



Capital Requirements Directive

Pillar 3 Disclosures

April 2011

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MARKET HARBOROUGH BUILDING SOCIETY

Pillar 3 Disclosures as at 31 December 2010

1. Background

A legislative capital adequacy framework, the Capital Requirements Directive (CRD - also known as Basel II) was introduced in the European Union in 2007 which governs the amount of capital that banks and building societies are required to hold in order to protect their members, depositors and shareholders. The Society seeks to ensure that it protects its members by holding sufficient capital at all times.

The Financial Services Authority (FSA), Market Harborough Building Society's (the Society) regulator, is the body responsible for implementing the CRD in the UK. The Society has been operating under the Basel II regime since 1 January 2008. It has adopted the Standardised Approach for Credit risk and the Basic Indicator Approach for Operational risk.

The CRD consists of 3 elements, or 'Pillars', which represent the key principles of the Basel II regime:

Pillar 1

This covers the minimum capital requirements of Basel II. The calculation is based on a risk based approach. It focuses on credit and operational risk in determining the Society's Capital Resources Requirement (CRR).

Pillar 2

This covers the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP). Under the ICAAP the Society's Board has undertaken an assessment of all of the key risks facing the Society's business for which capital has not been provided under the Pillar 1 requirements. The results of the Board's assessment are subject to review by the FSA under the SREP arrangements.

Pillar 3

This covers the disclosures that the Society is required to make under the CRD. This document discloses that information and is in accordance with the Rules laid down in the FSA Handbook in section 11 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU).

The Society's Board first approved the ICAAP in December 2007 in advance of its adoption of the CRD's requirements from 1 January 2008. Since then the ICAAP has been updated and approved by the Board at least annually, most recently in April 2011. The figures in this disclosure document relate to the Market Harborough Building Society Group which is made up of the Society and its wholly owned, solo-consolidated, subsidiary, Market Harborough Mortgages Limited, a mortgage lending subsidiary with mortgage assets totalling £1.85m. They are drawn from the Group's Annual Report and Accounts as at 31 December 2010 and are consistent with the ICAAP approved by the Board in April 2011. References to the Society in this document therefore include Market Harborough Mortgages Limited.

The FSA conducted the SREP during September 2009, the conclusion of which was that the actual level of the Society's capital is significantly in excess of the minimum requirements.

The Pillar 3 disclosures will be updated on an annual basis, following publication of the Annual Report and Accounts.

The Board's Disclosure Policy for its Pillar 3 disclosures is based on its interpretation of the requirements of BIPRU 11.

2. Risk Management Objectives and Policies

The Board is responsible for determining a framework for risk management and control. It has in place a formal risk management structure which includes policy statements, exposure limits, mandates and reporting lines. It approves all policies and Committee terms of reference. The Executive Directors are responsible for designing, operating and monitoring risk management and internal control processes. An Internal Audit function is in place to undertake checks in order to provide assurance that these processes are appropriate and effectively applied.

The Assets and Liabilities Committee (ALCO), a Committee appointed by the Board and comprising both non-executive and executive directors, is responsible for monitoring balance sheet risks on the Board's behalf. The Audit and Compliance Committee, consisting solely of non-executive directors, considers the adequacy of internal controls and compliance with regulatory and other requirements (such as codes of practice). It is the Audit and Compliance Committee to which the findings of Internal Audit are reported.

A Risk Register, which forms part of the ICAAP document, records the key risks to which the Society is exposed and includes an assessment of their likelihood and impact. This is reviewed by the Board at least twice a year and forms a basis for the identification of the risks for which capital is provided under Pillar 2.

Principal Risks

The principal business and financial risks to which the Society is exposed are Credit, Interest Rate, Liquidity, and Operational risks. The ways in which these risks are managed include:

- a. the use of forecasting and stress-testing models. These help in the development of business strategy;
- b. the production of key risk information and indicators to measure and monitor performance; and
- c. the monitoring and control of risks by management, and by the Board and its committees.

Credit risk

This is the risk that losses may arise as a result of failure by borrowers or market counterparties to meet their obligations to repay. Credit risk arises primarily from mortgage loans to customers and from investments of liquid assets as part of the Society's treasury operations.

A component of credit risk is concentration risk, which arises where there is a concentration of exposures within the same category, whether it is geographical location, product type, industry sector or counterparty type.

Credit risk is managed through adherence to Board-approved Lending and Treasury Policy Statements, which set out limits that are reviewed in the light of changes in economic conditions and in the Society's objectives. The ALCO monitors the Society's exposure to treasury counterparties on the Board's behalf. The performance of the mortgage book is monitored by the Board.

The Society is almost exclusively a residential mortgage lender and is exposed only to the UK market. An analysis of its portfolio of mortgages to individuals secured on residential property as at 31 December 2010 indicates that its main concentration risk is geographical, as by value 30% of its mortgages are in the East Midlands, the Society's core area of operation, and a further 31% are in Greater London and the South East. The Society has only a modest exposure to commercial and buy-to-let mortgages and has not undertaken sub-prime lending. Exposures are monitored regularly by the Board to ensure that policy limits are not exceeded.

In addition to the capital provided under Pillar 1, capital is provided under Pillar 2 to cover mortgage losses that may arise in an economic downturn.

Further information on credit risk is provided in section 5 of this disclosure document.

Interest Rate Risk

This is the risk of loss of income from movements in interest rates. Exposure to this risk is controlled by managing the margin between administered savings rates and the Standard Variable Mortgage Rate, through natural hedges that exist in the balance sheet, and through the use, where appropriate, of hedging contracts with external counterparties, within limits set out in the Society's Financial Risk Management Policy. A capital provision has been made under Pillar 2 as part of the ICAAP to cover the impact that a 3% parallel shift in interest rates would have on the Society's Capital over 5 years.

Further information on interest rate risk is provided in section 6 of this disclosure document.

Liquidity risk

Liquidity risk is the risk that the Society is unable to meet its financial obligations as they fall due as a result of imbalances in cash flows. This risk is managed by maintaining a prudent level of liquid resources at all times in accordance with limits set out in the Liquidity Policy. There is also a risk that the cost of funding the Society's activities may increase due to a scarcity of funds from retail and/or wholesale sources. To cover this risk a capital provision for the marginal cost of substitution funding has been made under Pillar 2 as part of the ICAAP.

Operational risk

This is the risk of loss arising from inadequate or failed internal processes, people and systems, or from external events. The Society operates a robust control environment to mitigate operational losses, including the maintenance of insurance policies. Key operational risks are identified in the Risk Register. A Contingency Plan is in place to ensure that disruptions to the Society's business can be appropriately managed.

Other material risks

Other material risks to which the Society is exposed are:

Business/Strategic Risk

This is the risk that the Society may not be able to carry out its corporate objectives due to changes in its operating environment. The Society manages this risk through carefully thought-through and detailed business plans and policies. This includes the approval each year of a detailed budget for the forthcoming year and a medium term Corporate Plan covering three years. The assumptions in the Corporate Plan are stress-tested to ensure that the Society's business model is robust enough to meet unexpected changes in its operating environment.

Pension Obligation Risk

This is the risk that the Society will be required to fund a deficit in the defined benefit pension scheme as a result of a fall in the value of the scheme's assets or an increase in the scheme's liabilities due to a change in actuarial assumptions. A capital provision for this risk has been made under Pillar 2 as part of the ICAAP.

Claims on the Financial Services Compensation Scheme (FSCS)

Along with other deposit takers the Society is liable to any claims on the FSCS as a result of the failure of other deposit takers. A capital provision for this risk has been made under Pillar 2 as part of the ICAAP.

Loss of Key Personnel

Many of a building society's activities require specialist skills which, by their nature, can be considered to be scarce. To mitigate this risk the Society has in place a comprehensive succession plan for both Non-executive directors and senior staff. In addition a capital provision has been made under Pillar 2 as part of the ICAAP to cover the cost of buying-in specialist skills should the need arise.

Insurance Risk

This is the risk that there may be gaps in the risks covered by the Society's insurances, that there is insufficient cover in place, or that the covenant of the insurer is defective. Processes are in place which provide the Board with the assurance that the Society's insurance arrangements are robust.

Conduct Risk

This risk concerns the way in which the Society conducts its business with its customers. This includes, for example, the way that it deals with borrowers in arrears, complaints handling and behaving in a way that treats all customers fairly. Included in the Society's approach to conduct risk is a regular review by the Board of the fair treatment of customers. The Board is satisfied that the Society's approach to conduct risk is both appropriate and robust.

Residual Risk

There are risks in any business which it may not be able to readily identify. Provision has been made for this by applying a 10% buffer to the sum of the Pillar 1 and Pillar 2 capital requirements identified in the ICAAP.

3. Capital Resources

The Society's capital resources as at 31 December 2010 amounted to £27.99m. This is made up predominantly of Tier 1 capital which is represented entirely by its general reserves (accumulated profits). Its Tier 2 capital is made up of the general provision for bad and doubtful debts.

Tier 1 and Tier 2 Capital Resources

	£m
<u>Tier 1</u>	
Gross (accumulated profits held as general reserves)	27.35
Deductions	-
Net Tier 1 capital resources	<u>27.35</u>
<u>Tier 2</u>	
Gross (general provisions for bad and doubtful debts)	0.64
Deductions	-
Net Tier 2 capital resources	<u>0.64</u>
<u>Total capital resources</u>	
Gross	27.99
Deductions	-
Net Total capital resources	<u>27.99</u>

4. Capital Adequacy Assessment

The Society maintains a three-year strategic planning framework which is reviewed by the Board annually and takes account of current and changing economic conditions. The process culminates in the production of a three-year Corporate Plan which includes the budget for the forthcoming year's business activities. The Corporate Plan reflects the Board's low appetite for risk and takes full account of the effect that planned activities are likely to have on Capital. It is therefore consistent with the ICAAP. The combination of the Corporate Plan and the ICAAP therefore ensures that the Society's capital resources will be sufficient to support its corporate objectives.

In addition to identifying the Society's current Pillar 1 Capital Resources Requirement, the ICAAP is also the Society's capital planning document for the period of the Corporate Plan. It therefore includes calculations of what the Pillar 1 Capital Resources Requirement will be for each year of the Plan. These calculations use the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. A risk weighting of 8% is applied to risk-weighted asset values calculated in accordance with BIPRU 3 to determine the minimum Pillar 1 capital requirement for credit risk. The minimum Pillar 1 capital requirement for operational risk is 15% of the Society's average net income over the previous three years.

The table below sets out the Society's Pillar 1 capital requirement as at 31 December 2010 by asset class:

PILLAR 1 CAPITAL RESOURCES REQUIREMENT

	Exposure	Risk weighted assets value	Minimum capital required
	£m	£m	£m
<u>CREDIT RISK</u>			
<u>Non-cash liquidity exposures</u>			
Central government	22.45	0.00	0.00
Regional and local government	-	-	-
Credit institutions	76.55	15.31	1.23
Total non-cash liquidity exposures	99.00	15.31	1.23
<u>Loans & advances to customers</u>			
Non-residential and business - performing loans	0.17	0.17	0.01
Non-residential and business - past due loans	-	-	-
Residential use - performing loans	330.40	118.51	9.48
Residential use - past due loans	0.62	0.62	0.05
Total loans and advances to customers	331.19	119.30	9.54
<u>Other on-balance sheet exposures</u>			
Fixed and other assets	3.12	2.79	0.22
Total other on-balance sheet exposures	3.12	2.79	0.22
<u>Off-balance sheet exposures</u>			
Interest rate contracts	0.24	0.05	0.00
Other	10.21	5.10	0.41
Total off-balance sheet exposures	10.45	5.15	0.41
<u>TOTAL CREDIT RISK</u>	443.76	142.55	11.40
<u>OPERATIONAL RISK</u>			0.87
<u>TOTAL PILLAR 1 CAPITAL RESOURCES REQUIREMENT</u>			12.27

5. Credit Risk

Mortgages

Under the CRD mortgages are 'past due' if repayments are 90 days or more in arrears at the accounting date. The Society closely monitors arrears of mortgage repayments and specific and general provisions are made if appropriate. The Society's loan book is performing well compared with national arrears statistics. No properties have been repossessed since June 2006.

The following table provides an analysis for capital adequacy purposes, and by geographical region, of the Society's mortgage assets as at 31 December 2010:

Geographical region	Non-residential			Residential		
	Performing £m	Past Due £m	Total £m	Performing £m	Past Due £m	Total £m
Greater London	-	-	-	28.08	-	28.08
South East	-	-	-	78.55	0.20	78.75
South West	-	-	-	20.63	-	20.63
East Anglia	0.02	-	0.02	14.78	0.03	14.81
East Midlands	0.13	-	0.13	98.47	0.35	98.82
West Midlands	-	-	-	25.17	-	25.17
North	0.02	-	0.02	7.45	-	7.45
North West	-	-	-	23.99	-	23.99
Yorkshire & Humberside	-	-	-	18.54	0.04	18.58
Scotland	-	-	-	5.93	-	5.93
Wales	-	-	-	8.81	-	8.81
Total	0.17	-	0.17	330.40	0.62	331.02

The following table provides a reconciliation of the above table to 'Loans and advances to customers' in the Annual Report and Accounts 2010:

RECONCILIATION OF LOANS AND ADVANCES TO CUSTOMERS

	£m
Loans and advances to customers per Report & Accounts	330.55
Add back: General and Specific loss provisions	0.64
Society accounting value of loans and advances to customers	331.19
Total residential exposures for capital adequacy purposes (as above)	331.02
Total non-residential exposures for capital adequacy purposes (as above)	0.17
Society capital adequacy value of loans and advances to customers	331.19
Adjustments to reflect different reporting requirements and timing differences	-
Reconciled value of loans and advances to customers	331.19

A residual maturity analysis of Loans and Advances to customers is provided at Note 12 of the Annual Report and Accounts 2010. It should be noted that the analysis may not reflect actual experience of repayments since many mortgage loans are repaid early.

Mortgage Provisions

The Society's accounting policy in relation to provisions for bad and doubtful mortgage debts is set out in full in Note 1, Principal Accounting Policies, to the Annual Report and Accounts 2010.

Full details of the movements on provisions for bad and doubtful mortgage debts are provided in Note 8 to the Annual Report and Accounts 2010.

For capital adequacy purposes, general provisions are regarded as Tier 2 capital. There were no specific provisions as at 31 December 2010.

Treasury

The Society's Treasury Policy statements, which include the Liquidity Policy and the Financial Risk Management Policy, are used to manage the credit risk that arises from exposures to treasury counterparties. The Liquidity Policy includes limits for the exposure to counterparties on both an individual and geographical basis. Counterparty exposures are reviewed monthly by the Assets and Liabilities Committee.

The Society's exposure to treasury counterparty risk is restricted under the Liquidity Policy to banks and building societies. To assist in determining counterparty credit quality the Society has nominated the Fitch ratings agency as its External Credit Assessment Institution (ECAI). Exposure limits for individual banks on the Society's list of authorised counterparties are set taking into account Fitch's Short Term, Long Term, Individual and Support Ratings. No bank is included on the list unless it has, as a minimum, a Short Term rating of F1 and a Long Term rating of A-. Exposures to unrated counterparties are restricted to UK building societies. In addition to the use of Fitch ratings market intelligence is used in assessing counterparty risk, in recognition that there may be a delay between a counterparty being in difficulty and this being reflected in a downgrading of its Fitch rating. A process is in place to reduce counterparty exposure limits, or to remove counterparties from the approved list, immediately without reference to the Assets and Liabilities Committee or the Board, but counterparties cannot be added without Board approval.

Exposures to counterparties in respect of off-balance sheet instruments are calculated using marked to market valuations and counterparty limits are inclusive of any such exposures. Note 24 in the Society's Annual Report and Accounts 2010 provides full details on the Society's use of off-balance sheet instruments, including their fair value.

The following table shows the breakdown of the Society's non-cash liquid assets by maturity and Fitch rating as at 31 December 2010 under the Standardised Approach; none of these exposures are impaired or past due.

Fitch Rating	Maturity less than 3m	3 months to 1 year	Over 1 year	Total
	£m	£m	£m	£m
AAA (UK Treasury Bills)	10.49	11.98		22.47
AA to AA-	37.48		-	37.48
A+ to A	22.02	-	-	22.02
Unrated building societies	17.02	-	-	17.02
TOTAL	87.01	11.98	-	98.99

An analysis of the residual maturity of these exposures can be found in Notes 10 and 11 to the Annual Report and Accounts 2010.

6. Interest Rate Risk

As identified in section 2 of this disclosure document, this is the risk of loss of income from movements in interest rates. Such losses can occur because of the differing characteristics of the various elements within the balance sheet and mis-matches between balances with the same characteristics on opposite sides of the balance sheet.

It has been established in the ICAAP that the interest rate risk to which the Society is most exposed, if mitigating action is not taken, is basis risk. Basis risk arises where balance sheet components are subject to different market forces. This includes exposures to fixed rate balances; in particular if fixed rate mortgages and fixed rate savings balances are matched with balances on the other side of the balance sheet which are at variable rates.

Basis risk is managed by using a combination of on- and off-balance sheet hedges and by the setting of exposure limits, which are set out in the Financial Risk Management Policy approved by the Board. Exposures against these limits are monitored on a continuous basis. The impact of movements in interest rates is stress-tested on a monthly basis and the results of this 'gap analysis' are reported to the Assets and Liabilities Committee. The stress test measures the effect of a parallel shift in interest rates of up to 3%. The Board has set a limit on the effect that a 3% parallel shift in interest rates can have on the Society's Capital, after the effect of on- and off-balance sheet hedges is taken into account. Capital is provided accordingly under Pillar 2.

7. Remuneration Policies and Practices

A risk arises if the Society's remuneration policies and practices could result in staff being rewarded for decisions inconsistent with the Board's risk appetite. It is therefore the Society's policy on remuneration to seek to ensure that its remuneration decisions are in line with effective risk management.

The Society seeks to ensure that its remuneration decisions are in line with its business strategy and long term objectives, and consistent with the Society's current financial condition and future prospects. It also seeks to establish an appropriate balance between the fixed and variable elements of remuneration, although this balance will vary depending on the seniority and nature of an individual's employment. Performance measurements used to calculate variable remuneration are therefore adjusted to take into account current or potential risks to the business and are consistent with the need to retain a strong capital base. Variable remuneration is not paid unless it is sustainable within the Society's situation as a whole. Guaranteed incentive payments do not form part of any remuneration package and all incentive schemes are non-contractual.

The Board has identified that those staff whose professional activities have a material impact on the Society's risk profile are the members of the Executive team, two of whom, the Chief Executive and the Deputy Chief Executive & Finance Director, are executive directors.

Executive directors

Information concerning the mandate of the Remuneration Committee and the decision-making process it uses in determining the remuneration policy for the executive directors, and information on the link between pay and performance, is contained in the Directors' Remuneration Report in the Society's Annual Report and Accounts 2010.

Aggregate information on the remuneration of the two executive directors is given below:

	£
Fixed remuneration	252,084
Variable remuneration	<u>50,198</u>
Total	<u>302,282</u>

Other executives

The Remuneration Committee is also responsible for determining the terms and conditions of other members of the Executive team after consultation with the Chief Executive. These are as follows:

Financial Controller
Head of Business Services & Compliance
Head of Information Technology
Head of Sales & Marketing
Secretary

Aggregate information on remuneration in respect of these members of the Executive team is given below:

	£
Fixed remuneration	266,236
Variable remuneration	<u>68,420</u>
Total	<u>334,656</u>

8. Conclusion

This Pillar 3 disclosure document has been prepared in accordance with the requirements of BIPRU 11 and provides information on the Society's approach to risk management based on its size and the complexity of its business operations.

It is updated annually within four months of the Society's financial year end.

If a further explanation of the disclosures is required this should be requested in writing from The Secretary, Market Harborough Building Society, Welland House, The Square, Market Harborough, Leicestershire, LE16 7PD.