls over arrears with losses arising from default leading to possession in the year to 31 October 2010 amounting to £13,600. The average loan to value on the residential mortgage book, which accounts for 95.9% of the Society's total mortgage book, was 36.5% as at 31 October 2010.

A table of the Society's "past due" loans by geographical area, which are loans greater than 3 months in arrears, as at 31 October 2010 are set out below:

Region	Residential		Commercial		Total
	Past Due	Performing	Past Due	Performing	
	£m	£m	£m	£m	£m
Stafford ST16 – ST21	0.2	43.1	0	3.1	46.4
Rest of Staffordshire	0.2	31.3	0	1.7	33.2
Rest of England	0.2	59.3	0	1.0	60.5
Scotland	0	0.4		0	0.4
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<b>Total</b>	<b>0.6</b>	<b>134.1</b>	<b>0</b>	<b>5.8</b>	<b>140.5</b>
	=====	=====	=====	=====	=====

The Society's provision for bad and doubtful debts as at 31 October 2010 is set out below:

	Loans fully secured on Residential Property		Loans fully secured on Land		Total £000
	Specific	General	Specific	General	
	£000	£000	£000	£000	
Balance at 1 November 2009	28	251	0	10	289
Charge/(release) for the year	46	(97)	0	0	(51)
Amounts released during the year	(13)	0	0	0	(13)
	-----	-----	-----	-----	-----
<b>Balance at 31 October 2010</b>	<b>61</b>	<b>154</b>	<b>0</b>	<b>10</b>	<b>225</b>
	=====	=====	=====	=====	=====

The Assets and Liabilities committee is responsible for reviewing the Lending policy of the Society and monitoring the arrears profile. Arrears are monitored by the Board on a monthly basis and by Management on a weekly basis.

### Counterparty Credit Risk

The Society's counterparty treasury credit risk management policy is to ensure that the Society can obtain the best possible return whilst operating within prudent limits in respect of counterparties, and is contained within the Liquidity and Financial Risk Management Policy.

The Society only invests funds in British Government Securities, Banking Institutions rated at least F1 and with larger Building Societies. The assets are managed with advice from external fund managers.

New limits and counterparties are approved by the Assets and Liabilities Committee (ALCO). ALCO monitors exposures to counterparties and countries and ensures the Society is operating within its Board approved limits at its quarterly meetings. The Board reviews the Society's exposure by sector on a monthly basis.

The table below shows the breakdown of liquid assets at 31 October 2010 using the standardised approach.

Fitch Ratings Services	Maturity of Treasury Investment			
	< 3 Mths £m	3 months to 1 year £m	>1 year £m	Total £m
F1	2.0	1.0	0	3.0
F1+	9.4	15.3	3.5	28.2
Unrated Building Societies	5.0	6.0	0	11.0
Treasury Bills	4.0	0	0	4.0
British Government Securities	0	0	6.7	6.7
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<b>Total</b>	<b>20.4</b>	<b>22.3</b>	<b>10.2</b>	<b>52.9</b>
	=====	=====	=====	=====

No provisions for loss relating to counterparty risk are held by the Society as at 31 October 2010.

## 6. Liquidity Risk

Liquidity risk is the risk that the Society will be unable to meet its financial obligations as they fall due. The Society's Liquidity and Financial Risk Management policy addresses both the level and quality of liquid assets.

Liquidity is monitored daily and weekly by the Executive and senior management, review at ALCO meetings, and included in the Management Information for Board meetings.

## 7. Operational Risk

### Overview

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The Society has used the standardised approach to Operational risk. Under this approach, the capital charge for Operational risk is calculated by averaging the annual income from prescribed business lines over the past three years and applying a set regulatory multiplier to the different business lines. As at 31 October 2010, this formula produced a capital requirement of £419,000 which is shown in the Minimum Capital Requirement (Pillar 1) table on page 8.

### Operational risk framework

The Society's product range comprises of a single variable rate flexible mortgage product and a range of variable rate investment products. The Society does not provide financial advice and only senior management can deal with mortgage applications. The risk therefore of mis-selling by the Society is not considered significant.

The Society considers that its simple product range, robust systems, policies and internal control framework are the major factors in the achievement of strong control of Operational risk. The main operations and controls are summarised in the Risks and Controls Register which is reviewed by the Audit Committee, both Internal and External Auditors and the Board.

## 8. Concentration risk

The types of concentration risks facing the Society are concentration in one product type, geographical concentration and over exposure to single borrowers, investors, or counterparties.

Although the Society has only one mortgage product, which is predominantly secured on residential property and wholly within the UK, this concentration is considered to be of low risk because of the inherent nature of the assets and the controls in place to ensure that the Society does not incur loss which is supported by the Society's successful track record.

The Society has no dependency on any one form of introduction for mortgages and there is no concentration risk in the type of property held as security.

The Board review the Society's product offering on an annual basis taking account of market and customer changing trends. The simplicity of the Society's product range has been supported by strong mortgage demand throughout and beyond the recent credit crisis which supports the Boards view that the risk to the Society in this area is low.

## 9. Interest Rate Risk

The Society's Interest rate risk arises from the potential impact that changes in interest rates could have on the Society's cash flows. This Society does not have any fixed rate savings or mortgage products, only variable, and therefore the Interest Rate Risk for the Society is significantly less than for other similar institutions. The Society's main exposure to interest rates arises from its investment in Government Gilts and Certificates of Deposit with other financial institutions. The Society uses specialist external treasury advisers for investing surplus funds and has a good spread of maturity of its invested monies to manage this risk effectively.