



Teachers' Building Society

Pillar 3 of the Capital Requirements Directive:
Disclosures

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Pillar 3 Disclosures

1 INTRODUCTION

The Capital Requirements Directive (CRD) governs the amount and quality of capital to be held by financial institutions in order 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 Teachers Building Society maintains sufficient capital to cover, as a minimum, the impact of a severe economic downturn. This includes holding sufficient capital to cover the activities of its wholly-owned subsidiary TBS Financial Services Limited (TBSFS). TBSFS provides financial advice to those Society members who express an interest in this service and also to those who are not members of the Society. References hereafter to the Society include both the Society and TBSFS.

The 3 'Pillars' that make up the CRD are:

- Pillar 1 Minimum capital requirement

The Society has followed the Standardised Approach to credit risk and the Basic Indicator Approach to operational risk permitted by the CRD when calculating the minimum capital requirement. These methods involve applying a defined risk-based capital calculation to produce the Society's credit and operational risks.

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

The Society's Board has undertaken a thorough assessment of the risks to which the Society is exposed and the FSA has reviewed this assessment as part of the regular Supervisory Review and Evaluation Process (SREP). The Board's assessment process includes stress testing to ensure that the Society can maintain adequate capital in the event of a severe economic downturn. As a result of these reviews the Board and FSA have agreed the amount of capital considered necessary to cover the risks relevant to TBS.

- Pillar 3 Disclosure

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

The document will be updated on at least an annual basis.

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2 RISK MANAGEMENT POLICIES AND OBJECTIVES

Teachers 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 Society also uses wholesale financial instruments to invest its liquid asset balances, to raise wholesale funding, and to manage the interest rate risks arising from its operations.

In determining the Society's overall risk appetite, the Board has borne in mind the Society's constitution as a mutual organisation run for the benefit of its members. The Board has an established risk management framework for the Society that is proportionate to both the size of the Society and the risks to which it is exposed. This framework enables the Society to identify, monitor, control and report on all the key risks faced by the Society.

Risks are managed by the use of forecasting and stress testing models to help guide business strategies; the production of key risk information and indicators to manage and monitor performance; and the use of management and Board committees to monitor and control specific risks.

Key risk areas considered are:

Credit Risk

Credit risk is the risk that losses may arise as a result of the Society's borrowers or market counterparties failing to meet their obligations to repay. The Society's Credit Committee is responsible for monitoring and reviewing the Society's Credit Risk, Lending and Arrears Management Policies and recommends any changes to the Society's Executive Committee. The Credit Committee also reports to the Audit and Risk Committee on whether exposures are in accordance with the Credit Risk Policy including concentration to individual counterparties and sector concentration. The Board has overall responsibility for the Policy and approves any changes based on recommendations from the Executive Committee and the Audit and Risk Committee. The Executive Assets and Liabilities Committee (ALCO) is responsible for determining the deposit counterparties to which the Society should lend within the limits set out by the Policy.

Market Risk

Market risk is the risk of loss arising in a trading book from adverse movements in interest and exchange rates, market prices and conditions, and concentration around a future date. Because the Society does not operate a trading book it is not exposed to this risk.

Interest Rate Risk and Basis Risk

Interest rate risk is the risk to cash flows and profits arising from changes to and existing differentials in interest rates. In particular the Society is exposed to fixed interest rate mortgages largely funded by variable rate savings, but the risk also arises from some liquid assets and wholesale funding.

The Society's ALCO monitors and manages this exposure using a combination of on- and off-balance sheet instruments.

The following activities are affected by changes to interest rates:

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

Interest rate swaps are used to manage the risks of fixed rate retail lending. The Society's interest rate related risk appetite is measured against the impact of a parallel shift in interest rates of 2%. Prepayment risks associated with fixed rate mortgages are mitigated through the use of early repayment charges

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The use of interest rate swaps may itself create basis risk which, for Teachers' Building Society, is the risk that income from the swap does not match the cost of funding the asset being hedged. The Board manages this risk primarily by means of policy, which limits overall exposure to fixed rate mortgages and liabilities and to other assets and liabilities where interest rates are not set by the Society. Exposure to this risk is regularly reviewed and approved by the ALCO.

Liquidity Risk

Liquidity risk is the risk that the Society will be unable to meet its financial obligations as they fall due.

The risk is managed by holding an appropriate level of easily realisable liquid assets in order to meet withdrawal requests from investors and to advance funds to new borrowers, and by managing the maturity dates of wholesale funding. The Society also has 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 Society. The Society's policy with regard to liquidity risk is set out in its Financial Risk Management Policy. The policy is regularly reviewed and updated by the Board following recommendations from the Executive Committee and the Audit and Risk Committee, and compliance with its limits is closely monitored.

Operational Risk

Operational risk is the risk of loss or negative impact to the Society resulting from inadequate or failed internal processes, people and systems, or from external events (such as regulation or sudden changes economic environment). It includes legal and financial crime risks, but does not include strategic, reputational and business risks.

The Operational Risk Management Committee is responsible for overseeing the identification, evaluation and management of operational risk within the Society. This Committee reports to the Executive Committee and the Audit and Risk Committee, which in turn report to the Board. Managers of the key operational risk areas are responsible for managing risks identified, and for implementing and reviewing the appropriate controls and processes to mitigate the risks in their area of responsibility. These processes and controls are formally reviewed by them on a regular basis. A risk assessment process is maintained by management and overseen by the Operational Risk Committee. Staff are encouraged to report any weaknesses they identify in processes and controls and are made aware of risks and how to address them. The Society measures risks before and after the application of appropriate controls, and the Board is responsible for deciding on whether it accepts any residual risk that exists after the application of these controls.

Business Risk

The Society recognises that in an adverse macroeconomic environment it may be unable to achieve its corporate plan objectives because of volatility in earnings and increased costs. The Society has a well developed corporate planning process, which involves the Board and Executive Committee, which consider the potential impact of negative scenarios such as a margin squeeze.

Concentration Risk

As a small building society operating in a niche market for lending but in the wider market for retail deposits, the Society is exposed to concentration risk because its activities and those of its subsidiaries are highly concentrated in residential lending and associated products and services funded predominantly by retail investments.

The Society is also exposed to a small geographical concentration risk because, although it operates nationally, it has a small concentration of mortgage customers in the Greater London area and in the Southwest region around its office in Dorset.

Other types of concentration risk monitored and controlled through the implementation of policy limits are funding source, large exposures to individuals or groups of connected counterparties, and product type.

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Pension Risk

Although the Society closed its final salary pension scheme to the accrual of further service years on 31 December 2002, it remains exposed to the risks of changing asset values in the scheme and, to a lesser extent, the risk of increased liabilities. Further details of the Society's exposure appear in the Annual Report and Accounts.

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 Society covers unforeseen events that are not modelled by the Society, and is comfortably in excess of the minimum required by the FSA.

3 MAIN BOARD AND COMMITTEE STRUCTURE

The Society's Board of Directors comprises three executive directors and four non-executive directors. The subsidiary company board comprises two of the Society's executive directors and two of its non-executive directors.

The risk management process is overseen by the Audit and Risk Committee, which is a sub-committee of the Board. This Committee, all of whose members are Non-executive directors, meets at least five times a year and appraises the Society's systems of control and inspection and receives reports from the Internal Auditor and the Compliance Officer. The Committee formally reviews the work of the internal and external auditors and the Compliance Officer for the preceding year and their plans for the ensuing year, and assesses the overall effectiveness of the Society's control environment.

The Operational Risk Management Committee, which meets monthly, comprises the Executive Directors and senior managers of the Society, and is responsible for overseeing the Society's overall risk assessment processes and the principal operational risks of the Society. It reports to the Executive Committee and the Audit and Risk Committee, which in turn report to the Board. The Operational Risk Management Committee's main purpose is to provide assurance on the management and mitigation of risks. The Committee reviews the risks and controls identified by managers and staff, and ensures that risks have been adequately assessed and mitigated.

The Credit Committee, which comprises members of the executive management team, monitors compliance with, and proposes amendments to, the Society's Credit Risk Policy, Lending Policy and Arrears Management Policy, and monitors external risks to the Society's lending. It also considers mortgage applications which fall outside the limits of the normal mortgage underwriting function.

The Assets and Liabilities Committee determines treasury and balance sheet risk management strategies, capital and funding requirements, and the content of the Society's Financial Risk Management Policy. The Committee, which meets at least monthly, comprises the three Executive Directors and members of the Society's management team. The Committee is an executive decision making committee and the minutes of its meetings are provided to the Audit and Risk Committee. The principal objective of the Committee is to identify, control and manage the operational, structural, funding and settlement risks inherent in the Society's balance sheet with particular regard to the impact on the Society'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. It is also responsible for product development and for setting the Society's interest rates. In addition the Committee is responsible for ensuring that the Society complies with the Society's Financial Risk Management, Treasury Investment and Funding Policies and with regulatory limits. The Committee receives a variety of reports to enable it to discharge its responsibilities.

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4 CAPITAL RESOURCES

The Society's total assets at 31 December 2010 were £238.9M. At that date its Capital Resources totalled £19.3M and comprised:

- £18.6M of Tier 1 Capital in the form of General Reserves
- £0.6M of Tier 2 Capital in the form of mortgage related general provisions
- £0.1k of Tier 2 Capital in the form of Revaluation Reserves

The Society maintains sufficient capital to support its ongoing activities, and this requirement is an integral part of the Society's corporate planning process. The Society's corporate plan covers a rolling three year future period, 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 Society may be contemplating. Closely linked to the corporate plan is the Internal Capital Adequacy Assessment Process (ICAAP), which is a formal process which considers the Society's capital requirement in normal and stressed conditions..

The ICAAP includes a review of the Society's business activities and an assessment of the amount of 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 Society's appetite for such exposures, with limits being established and monitored on a regular basis for each type of credit exposure. The Society 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.

The ICAAP considers the effects on capital of a severe economic stress and identifies any mitigating actions available to the Society to support its capital position. For Teachers Building Society, the economic stress is considered most likely to affect the level of mortgage losses, the recoverability of liquid asset exposures and pension scheme assets and liabilities.

The results of the ICAAP are reviewed by, and discussed with, the FSA during the SREP. During this process the Society and the FSA agree on the amount and quality of capital to be held by the Society, and this is documented by means of Individual Capital Guidance (ICG) issued to the Society by the FSA. The most recent SREP was undertaken by the FSA in October 2010 and it issued its ICG on 13th December 2010.

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5 RISK WEIGHTED EXPOSURES AND OPERATIONAL RISK CAPITAL

The Society applies the 'Standardised Approach' to Credit Risk as specified by the CRD, 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 Society uses the 'Basic Indicator Approach' to evaluate the additional capital required to cover the Operational Risk associated with the Society's activities. The resulting capital requirements at 31 December 2010 are detailed below:

CRD category	Description	Asset value £m	Weighted exposure value £m	Capital required £m
Exposures to Central Governments	UK government Treasury bills and Gilts	6.1	-	-
Exposures to Multilateral Development Banks	Bonds issued by Supranational Banks	3.0	-	-
Exposures to Institutions	Liquid asset exposures to Credit Institutions	49.4	11.6	0.9
Retail exposures	Residential Mortgages - performing loans with loan-to-value of up to 80%	169.8	59.4	4.8
Real Estate exposures	Non-residential mortgage exposures and residential performing mortgages with loan-to-value of more than 80%	9.5	8.4	0.6
Past due items	Non-performing mortgages	1.0	1.0	0.1
Other items	Fixed and other assets	2.9	1.2	0.1
Total Credit Risk requirement		241.6	81.6	6.5
Operational Risk requirement				0.4
Total Pillar 1 Capital resources requirement				6.9

6 COUNTERPARTY CREDIT RISK

Treasury Assets

The Society's treasury assets are invested with a range of institutions in accordance with its Credit Risk Policy and Treasury Investment Policy. The assets at 31 December 2010 analysed for capital weighting purposes were as follows:

Rating	Maturity less than 3 months £m	3 months to 1 year £m	More than 1 year £m	Total £m
AAA to AA-	34.7	5.1	5.1	44.9
A+ to A-	1.5	0.6	0.5	2.6
BBB+ and below	2.0	-	-	2.0
Unrated Building Societies	5.0	4.0	-	9.0
Total	43.2	9.7	5.6	58.5

Analysis of mortgage assets

The Society lends nationally, but has a small concentration of mortgages in the Greater London area and in the Southwest region around its office in Dorset. The following analysis provides information on the geographic distribution of the Society's mortgage book by loan purpose, together with arrears information.

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Region	Residential			Non-Residential			Total all mortgages £m
	Performing	Past due	Total	Performing	Past due	Total	
	£m	£m	£m	£m	£m	£m	
Northern	6.6	0.1	6.7	-	-	-	6.7
Yorkshire	13.6	-	13.6	-	-	-	13.6
Northwest	16.9	-	16.9	-	-	-	16.9
East Midlands	8.4	0.4	8.8	-	-	-	8.8
West Midlands	15.2	-	15.2	-	-	-	15.2
East Anglia	8.9	0.1	9.0	-	-	-	9.0
Outer Southeast	18.8	-	18.8	-	-	-	18.8
Outer Metropolitan	21.7	0.2	21.9	-	-	-	21.9
Greater London	26.7	-	26.7	0.1	-	0.1	26.8
Southwest	27.8	0.2	28.0	4.9	-	4.9	32.9
Wales	7.3	-	7.3	-	-	-	7.3
Scotland	2.4	-	2.4	-	-	-	2.4
Total	174.3	1.0	175.3	5.0	-	5.0	180.3

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7 PROVISIONS

Provisions for losses are based upon an appraisal of loans, advances and other assets. Specific provisions are considered in respect of properties in possession and in respect of mortgage accounts one month or more in arrears.

The provision on each account represents the amount required to reduce the outstanding balance of the asset to its expected realisable value, by using industry recognised house price indices, and adjusting for costs of realisation, other recoveries and the probability of possession.

Portfolio provisions are made where it is considered that there is impairment in the value of assets at the year-end that is not already covered by specific provisions. Such provisions represent the Board's assessment of the potential losses which, although not yet specifically identified as relating to payment arrears, are known from experience to exist in the Society's loan portfolio.

The amount shown in the Society's income and expenditure account in its Annual Report and Accounts represents the actual losses incurred and the net change in provisions. Interest that is considered to be irrecoverable on advances secured on repossessed properties is excluded from income from the date of repossession.

These provisions are deducted from the appropriate asset values shown in the balance sheet. Details of both the balance sheet amounts and the provisions can be found in the Society's Annual Report and Accounts.