Pillar 3 Disclosures 31 December 2019

Approved by the Board: 25 February 2020

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1. Overview

1.1 Background

Basel III is a comprehensive set of reform measures in banking prudential regulation, developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector.

In 2013, the European Union adopted a legislative package, the Capital Requirements Directive IV (CRD IV) to strengthen the regulation of the banking sector and to implement the Basel III agreement in the EU legal framework. CRD IV is made up of the Capital Requirements Directive (2013/36/EU) (CRD) which must be implemented through national law and the Capital Requirements Regulation (575/2013) (CRR), which is directly applicable to firms across the EU.

Basel III, in the form of the new CRD IV came into force on 1 January 2014 and updates the three "pillars" of the Basel Framework which first came into force from 1 January 2008. Pillar 1 of the standards sets out the minimum capital requirements firms are required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1, assess the suitability of Pillar 1 capital requirements and demonstrate their ability to manage their capital position through a severe stressed scenario. Pillar 3 aims to improve market discipline by requiring firms to publish key details of their risks, capital and risk management.

Details of the impact the Basel III requirements have had on the Society and Group are shown in section 12.2, including in relation to transitional provisions.

1.2 Future Developments

The Basel Committee on Banking Supervision (BCBS)

The BCBS issued revised Pillar 3 disclosure requirements in January 2015 to promote more standardised, comparable and frequent Pillar 3 reporting. A further consultative document on Pillar 3 disclosure requirements considering a consolidated and enhanced framework was issued by the BCBS in March 2016. In 2017 the BCBS issued additional Pillar 3 disclosure requirements – "consolidated and enhanced framework": the second phase of the Committee's review of the Pillar 3 disclosure framework. At 31 December 2019 the requirements had not been adopted into European law.

The BCBS also issued Basel III framework revisions in December 2017 "Basel III: Finalising post-crisis reforms". The revisions aim to enhance the robustness and risk sensitivity of the standardised approaches for credit risk and operational risk (both applicable to the Group) and constrain the use of internally modelled approaches. Widely discussed under the banner of 'Basel IV' due to the significance of the changes, implementation is not expected until 2022.

The European Banking Authority (EBA)

The EBA launched a consultation on Guidelines relating to disclosure requirements in June 2016, clarifying an intention to implement the BCBS Pillar 3 recommendations though a 'comprehensive review' of the CRR. Globally and other systemically important institutions were recommended to implement a subset of the new disclosures in their 31 December 2016 reporting with focus towards expanded risk weighted asset disclosures.

The Group is neither globally nor systemically important and has adopted the CRR's standardised approach to credit risk, including the calculation of risk weighted assets, and consequently has not early-adopted of the BCBS templates.

The expected future trend remains towards disclosures that are more granular, more frequent and of significantly increased volume. The most significant revisions include an increased use of templates in required disclosures, accompanied by specific definitions. The Group continues to monitor the EBA's implementation progress and proposals.

CRD IV and CRR
Long-running reviews of standardised credit risk and operational risk are yet to be concluded with the European Commission also proposing changes to the existing CRD IV and CRR frameworks.

The Basel Committee on Banking Supervision's revisions are not expected to be concluded and applicable in advance of 2022 and the Group will monitor and engage with the process as these 'Basel IV' proposals are finalised.

International Financial Reporting Standard 9 – Financial Instruments (IFRS 9)

The CRR was amended in December 2017 to introduce transitional arrangements that reduce the capital impact of increased IFRS 9 provisions throughout a 5 year transitional period (2018-2022).

The Group has elected to adopt the provisions and includes reporting both the transitional and fully loaded IFRS 9 capital positions in this Pillar 3, as required by the CRR amendments. The Group's implementation of IFRS 9 has not given rise to any significant transitional adjustments due to the relative stability of provisions held against non-defaulted mortgage loans on transition. For further detail, see the Society's 2018 Annual Report and Accounts.

1.3 Policy

This document has been prepared in accordance with the requirements of Part Eight (Articles 431 to 455) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council.

The Group adopts the standardised approach to credit and operational risk.

These disclosures are on a standardised basis and, unless otherwise stated, all figures are as at 31 December 2019 and based on the most recently published Annual Report and Accounts.

This report will be prepared on an annual basis, or more frequently as applicable to any revised reporting frameworks (see 1.2 above). This report will be published on the Newcastle Building Society website (www.newcastle.co.uk), in line with publication of the Annual Report and Accounts.

These disclosures are not subject to external audit, although where they are equivalent to those prepared under accounting requirements for inclusion in the Group's audited Annual Report and Accounts, those disclosures in the Annual Report and Accounts have been subject to external audit. These disclosures do not constitute any form of financial statement and must not be relied upon in making any judgement on Newcastle Building Society or the Group (as defined in section 2).

These disclosures were reviewed and approved by the Group's Board on 25 February 2020.

2. Scope

The Pillar 3 reporting framework applies to Newcastle Building Society (the Society) and its subsidiary undertakings (the Group).

The Society's consolidation group for accounting purposes comprises the Society itself and the following subsidiaries:

- Newcastle Financial Advisers Limited
- Newcastle Strategic Solutions Limited
- Newcastle Systems Management Limited
- Newcastle Portland House Limited
- Newcastle Mortgage Loans (Jersey) Limited
- Fidelis Financial Solutions Limited

All of the above subsidiary undertakings are incorporated in England and Wales and operate in the United Kingdom, except for Newcastle Mortgage Loans (Jersey) Limited, which is incorporated in and operates in Jersey.

In 2019, two of the Groups subsidiaries, Newcastle Strategic Solutions Limited (our savings management outsourcing subsidiary) and Newcastle Systems Management Limited (our IT subsidiary) were merged. The combined subsidiary (Newcastle Strategic Solutions Limited) simplified our Group structure and will enable us to provide a more efficient approach for our clients and how we operate internally.

In November 2019, Newcastle Financial Advisers Limited acquired Fidelis Financial Solutions Limited, an independent financial advice business. After the acquisition, the trade of Fidelis Financial Solutions Limited was integrated into Newcastle Financial Advisers Limited.

For prudential and Pillar 3 reporting purposes, the Group presents its consolidated position. There are no current or foreseen legal impediments to the prompt transfer of capital resources or the repayment of liabilities within the Group.

Further details of Group consolidation policies and the Group structure are given in Notes 1 and 15 of the Group's audited Annual Report and Accounts.

3. Executive summary

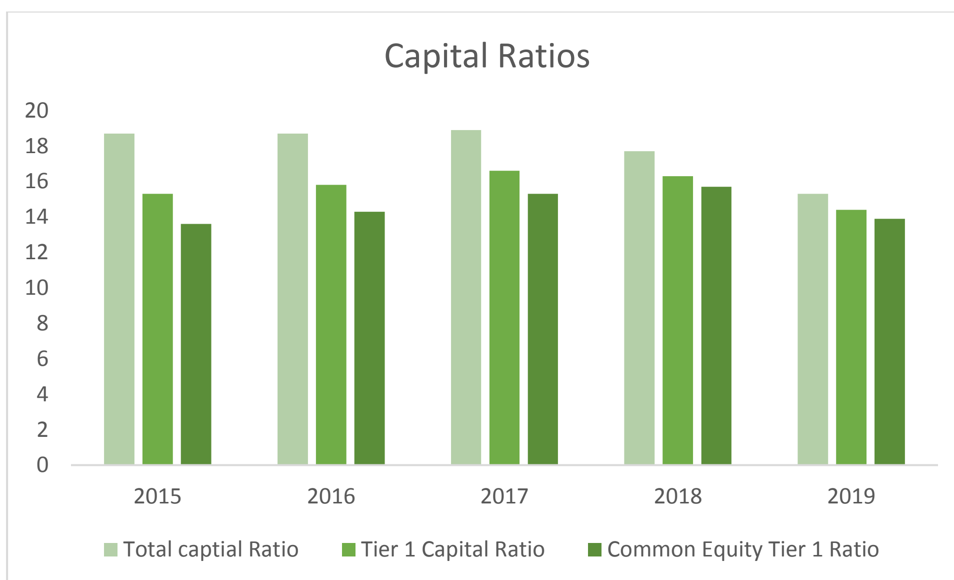
The Group's capital base continues to be strong, with a common equity tier 1 ratio of 13.9% as at 31 December 2019.

The Group's strategy remains to grow its prime residential mortgage business whilst winding down legacy portfolios. The success of this strategy is demonstrated by prime growth in 2019 notably exceeding legacy divestment. Thus, net prime residential lending of £575m let to overall net lending of £523m. As a consequence, the Group's risk weighted asset base grew to £1,447m, resulting in a reduction of the common equity tier 1 ratio from 15.7% in 2018 to 13.9% in 2019, despite strong profits of £11.4m. The reduction in the common equity tier 1 ratio was part of the group's business plan, as previously capital headroom had been above a level considered prudent.

With aspirations for continued balance sheet growth, the Group recognises the ongoing need for robust and effective risk management, mitigation and governance. The Group's risk management framework is designed to enable the Group to proactively identify and manage risks to support the achievement of the Group's objectives. It includes monitoring and controlling the significant risks to which the Group is exposed to ensure the security and resilience of the Group. The ability to identify, measure, monitor, report and control risks is key to delivering sustainable and resilient business performance, including fair outcomes for Members and customers.

On 23 December 2019, the Society's holding of £25.0m in subordinated debt matured. For regulatory purposes, the Tier 2 capital value of the debt had amortised to £nil on a straight line basis in the five years leading up to its contractual maturity.

The five year trend for the Group's capital ratios is shown in the table below and further details are included on page 24 of the Annual Report and Accounts and in section 5 of this document.



The Group complied with PRA Individual Capital Guidance plus planning buffers throughout 2019 and capital plans show the Group continuing to comply, with adequate headroom, over the 5 year planning horizon.

4. Risk Management

4.1 Background

The Board is ultimately responsible for ensuring that adequate systems of risk management are in place, and that the Group's strategy, risk appetite, and risk management are consistent. To assist the Board, the Group Risk Committee (GRC) oversees the management of risk across the Group and is supported by various sub-committees and the Prudential Risk department. The Group Risk department, which includes managers that cover Credit, Treasury, Operational, Conduct and IT Risk, is responsible for ensuring that appropriate risk management is applied. This includes the provision of reports on risks, and risk management for the GRC and its sub-committees. The Interim Chief Risk Officer provides formal updates on risk management to the Board, in relation to the Group, at least quarterly.

The Society and Group risk management framework operates under the 'three lines of defence' principle.

- The first line of defence consists of core business units, which ultimately hold the responsibility for identifying and managing risk while adhering to corporate risk appetite, policies and standards. The first line also hold responsibility for implementing and maintaining regulatory compliance.
- The second line risk function facilitates and monitors the implementation of effective risk management while developing and maintaining risk management policies and methodologies. The second line reports primarily to senior management and risk governance committees.
- The third line of defence consists of the Internal Audit team. The third line of defence provide independent assurance to the Board and senior management on the adequacy of the design and operational effectiveness of internal control systems and measures across the business.

The risk framework includes the use of Board approved risk appetite statements covering a variety of principal risks that the organisation faces. There is a demonstrated level of balance within the framework with evidence of stress testing, scenario analysis and recovery planning. Overall, there is a high degree of awareness and understanding of risk across the organisation. Senior management understand and champion the basis for risk measures with detailed understanding of strengths and limitations. The culture across the organisation supports the development of risk skills which is articulated from the top down and gives due focus to risk management.

The Group has detailed risk management policies for each principle risk area setting out how risk is managed across the Group, including specific risk appetite statements. The risk appetite statements outline for each principle risk area the basis on which risks are accepted or declined. This forms the basis for the various limits and key criteria, set out in policies, which must be followed in order to mitigate risk exposures. These limits are embedded into daily, weekly and monthly management and Board reporting in order to monitor compliance with the Group's risk profile.

Further details on risk appetite and risk management are given in the Risk Management Report in the Annual Report and Accounts.

4.2 Principal Types of Risk

Credit Risk

Credit risk is the risk that a borrower, treasury counterparty or debtor will not be able to meet their obligations as they fall due and the collateral is insufficient to meet the debt obligations. Credit risk arises primarily on retail and commercial loans, and on treasury assets held for liquidity purposes.

Credit Risk – Residential lending

Credit risk for residential lending is sensitive to unemployment rates, house prices, and interest rates. For example, if a borrowing customer loses their job they may be unable to meet their repayments. If the Society takes possession of the property, it may not realise enough on subsequent sale to repay the loan balance. In a recession when unemployment rises and house prices fall the risk is greater.

The Group has comprehensive policies in place covering credit risk management that set out criteria that must be followed before funds are advanced and also incorporate limits for concentration risk arising from, inter alia, large exposures, geographical areas and lending types. Return on Capital Employed benchmarks are set to ensure reward is commensurate with the risk taken, once the risk is considered acceptable.

Residential lending policies set out credit risk policies and prudent underwriting criteria for retail lending. Loans are underwritten individually based on affordability, credit score and credit history, acceptable collateral (including loan to value), and the Society's lending criteria. In the first instance, the Society makes use of a tailored application scorecard to facilitate the assessment of credit risk at the application stage. The Society does not undertake subprime or self-certification lending.

The lending policy is subject to review at least annually and the residential mortgage book is subject to ongoing reporting to the Credit Risk Committee in relation to its credit risk characteristics (including loan to value, loan to income, arrears, credit score profile, early delinquencies, and arrears arising from cohorts of lending).

The Prudential Risk department monitors and reports credit risk within the residential mortgage portfolios, including stress testing. This team also monitors the performance of the commercial and residential investment portfolios through annual reviews and key risk management information, including arrears trends, breach reports and monitoring schedules of the portfolio as a whole.

Credit Risk – Commercial lending

Credit risk for commercial lending is sensitive to economic conditions that can impact the viability of tenants and commercial real estate values. For example, if a commercial borrower loses a tenant, they may be unable to meet repayments. If the Society takes possession of the property it may not realise enough on subsequent sale to repay the loan balance. In a recession, when more tenants fail and commercial property values fall, the risk is greater. The commercial loan book is actively being managed down.

A commercial approach to collections and recovery for commercial and buy to let (BTL) portfolio borrowers is taken by the Society featuring a more proactive and targeted response where difficulties are identified such as late payments, tenant failure, ratings downgrades and general negative market news.

Credit Risk Committee (CRC)

CRC is responsible for the oversight of the retail and commercial credit risk framework. This committee acts under the authority of Group Risk Committee and has delegated authority to make decisions and recommendations in accordance with the agreed terms of reference. This committee also has the responsibility for the Group's non-retail mortgage portfolio.

For the avoidance of doubt, CRC is the result of bringing together the former Retail Credit Committee (covering retail mortgage portfolio) & Commercial Credit Committee (covering non-retail mortgage portfolio).

Credit risk – Treasury

The Group operates under a treasury policy which sets out the general principles of prudential management for its treasury operations. The policy incorporates the requirements of the Building Societies Act 1986, regulatory policy (including the Capital Requirements Regulation (CRR)) and international accounting standards. It also details the Group's risk appetite statement, operational limits and guidelines, and stress testing requirements.

Treasury counterparty risk is monitored by the Balance Sheet Management department in accordance with the Treasury Policy. All treasury counterparty ratings, credit default swap (CDS) spreads and market information are monitored and prompt action is taken where market conditions require a tightening of criteria.

Credit risk on liquid assets is controlled via the operation of approved counterparty, sector, instrument, and country limits for treasury assets. Counterparty limits are set with regard to external ratings agency assessments with the Group investing only in highly rated financial institutions or other building societies with strong capital ratios. The Group supplements ratings agency information with more extensive credit assessment procedures for counterparty limits including market information and movement on CDS spreads for countries and individual counterparties.

Where possible, derivative contracts are cleared via the London Clearing House (LCH), which acts as appointed central counterparty to treasury swaps originally undertaken with institutional counterparties. Derivatives that cannot be centrally cleared are held bilaterally with non-LCH counterparties. The Group has a Credit Support Annex in place for all derivative counterparties, which requires all exposures to be collateralised. See section 7.7 for detail of the collateral policy with respect to derivative exposures. Derivatives are only used by the Group in accordance with the Building Societies Act 1986. These instruments are not used for trading or speculative purposes and their sole purpose is to mitigate risks arising from movement in interest rates.

Liquidity Risk

Liquidity risk is the risk of loss or failure caused by the Group being unable to meet its liabilities or commitments as they fall due, or to be able to do so only at excessive cost. The nature of the business of a building society is to lend long term (contractually up to 40 years) and fund with short term savings accounts. This leads to a maturity mismatch between assets and liabilities.

The Group's liquidity policy is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding, enabling the Group to meet its financial obligations when they fall due. This is achieved by maintaining a prudent level of liquid assets and ensuring that funding and lending plans are in balance.

The Group has continued to maintain a significant level of high quality liquid assets throughout 2019, as detailed in the Strategic Report in the Annual Report and Accounts.

The Group has complied with the Liquidity Coverage Ratio (LCR) requirements and Individual Liquidity Guidance as set by the PRA throughout 2019. The LCR ratio shows high quality liquid assets as a percentage of net cash outflows over a 30 day stress period. For further information see section 7.7 of this document.

On a day to day basis liquidity risk is monitored within Treasury and the Balance Sheet Management department with oversight and challenge provided by the Prudential Risk department.

Assets and Liabilities Committee (ALCO).
The Group's liquidity risk is overseen by ALCO. ALCO reviews and approves the results of liquidity stress testing scenarios and cash-flow forecasts under base case and stressed scenarios. ALCO appraises long term funding plans and stress scenarios to ensure adequate liquid assets are in place to meet both regulatory and operational requirements following input by the Group Balance Sheet Management and Product Development departments. ALCO also approves the Treasury Policy and the Individual Liquidity Adequacy Assessment Process (ILAAP).

Conduct Risk

Conduct risk is the risk of customer detriment arising from the Group's activities, including: poor consumer outcomes, resulting from poorly designed or targeted products; mis-selling of products; inadequate controls relating to the prevention and detection of fraud or money laundering.

The Group has established a conduct risk framework including a Retail Conduct Risk Appetite statement supported by detailed policies relating to compliance, conduct risk, and financial crime.

Compliance with the Retail Conduct Risk Appetite statement is monitored by the Enterprise Risk Committee (ERC), with oversight from the Group Risk Committee. The Group has a product approval committee, Mortgages and Savings Committee (MASC) which approves all products. Included in the terms of reference for MASC is consideration of risks to consumer outcomes arising from products or services which also form part of the Product Risk Assessments for new product propositions.

The Group's Customer Outcomes department sits in the first line of defence in addition to the Conduct Risk department in the second line of defence. As a mutual, the Society takes its duty to treat customers fairly very seriously with a range of customer metrics that look at evidence supporting good customer outcomes (or suggesting poor outcomes) reported to the Board on a monthly basis. The Group maintains a 2nd line Compliance Plan, which is risk based, reporting to ERC with oversight from the GRC.

Operational Risk

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, people and systems, or from external events. For the Group this definition includes legal risk, strategic risk and reputational risk.

The Group has an established operational risk framework, set out in the operational risk policy and standards, detailing the measurement and management of risk, operational risk appetite, use of scenario testing for operational risk, tracking of risk events and operational losses, timescales for implementation of action plans and escalation procedures for more serious risk events that require immediate action to mitigate loss.

A key feature of the Group's operational risk framework is that key risks and controls are identified for all areas of the business ranging from the high level risks, discussed at Board level, down to the risks within individual departments. Risk assessments remain the responsibility of the relevant departmental managers and Executives, and are updated regularly for new risks, as a results of risk events and following internal audit reviews.

Risks are scored in terms of the impact and probability of the risk arising and are scored before and after considering the impact of controls. The operational risk system is also utilised by Internal Audit with the audit inspection plan based on high scoring risk areas and areas with significant reliance on key controls to mitigate the impact of otherwise significant risks. Group corporate insurance policies are also negotiated with full regard to the key risks within the Group.

ERC monitor operational risk with oversight by GRC on a quarterly basis.

Market Risk

Market risk is the risk of losses in on and off-balance sheet positions arising from adverse movements in market prices.

The principal market risk to which the Group is exposed is interest rate risk. Interest rate risk relating to the non-trading book is covered further in section 9. The Group has no exposure to foreign currency and only a very small direct exposure to equities through shareholdings in Standard Life arising from the de-mutualisation of the insurance company in 2006, as well as a small holding of units in Openwork LLP by Newcastle Financial Advisers Limited. At 31 December 2019 these holdings were held on the balance sheet at £0.4m, a value that fairly reflects their market price. The Group has an indirect exposure to the performance of equities through its defined benefit pension scheme.

The Group’s treasury policy sets out processes and controls in place to manage and monitor interest rate risk.

The Group's interest rate risk is managed by ALCO and the Balance Sheet Management department. ALCO monitors the use of interest rate derivatives used to manage interest rate risk, considers and agrees the Society’s interest rate view and monitors compliance with limits in the Treasury Policy.

Concentration Risk

Concentration risk is the risk arising from a single large exposure or a group of exposures where the potential for loss is connected. Concentration risk arises from operating in a particular geographical location, a particular industry sector or from large exposures in the form of large loans to single borrowers or treasury counterparties.

The Group has a comprehensive range of limits and controls in place which enable the Board and related sub-committees to measure and monitor concentration risk across the Group’s business and at a Group consolidated level. GRC has oversight of all relevant management information and is able to provide assurance and recommendations to the Board in relation to the management of any significant emerging risks.

The Society, whilst being a regional building society, has lending secured against residential property across the UK with no individual geographic concentrations in excess of a fifth of its residential mortgage book. For further detail see section 7.5 of this report. Commercial borrower activity is similarly monitored with any large exposure to individual borrowers considered as a source of potential concentration risk. GRC is satisfied that, as at 31 December 2019, no exposure in any one risk concentration exceeds the Group’s risk appetite

Pension Fund Obligation Risk

The Group has funding obligations for a defined benefit scheme which is closed to new entrants. It was closed to future benefit accrual with effect from 30 November 2010. Pension risk is the risk that the value of the Scheme’s assets, together with any agreed employer contributions, will be insufficient to cover the projected obligations of the Scheme over time. The return on assets, which includes equities and bonds, will vary with movements in equity prices and interest rates.

The projection of the Scheme's obligations includes estimates of mortality and inflation, the actual out-turn of which may differ from estimates. The Scheme is also exposed to changes in pension legislation. To mitigate these risks the Trustees of the Scheme, in consultation with the Society, review reports prepared by the Scheme's independent actuary on a quarterly basis and take appropriate actions including adjusting the investment strategy. The Group also performs stress testing on the pension scheme liabilities and assets as part of capital planning as set out in the Internal Capital Adequacy Assessment Process (ICAAP). The pension scheme assets are invested 64% in assets that "match" the liabilities and 36% in "growth" assets linked mainly to equities through a variety of funds including Diversified Growth Funds. 70% of interest rate risk to the value of scheme liabilities is offset by scheme assets where the value is sensitive to interest rates. Investments into the pension scheme are well diversified, such that the failure of any single investment would not have a material impact on the overall level of assets. However, the scheme is still exposed to significant market volatility, particularly in long term gilt rates and equities.

The Society accounts for its defined benefits pension scheme in line with International Accounting Standard 19. Key assumptions made in calculating the year end obligation include assumed future discount, RPI, CPI and mortality rates. For further detail see Note 19 of the 2019 Annual Report and Accounts.

Solutions Business Risk

The Group's business model includes diversification via the Solutions business, through the Group's subsidiary Newcastle Strategic Solutions Limited (NSSL). This increases the exposure to operational risk, particularly in relation to IT systems capability and human error.

The Society established the Solutions business in 1997, whereby the Group provides outsourced services, such as internet banking, IT services, and savings account administration to other financial institutions. There are various operational and strategic risks arising from the Solutions business including:

- Systems failures (mainframe, internet and telephony);
- Breach of information security/Data Protection Act;
- Failure of Group's employees to follow third party procedures/basic human error;
- Failure of a business partner; and
- Poor service – resulting in failure to meet Service Level Agreements.

The Group has systems and controls in place to address the risks in the Solutions business including dedicated teams in IT, Finance, Compliance, Financial Crime, technical departments and dedicated relationship and service managers.

NSSL's Board oversees third party contract risks, financial performance and operational matters that arise from NSSL. In 2019, the risk monitoring, reporting and mitigation for information technology across both the Solutions business and the wider Group was transferred to the Board of NSSL. The strategic direction of information technology is the responsibility of the Group's Chief Information Officer.

The growth and potential impact of cybercrime is a challenge facing many businesses, not just in the financial services sector. The Group takes this possible threat very seriously and has put in place appropriate measures to safeguard Members and the business clients of NSSL. However, given the nature of the threat, this is an area which remains under constant review, utilising both internal and external expertise to inform our strategy. In 2018 the Group's Solutions business received ISO 27001 Certification for its Information Security Management System, which has been maintained throughout 2019.

Deferred taxation

The Group's calculation of Common Equity Tier 1 Capital contains deductions for certain deferred taxation components. Under Basel III, the Group's deferred tax assets that rely on future profitability, excluding those arising from temporary differences, must be deducted from Common Equity Tier 1 Capital, reducing both Tier 1 and Total Capital Available. See section 12 for details of the impact of transition to the final Basel III position on the Group capital position.

Capital risk

Capital risk is the risk that the Group is or becomes inadequately capitalised to address the risks to which it is exposed. The ICAAP is updated on an annual basis reflecting a comprehensive internal assessment of the level of capital needed in respect of both risks faced under 'business as usual' and stressed scenarios. Point in time and forecast capital adequacy is also monitored on a monthly basis by ALCO and the Board. See section 6 for further detail.

'Brexit' risk

The UK voted to leave the European Union (EU) in June 2016, and subsequently left the EU on 31 January 2020, entering into a period of transition. This has abetted a period of uncertainty, which has been filled with market volatility, depreciation of the value of Sterling and ongoing uncertainty regarding the UK's short-term economic outlook. The Group will now monitor the negotiations between the UK and the EU, in respect of a future trade agreement, which is due to be agreed by December 2020.

The Group does not trade outside the UK, and does not rely on employees from the EU. As a UK deposit taker and UK mortgage lender, the Group does not expect to be significantly impacted by the consequences of the UK's decision to leave the EU and will continue to monitor its exposure to risks arising from 'Brexit' through its existing risk framework. Particular focus is expected towards the UK's regulatory environment through its current dependency on the EU regulations, including the ability of EU firms to passport permissions into the UK.

'Brexit' risk influences many of the principal risks highlighted above therefore the position continues to be kept under review within all lines of defence.

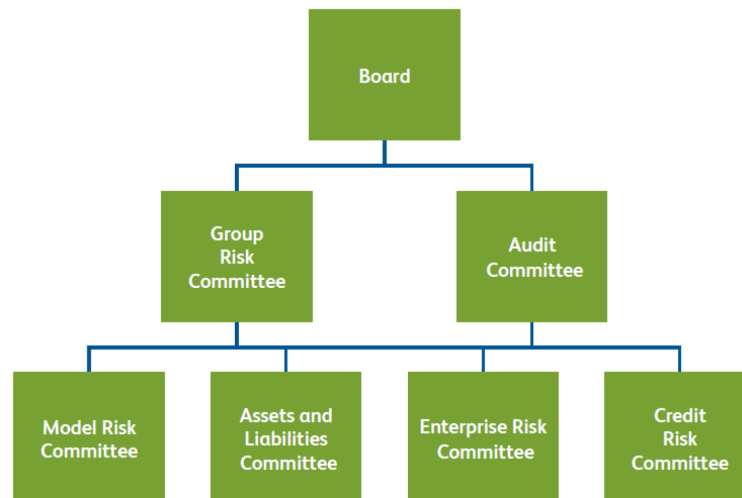
4.3 Risk Governance

The Board is ultimately responsible for ensuring that adequate systems of risk management are in place, and that the Group's strategy, risk appetite, and risk management are aligned. To assist the Board, a Group Risk Committee (GRC) oversees the management of risk across the Group (see below).

A second line of defence risk department, whose role is to ensure that appropriate risk management is applied across the organisation, supports the GRC. This includes the provision of reports on risks, and risk management for the GRC and its sub-committees.

The risk governance structure is set out below.

Risk Governance Structure



Group Risk Committee (GRC)

The GRC oversees the risk management and governance framework and overall risk profile. The Committee meets at least quarterly and more frequently when required.

The duties of GRC include:

- Oversight of overall risk appetite, risk management strategy and framework, including oversight of both prudential and conduct risk appetites;
- Oversight of compliance with risk policies;
- Oversight of the risk sub-committees (see below);
- Review and assessment of the adequacy of risk management information to monitor and control risks;
- Consideration and approval of the top risks for the Society and Group including low likelihood, high impact risks; and
- Approval of stress testing and scenario testing.

The GRC is supported by four sub-committees that meet on a monthly basis, as follows:

Credit Risk Committee (CRC)

CRC is responsible for the oversight of the retail and commercial credit risk framework. This committee acts under the authority of the GRC and has delegated authority to make decisions and recommendations in accordance with the agreed terms of reference. The CRC ensures the use of regular stress testing and scenario modelling that are reflective of the nature of the associated risk.

The duties of CRC include:

- Consideration, review and recommendations, at least annually, on the residential lending policy statement (including interest only policy) and arrears and possessions policy (Residential & Retail BTL);
- Monitoring of controls in relation to credit risk management and compliance with lending;
- guidelines set out in SS20/15 (the Building Societies' Sourcebook);

- Annual consideration of the appropriate lending approach (Traditional, Limited or Mitigated) in the light of the existing book, lending activities and the corporate plan;
- Review of risk metrics and management information for the retail mortgage portfolio;
- Review and approval of risks surrounding new types of mortgage products including assessing return on capital employed (ROCE) requirements;
- Oversight and approval of six monthly stress testing of the Residential and Retail BTL lending books and quarterly stress testing of the Equity Release lending books, to assess the potential losses under a range of stressed scenarios;
- Review of losses on possession sales to identify causal factors that should be considered for feeding back into lending policy;
- Annual review of the valuation process, including reviewing the use of valuers and assessing the effectiveness of the panel and key valuers utilised during the year;
- Annual recommendation of Mortgage Indemnity Guarantee (MIG) insurance cover proposals;
- Consideration of new projects impacting credit risk, including implementation of any major changes to the mortgage application or administration processes; and
- Annual review of the legal process, including use of solicitors and assessing the effectiveness of the panel and key solicitors utilised during the year.

The CRC met ten times during 2019.

Enterprise Risk Committee (ERC)
ERC oversees the risk framework for Operational, Conduct and IT Risk and Operational Resilience. This committee ensures that risk event trends are monitored appropriately with robust action plan management. The ERC also has the responsibility to ensure that key group-wide policies are appropriate for the business before they are submitted to the GRC for final ratification. All relevant operational risk management information is reported to the ERC on a monthly basis to assess compliance with overall limits and corporate risk appetites.

The duties of ERC include:

- At least annual review and approval of the Operational Risk Policy, Business Continuity Policy, Data Protection Policy, Records Management and Data Retention Policy, and Information Security Policy at least annually;
- Oversight of reports to ensure adherence to the Operational Risk Policy;
- Review of risk indicators in risk dashboards including risk event trends across the business, actions being taken on significant risk events and any external impacts; and
- Consideration and recommendation on the Group's Corporate Insurance Policies.

ERC met 10 times during 2019.

Assets and Liabilities Committee (ALCO)
ALCO is charged by the GRC with setting the risk framework for the Society's balance sheet, including liquidity risk, funding risk, interest rate risk and basis risk. The tools available to ALCO include risk limits and guidelines, return on capital employed benchmarks and funds transfer pricing for all aspects of treasury risk management including liquidity risk, interest rate risk, counterparty credit risk, and balance sheet management.

Key duties of ALCO include:

- Review of the Treasury Policy and compliance therewith alongside monitoring of activity and controls underpinning the Treasury Policy;
- Consideration of treasury dealing strategy and holdings against the risk appetite set for treasury risk management;

- Review of risk associated with changes to the Society's balance sheet, including structural changes and consideration of policy or other actions appropriate to that risk assessment;
- Consideration and agreement of the interest rate view, based on changes to the economic outlook and interest rate environment;
- Annual review of the authorised list of treasury investment counterparties;
- Oversight of funding risk, including the management of funding and liquidity risk across stressed funding scenarios and agreement of contingency funding plans;
- Review of the encumbrance levels;
- Consideration of the management of risks to the net interest margin arising from changes in the market value of liquid assets, derivatives and embedded derivatives under applicable accounting standards, including quarterly review of stressed interest rate scenarios;
- Consideration of scenarios modelled as part of liquidity stress testing and identification of additional scenarios based on best practice and regulatory pronouncements.
- Annual review of the ILAAP;
- Review of compliance with specific guidelines issued by the PRA or FCA; and
- Annual review of treasury and risk staff training.

ALCO met 10 times during 2019.

Model Risk Committee (MRC)

MRC is a newly established committee that the Society introduced to ensure compliance with SS3/18 'Model Risk Management'. The MRC acts under the authority of the GRC in an advisory capacity and makes non-binding recommendations concerning the Group's adherence to the Model Risk policy. Recommendations are made to the GRC on suitable macro-economic scenarios, model risk appetite, model performance (monitoring) and model limitations. Approval of the Group's macro-economic scenarios remain the responsibility of the Board.
Key duties of this committee include:

- To support GRC to provide oversight of modelling and stress testing protocols, techniques and assumptions;
- To ensure the use of stress testing and scenario modelling is undertaken on a regularly basis, and is reflective of the nature of the associated risk;
- To review model suitability/stress test performance; and
- To report to GRC any concerns regarding increased risk that may have an impact on the Group's overall risk management.

MRC met five times during 2019.

4.4 Other Governance

This section contains an overview of other relevant governance bodies within the Group. Further details of the corporate governance arrangements are given in the Directors Report on Corporate Governance in the 2019 Annual Report and Accounts.

The Board

The Board is responsible for agreeing the overall strategy for the Group including approval of the Strategic Plan, with the responsibility for implementing it being delegated to the Executive team. The Board is responsible for monitoring operational and financial performance in pursuit of the strategic plan.

The Board oversees and approves the Group's recovery options, recovery plan and playbook, and resolution pack on an annual basis.

The Board is responsible for risk management, for governance, and for ensuring adequate internal controls. The Board delegates oversight of risk management to the GRC, and oversight of internal controls to the Audit Committee. The Board retains the responsibility for approval of the Society's Internal Liquidity Adequacy Assessment Process and Internal Capital Adequacy Assessment Process.

The Board is responsible for approving the budgets and forecasts, the adequacy of capital and liquidity plans, the adequacy of the systems of internal control and major capital expenditure. In addition, the Board is responsible for final approval of the interim results and Annual Report and Accounts on a going concern basis.

The Board consider the Group's governance structure, control environment, risk mitigation activities and risk monitoring sufficient to meet the Group's ongoing profile and strategy.

In addition to the GRC and sub-committees detailed above, the Board has six other committees which are noted below.

Remuneration Committee

Remuneration Committee considers and makes recommendations on Executive Director and Executive emoluments and contracts of employment. The Committee considers proposals from the Chief Executive for changes to the level of fees for Non-Executive Directors including the fees for the Chairman. The Remuneration Committee Report is included in the 2019 Annual Report and Accounts. In addition, section 10 of this report sets out the remuneration disclosures as required under Article 450 of the CRR which have been approved by the Remuneration Committee.

Nominations Committee

Nominations Committee comprises solely of non-executive directors, is responsible for oversight of the composition of the Board and the Board and subsidiary Committees, and leads the process for Board appointments. The Committee advises on the structure, size, and composition of the Board which includes succession planning, nominations to the Board and the ongoing membership of the Board. The Committee also ensures that the Board has the appropriate balance of skills, diversity and experience and reviews the membership of each of the Board Committees, in consultation with the Chairs of the relevant Committees as appropriate, to make recommendations to the Board as to any changes required to ensure that the Committees possess the necessary capabilities, experience, knowledge and behaviours required to operate effectively.

The Committee also assists in the development and monitoring of induction, training and professional development of all members of both the Group's governing body and its senior management functions.

Newcastle Strategic Solutions Limited (NSSL) Board

NSSL Board oversees all aspects of the outsourcing savings management business including risks, financial performance and operational matters. In addition it sanctions new third party contracts, in line with its delegated authority, after considering the relevant financial model, contract obligations and full project risk assessment. The NSSL Board establishes and reviews a risk appetite statement for NSSL, evaluate and monitor NSSL risk and compliance matters and consider and acts upon the findings of any external or internal audits and reviews.

Newcastle Financial Advisers Limited (NFAL) Board

NFAL Board oversees the strategic direction of the Group's financial advice subsidiary, ensures compliance with all relevant legislation and acts on the findings of any external/ internal audits or reviews.

Audit Committee

Audit Committee considers all audit matters relating to the Group, the system of internal control, financial reporting and evaluation of first and second lines of defence for risk management.

Reports from the Interim Chief Risk Officer, the Head of Internal Audit Services and the external auditors provide input on key risks and uncertainties direct to the Audit Committee.

The main responsibilities of the Committee as delegated by the Board are:

- Financial reporting: monitoring of the integrity of the financial statements of the Group including the interim and annual reports, and any other formal announcements relating to the Group's financial performance. This includes review of significant financial reporting judgements and offering advice to the Board on whether the Annual Report and Accounts, taken as a whole, are fair, balanced and understandable, providing the information necessary for Members to assess the performance, strategy and business model of the Group;
- Effectiveness of internal control and risk management systems, including internal financial control: The Audit Committee works closely with the GRC to ensure that management and colleagues take appropriate responsibility for departmental, business unit and subsidiary risk mitigation and internal control. This includes review of the scope and effectiveness of the Group's internal controls and risk management systems, including those for ensuring compliance with the regulatory environment in which the Group operates. The Committee also reviews the Group's procedures for detecting fraud and irregularities ensuring arrangements are in place by which staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting control or other matters and to ensure independent investigation and appropriate follow up of such matters is undertaken;
- Internal audit: The Group's internal audit function is carried out by the Internal Audit Services department and reflects the Audit Committee's primary available resource. The Committee retains the authority to obtain outside legal or independent professional advice as it sees fit.
- The Committee approves and reviews the Internal Audit work programme and results and ensures the Internal Audit Services department maintains sufficient access to the Board, management and the books and records of the Society and its subsidiaries. This oversight allows the Audit Committee to monitor and assess the role and effectiveness of the Internal Audit function in the overall context of the Group's internal control framework, ensure appropriate management responsiveness to audit findings and recommendations given and promote open communication between the Group's Risk, Compliance, Finance, Internal Audit and External Audit functions.
- External audit: The Audit Committee oversees the Group's relationship with the external auditors, including appointment, re-appointment, removal and assessment of independence, objectivity, effectiveness and remuneration. The Group has established a policy on the use of the external auditors for non-audit work which is considered and approved annually by the Audit Committee. The principal purpose of this policy is to ensure the continued independence and objectivity of the external auditors.
- Whistle blowing: The Audit Committee reviews the Group's procedures for detecting fraud and whistle blowing and ensures that arrangements are in place by which colleagues may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or any other matters, and to ensure that arrangements are in place for independent investigation and appropriate follow up action. During 2019, in line with recommendations made by the Financial Reporting Council's UK Corporate Governance Code, responsibility for oversight of the Group's whistle blowing practices has transitioned to the Group Board.

4.5 Risk Appetite

The Board approved risk appetite statements consider profitability in a stressed scenario, capital, liquidity, operational risk, credit risk, interest rate risk, fair treatment of customers and conduct risk, and IT risk. They set out key limits and escalation triggers.

The risk appetite statements, together with the risk position, are reported to the Board quarterly and formally approved annually.

5. Capital Resources

The Group's total capital requirement/individual capital guidance is communicated annually by the Prudential Regulation Authority and consists of minimum regulatory capital requirements (Pillar 1) plus additional, entity specific capital requirements for credit, market, operational, counterparty, credit concentration, interest rate and pension obligations risk (Pillar 2A). The Group's total capital requirement at 31 December 2019 was £138.4m. For the avoidance of doubt, the Group's total capital requirement, as defined above, is exclusive of regulatory buffer requirements.

Note: Throughout the Pillar 3 disclosures, Group positions are presented. Differences between the Group and the Society capital positions arise through differences in available capital resource being:

- Accumulated net losses in the Society's subsidiary entities of £2.1m; and
- Society holdings of intangible assets at £1.7m lower than the Group's holding.

These combine to increase the Society's available capital by c. £3.8 vs. the Group's position.

Differences also arise through differences in risk weighted assets, being:

- Society holdings of mortgage assets at £0.9m lower (RWA) than the Group's holding;
- Society holdings of tangible assets at £25.9m lower (RWA) than the Group's holding;
- Society holding of subsidiary share capital at £12.4m (RWA) (nil at a Group level); and
- Society holding of subsidiary loan and other intercompany assets at £30.8m (RWA) (nil at Group level).

These combine to increase the Society's risk weighted assets by c. £14.7m vs. the Group's position.

Both the Society and Group have operated within the Individual Capital Guidance (ICG) issued by the PRA throughout 2019, including meeting capital buffer requirements.

5.1 Total Capital Available

An analysis of Total Capital Available (TCA) as at 31 December is set out in the following table:

	Basel III Transitional **Group £m 31-Dec-19**	End Point Basel III **Group £m 31-Dec-19**	Basel III Transitional **Group £m 31-Dec-18**	End Point Basel III **Group £m 31-Dec-18**
Tier 1 capital				
Profit and loss reserves	204.4	204.4	194.8	194.8
Deferred tax assets that rely on future profitability excluding those arising from temporary differences[1]	(0.6)	(0.6)	(1.4)	(1.4)
Defined benefit pensions fund assets[2]	(0.9)	(0.9)	-	-
VFOCI reserve[3]	1.4	1.4	0.5	0.5
Additional valuation adjustments[4]	(0.4)	(0.4)	(0.3)	(0.3)
Intangible assets	(2.2)	(2.2)	(1.7)	(1.7)
Other adjustments	(0.1)	(0.1)	(0.1)	(0.1)
Common Equity Tier 1 capital	**201.6**	**201.6**	**191.8**	**191.8**
Permanent Interest Bearing Shares (PIBS)	20.0	20.0	20.0	20.0
PIBS Grandfathering to T2 capital	(14.0)	(20.0)	(12.0)	(20.0)
AFS reserve	-	-	-	-
Total Additional Tier 1 capital	**6.0**	**-**	**8.0**	**-**
Total Tier 1 capital	**207.6**	**201.6**	**199.8**	**191.8**
Tier 2 capital				
Collective Impairment allowance	0.4	0.4	0.6	0.6
PIBS Grandfathering to T2 capital	14.0	20.0	12.0	20.0
Subordinated debt	-	-	4.6	-
Total Tier 2 capital	**14.4**	**20.4**	**17.2**	**20.6**
Total Capital	**222.0**	**222.0**	**217.0**	**212.4**

1. Deferred tax assets relating to temporary timing differences of £0.2m are held on balance sheet at 31 December 2019 and are not deducted from Common Equity Tier 1, in line with article 48 of the CRR.

2. The Group's accounting policy is to derecognise net defined benefit pensions fund assets from the Balance Sheet. The Group's IAS 19 surplus of £8.0m (c. £6.6m net of associated deferred taxation in line with article 41 of the CRR) is therefore not required to be deducted in the table above having previously been written off as an adjustment to the Group's Other Comprehensive Income. The additional balance deducted from capital relates to future payments into the pension scheme. During 2019, the Scheme funding level hit the trigger resulting in deficit reduction contributions being able to cease.

3. Net market values of the Society's Fair Value through Other Comprehensive Income (FVOCI) debt security portfolio are included in Common Equity Tier 1 capital as part of other reserves, net of any associated deferred taxation.

4. Additional valuation adjustments are calculated under the simplified approach as the Group's gross value of assets and liabilities held at fair value is less than €15bn.

The following table details the Group's capital flows through 2019. Figures are presented under a Basel III transitional basis.

Basel III Transitional	**£m**
Common Equity Tier 1 capital at 31 December 2018	**191.8**
Group profit after taxation for the financial year 2018	11.4
Other comprehensive (expense)/income:	
Derecognition of Pension surplus	(0.9)
Movement on FVOCI reserve	0.8
Income tax on movement on FVOCI reserve	0.1
Other movements:	
Decrease in loss based deferred tax asset	0.8
Increase in contributions to defined benefits pension scheme	(0.9)
increase in intangible assets	(0.5)
Increase in additional valuation adjustment	(0.1)
IFRS 16 day 1 transition adjustment	(0.9)
Common Equity Tier 1 capital at 31 December 2019	**201.6**
Additional Tier 1 capital at 31 December 2018	**8.0**
PIBS Grandfathering to T2 capital	(2.0)
Amortisation of PIBS issue costs	-
Additional Tier 1 capital at 31 December 2019	**6.0**
Tier 2 capital at 31 December 2018	**17.2**
Reduction in collective provision	(0.2)
Amortisation of capital value of Subordinated debt	(4.6)
Amortisation of subordinated debt issue costs	-
PIBS Grandfathering to T2 capital	2.0
Tier 2 capital at 31 December 2019	**14.4**
Total capital at 31 December 2019	**222.0**

The above table illustrates that the core driver of the Group's Common Equity Tier 1 (CET1) capital increase is the Group's profitability through 2019. Ongoing and improved profitability also drives a decrease of the Group's on balance sheet deferred tax assets that rely on future profitability to be utilised, decreasing correspondingly the deferred tax asset deduction to the Group's CET1.

The Group's accounting policy to derecognise defined benefit pension fund net assets saw the Group write off £0.9m of contributions made to the scheme via Other Comprehensive Income during 2019. These contributions would otherwise have increased the value of the pension scheme assets on Balance Sheet which would then have been deducted from Common Equity Tier 1 in line with article 36 of the CRR.

The Society holds a portfolio of derivatives to hedge against interest rate risk. With most of the Society's derivatives held in effective and formal fair value hedges throughout 2019, the Society's additional valuation adjustments are not significant, primarily reflecting un-hedged portions of the Society's debt securities held at fair value through other comprehensive income (FVOCI) on balance sheet.

Grandfathering of Tier 1 PIBS issued by the Society into Tier 2 capital continues in line with the CRR's transitional arrangements. £25m of Tier 2 subordinated debt issued by the Society has matured on 23 December 2019. For regulatory purposes, this had been amortised on a straight line basis for the 5 years leading to its contractual maturity.

The below table reconciles the Group balance sheet capital, reserves and subordinated liabilities to their regulatory capital values.

	31-Dec-19 £m
Balance sheet reserves	**205.8**
Loss based deferred tax asset (capital impact)	(0.6)
Expected payment to Defined benefit pensions fund assets	(0.9)
Intangible assets	(2.2)
Additional valuation adjustment	(0.4)
Other	(0.1)
Regulatory Common Equity Tier 1 capital	**201.6**
Balance sheet Subscribed capital	**20.0**
Grandfathering of PIBS under Basel III	(14.0)
Additional Tier 1 capital	**6.0**
Balance sheet subordinated liabilities	**0**
Collective impairment allowance	0.4
Grandfathering of PIBS under Basel III	14.0
Total Tier 2 capital	**14.4**
Total Regulatory capital	**222.0**

5.2 Common Equity Tier 1 Capital

Common Equity Tier 1 Capital primarily comprises profit and loss reserves being the accumulation of retained profits. Common Equity Tier 1 Capital is a key measure of focus under the capital regulations (see section 12). Under Basel III, deferred tax assets that rely on future profitability to be realised are to be excluded from Total Capital Available. The Group does not capitalise internally generated intangible assets but deducts from Common Equity Tier 1 capital externally purchased computer software meeting the IFRS definition of intangible assets. Additional Valuation Adjustments are also made in line with the CRR. For further detail of the transitional provisions of Basel III and their impact to the Group's capital position see section 12.

5.3 Additional Tier 1 Capital

Additional Tier 1 Capital consists of permanent interest bearing shares (PIBS). PIBS are unsecured deferred shares and rank behind the claims of all subordinated note holders, depositors, creditors and investing Members of Newcastle Building Society. Further details on PIBS are given in Note 27 of the Annual Report and Accounts. Under Basel III, the capital value of the Group's PIBS move from Tier 1 capital to Tier 2 capital over a transitional period. For detail of the Society's capital instruments' key features, see section 13 of this report.

5.4 Tier 2 Capital

Tier 2 capital comprises collective or 'general' impairment provisions held against the mortgage book and other balance sheet assets. It also includes PIBS that have been grandfathered from Tier 1 capital under Basel II to Tier 2 capital under Basel III. The Society's remaining £25m (book value) subordinated debt matured on 23 December 2019.

6. Capital Adequacy

The Group adopts the standardised approach to credit and operational risk for the purposes of calculating the Pillar 1 minimum capital requirements. Pillar 1 capital is reported to the Board each month and to the PRA on a quarterly basis.

6.1 Internal Capital Adequacy Assessment Process (ICAAP)

The Group assesses the overall capital requirement for current and future activities via the ICAAP. The ICAAP is updated on an annual basis, or more frequently where there is a significant change to the business strategy or a major change to the economic environment. The capital plan is updated in conjunction with the update to the Group's five year strategic plan so that strategy and capital are always in alignment and that the risks arising in pursuit of the strategy are always fully incorporated into capital requirements.

The ICAAP is presented to and approved by the Board on an annual basis. These disclosures include extracts from the ICAAP and are based on the final financial results of the Group contained in the 2019 Annual Report and Accounts.

The ICAAP covers all material risks to determine the capital requirement over the planning horizon and includes stressed scenarios to satisfy regulatory requirements. Where Pillar 1 capital is deemed insufficient to cover stressed losses, a supplementary Pillar 2 add-on is applied.

The Group ICAAP is subject to review by internal audit and external advisers (as part of the three year audit cycle as set out in the internal audit inspection plan) in order to confirm that the approach to the ICAAP is robust, compliant and up to date with the requirements of the PRA Handbook. The Group's ICAAP is subject to the Supervisory Review and Evaluation Process set by the PRA.

6.2 Minimum Capital Regulatory Requirement: Pillar I

The table below shows the Group's Pillar 1 Capital Resources Requirement (CRR) for each key risk area under the standardised approach (expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes) at 31 December:

	31-Dec-2019			31-Dec-2018		
	Group £m			Group £m		
Group Pillar 1	**On Balance sheet**	**Risk Weighted Assets[1]**	**Pillar 1 Capital @ 8%**	**On Balance sheet**	**Risk Weighted Assets**	**Pillar 1 Capital @ 8%**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**
Mortgage Loans Credit Risk	3,295.1	1,213.6	97.0	2,772.2	1,019.9	81.5
Liquidity Credit Risk	862.5	47.4	3.8	692.4	46.1	3.7
Other Assets	67.8	65.8	5.3	53.8	53.2	4.3
Hedging Instruments[2]	-	5.0	0.4	-	6.7	0.5
Mortgage commitments[3]	-	16.0	1.3	-	9.5	0.8
Total Credit Risk (standardised)	-	1,347.8	107.8	-	1,135.4	90.8
Operational Risk (standardised)	-	99.0	7.9	-	88.9	7.1
Total Pillar 1 CRR		**1,446.8**	**115.7**		**1,224.3**	**97.9**

1. Risk weighted assets are broadly derived from the following balance sheet categories:
- Mortgage loans credit risk: Loans and advances to customers.
- Liquidity credit risk: Cash and balances with the Bank of England, Loans and advances to banks, Debt securities and Assets pledged as collateral.
- Other assets: Property, plant and equipment, deferred tax assets and other assets.

2. Being Credit Valuation Adjustments of £1.9m and EADi adjustments of £3.1.

3. Mortgage commitments are not held on balance sheet. Hedging instrument credit risk is derived in line with the standardised method for own funds requirements for credit valuation adjustment risk - not balance sheet derived.

Risk weighted assets and capital are analysed at 31 December by exposure class in line with Article 112 of the CRR as follows:

Exposure Class	Capital @ 8%	
	31 Dec 2019 £m	31 Dec 2018 £m
Retail Exposures		
Residential Lending	92.0	76.8
Other Secured Lending	0.2	0.2
Past Due Items	1.2	0.8
Total Retail Exposures	**93.4**	**77.8**
Commercial Exposures		
Commercial Lending	3.6	3.8
Total Commercial Exposures	**3.6**	**3.8**
Liquidity and Collateral Exposures		
Deposits with central governments or central banks	-	-
Deposits with Qualifying Money Market Funds	0.2	0.1
Deposits with multilateral development banks	-	-
Financial Institutions	-	-
Covered Bonds	1.4	0.9
Residential Mortgage Backed Securities (RMBS)	1.8	2.2
Failed institution exposures (net of provisions)	-	-
Initial Margin posted to central counterparties	0.4	0.4
Total Liquidity and Collateral Exposures	**3.8**	**3.6**
Other		
Fixed and other assets	5.3	4.3
Off BS commitments	1.3	0.8
Off BS derivative	0.4	0.5
Total Other	**7.0**	**5.6**
Operational Risk		
Operational risk under standardised approach	7.9	7.1
Total Operational Risk	**7.9**	**7.1**
Total Pillar 1 Capital Requirement	**115.7**	**97.9**

There is no Pillar I requirement in respect of market risk as neither the Society nor the Group holds a trading book. Interest Rate Risk in the Banking Book is dealt with as a capital add-on at Pillar 2, based on the risk appetite set by the Board for a 200bp parallel shift in interest rates. Due to the sustained low 2019 interest rate environment, the rate shocks for interest rate reductions communicated to ALCO have also included smaller shocks at -10bp and -20bp during 2019 with the Committee also stressing the impact of longer term interest rate changes on collateral balances.

At 31 December 2019 the Group held excess capital over and above the Pillar 1 minimum regulatory requirement of £106.3m (2018: £119.1m).

The reduction is due to a 'larger' balance sheet resulting from higher lending in the year. This is primarily lower risk prime lending.

6.3 Capital buffers

The PRA's implementation of the CRD's provisions on capital buffers came into force on 1 January 2016. The Group is now required to hold sufficient Common Equity Tier 1 capital to meet its Capital Conservation, Countercyclical and PRA Buffer requirements.

The Capital Conservation Buffer is a buffer for all banks that is to be held to absorb losses without breaching minimum capital requirements. The buffer is designed to ensure that a degree of excess capital is built up and retained, rather than used to support additional growth or further activities, during periods of non-stress which can be drawn down on if losses are incurred in the future. The Capital Conservation Buffer was phased-in in equal increments of 0.625% until its final level of 2.5% in 2019 from a starting point in 2016 of 0.625%.

The Countercyclical Buffer is a buffer that can be varied over time. The primary objective of the Countercyclical Buffer is to ensure that the banking system is able to withstand stress without restricting essential services, such as the supply of credit, to the real economy. The Group has no material relevant exposures outside of the UK and consequently is subject to the UK's published Countercyclical Buffer: currently set at 1.0%.The Bank of England announced that the Countercyclical Buffer will increase in December 2020 from 1% to 2%.

The Capital Conservation and Countercyclical Buffers combine to form the CRD IV Buffer. The Society is not a globally systemically important institution and therefore holds no systemic buffers.

The Group also holds a specific PRA supervisory buffer, which is reduced by the CRD IV Buffer, where applicable, to ensure capital requirements to cover the same risks are not duplicated.

At least 56% of the ICG has to be met by post-buffer Common Equity Tier 1 and the Group has complied with this requirement throughout 2019. The Group does not 'double count' Common Equity Tier 1: i.e. Common Equity Tier 1 assigned against buffer requirements is not also assigned against ICG.

7. Credit Risk Measurement, Mitigation and Reporting

For the purposes of Pillar 3 disclosures, credit risk is sub-divided into residential mortgages, other secured lending, commercial lending, and treasury credit risks. Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent across most of the Group's activities. Adverse changes in the credit quality of borrowers or a general deterioration in the UK's economic conditions could affect the recoverability and value of the Group's assets and therefore its financial performance. Comprehensive risk management policies and processes have been established as part of the Group's overall governance framework to measure, mitigate and manage credit risk within the Group's risk appetite.

7.1 Exposures

The gross credit risk exposures (based on the definitions for regulatory capital purposes, before credit risk mitigation) and the averages for the year are summarised below:

	Average to Dec-19 £m	As at Dec-19 £m	As at Dec-18 £m
Mortgage Assets			
Residential Mortgages	2.575.3	2,852.7	2,297.8
Housing Associations	410.7	396.6	424.7
Other secured lending	3.0	2.6	3.3
Commercial Real Estate Loans	34.4	30.0	38.8
Serviced Apartments	18.9	18.2	19.6
Total Mortgage Assets	**3,042.3**	**3,300.1**	**2,784.2**
Treasury			
Deposits with central governments or central banks	266.4	309.1	223.7
Cash collateral pledged to derivative counterparties	210.1	219.7	200.4
Deposits with multilateral development banks	2.5	5.0	-
Deposits with Qualifying Money Market Funds	9.2	9.8	8.5
Covered bonds	143.6	169.8	117.4
RMBS	142.5	146.6	138.5
Other	0.4	-	0.7
Failed institution exposures (written down value)	0.1	-	0.1
Cash in hand and equivalent cash items	2.8	2.5	3.1
Total Treasury	**777.6**	**862.5**	**692.4**
Total	**3,819.9**	**4,162.6**	**3,476.6**

7.2 Retail Credit Risk

The Group has comprehensive policies in place covering all aspects of credit risk management that set out strict criteria that must be followed before funds are advanced. Prospective customer eligibility for loans is controlled by underwriting, using core credit score and affordability criteria. The Group risk appetite is supported by limits for concentration risk arising from, inter alia, larger loans, Buy to Let, higher LTV and geographical exposures.

These various limits combined with formal governance and policies reflect the Group's view and appetite for risk in the retail mortgage portfolio.

All limits and policies are reviewed annually by the Board and the GRC and, in between reviews, the profile and profitability of mortgage completions and mortgage pipeline is reviewed in the context of the underlying credit risk profile. An investigation is carried out in the event a loan goes into arrears within the first 12 months of completion to identify causal factors and inform policy generally.

The key areas covered in lending policy are:

- Limits on loan to value based on types of lending;
- Limits on higher loan to value lending;
- Approved broker requirements;
- Valuation requirements including use of approved valuers;
- Use of approved solicitor panels;
- Clear mandates with a more senior level of approval required for higher risk loans;
- Use of a detailed affordability model;
- Loan to income limits by number of loans (also tracked by value);
- Credit scoring to identify borrowers deemed a higher credit risk with automatic rejection or referral where appropriate;
- Strict underwriting criteria on borrower credit performance;
- Reporting of geographical concentration against guidelines;
- Maximum loan sizes and large loan limit;
- Strict valuation criteria driven by level of risk inherent within the loan to value;
- The requirement for income validation in all cases;
- Fraud and money laundering procedures including the use of fraud intelligence systems;
- Mortgage indemnity insurance for higher loan to value lending to mitigate loss (> 80% LTV); and
- Return on capital employed benchmark requirements.

In addition, all mortgage products are strictly controlled through the Group's Mortgages and Savings Committee (MASC) approval, in line with ALCO agreed funds transfer pricing, and subject to minimum Return on Capital Employed & risk appetite.

The Group does not offer and has never offered sub-prime or self-certified mortgages.

Credit risk under Pillar 1 is calculated using the standardised methodology in line the CRR and CRD regulations. Non-defaulted retail mortgage assets up to 80% LTV attract a 35% risk weighting, whilst the proportion above 80% LTV attracts a 75% risk weighting. Mortgages in default attract a risk weighting of 100% if no provisions are held and LTV is less than or equal to 80%, and 150% where the LTV is greater than 80% and no provisions are held. While the Society has Mortgage Indemnity Guarantee insurance in place for lending greater than 80% LTV, this is not included as mitigation within capital calculations.

7.3 Loans to Housing Associations

The Society has a large portfolio of loans to Housing Associations, which is reducing over time. The Society has not undertaken any new lending of this type with balances falling by £28m in 2019 to £397m, due to redemptions. There has been no loss experience on the portfolio since this area of business commenced and no Housing Association loans have expired or impaired.

7.4 Commercial Credit Risk

Commercial lending is split between lending to low risk Housing Associations detailed above and Commerical and Residential investment lending.

The Group has not undertaken new commercial lending since 2008 but the Commercial Lending and Credit Risk departments continue to monitor the performance of the legacy loan books on a regular basis.

Generally the Society expects all loans to be repaid on maturity given the strategy of winding down the portfolio but will grant forbearance in exceptional circumstances when this is also in the Society's best interests. If granted, forbearance to commercial borrowers can take the form of extending the loan term on maturity, capitalising arrears as part of a wider exercise to get a borrower back on track with a revised debt repayment plan, and adjusting the interest rate to aid serviceability particularly where a fixed rate has expired.

7.5 Geographical Distribution

The geographical distribution of all mortgage assets at 31 December 2019 is as follows:

			31-Dec-19			
	Residential Mortgages	Housing Associations	Other Secured Lending	Commercial Real Estate	Serviced Apartments	Total Balances
	Group £m	Group £m	Group £m	Group £m	Group £m	Group £m
UK	2,838.0	396.6	2.6	30.0	18.2	**3,285.4**
Jersey	2.3	-	-	-	-	**2.3**
Gibraltar	12.4	-	-	-	-	**12.4**
	2,852.7	**396.6**	**2.6**	**30.0**	**18.2**	**3,300.1**

The Group's Jersey and Gibraltar books are not material in size and considered to be of high credit quality. The Group's geographic concentration across its residential lending and BTL lending is detailed below.

Geographical Book	31-Dec-19 Exposure
North East	16.1%
Cumbria	0.9%
East Anglia	2.0%
East Midlands	6.9%
Gibraltar	0.7%
Greater London	12.9%
Jersey	0.1%
North West	9.6%
Northern Ireland	0.1%
Scotland	8.8%
South East	17.0%
South West	6.7%
Wales	2.7%
West Midlands	6.8%
Yorkshire	8.6%

7.6 Residual Maturity of Exposures by Asset Class

The following table shows residual maturity of exposures on a contractual basis as opposed to an expected basis. Where a loan is repayable by instalment, each instalment has been treated as a separate repayment in the maturity analysis set out below. The Group's experience is that in many cases mortgages are redeemed before their scheduled maturity date. As a consequence, the maturity analysis illustrated below may not reflect actual experience. From liquidity and matching risk perspectives, the Society's Balance Sheet Management department monitors and reports on expected, rather than contractual maturities to ALCO.

Residual maturity of mortgage assets at 31 December 2019:

	31-Dec-19				
	On demand Group £m	**3<12 months Group £m**	**1-5 years Group £m**	**> 5 years Group £m**	**Total Group £m**
Mortgage Assets	4.3	81.5	320.0	2,894.3	**3,300.1**

7.7 Treasury Credit Risk

The Group has exposures to banks, building societies, other financial institutions, sovereigns and asset backed securities in its banking book treasury portfolio. Assets held in the treasury portfolio are held for liquidity purposes or in the case of derivatives, for hedging purposes. The Group's policy is to maintain a level of high quality liquid assets in excess of regulatory requirements.

The Board's policy on managing credit risk relating to treasury exposures is set out in detail within the treasury policy. Credit limits are set for individual counterparties using external credit ratings which feed into the the assessment of the credit risk. Institutions, including building societies which do not have external ratings, are individually assessed based mainly on the strength of their capital ratios. Counterparties are approved by ALCO and GRC. Market information and Credit Default Swap spreads are also used to inform treasury dealing decisions and keep up to date on treasury counterparty credit risk. Limits are also in place for instrument types and countries to mitigate against concentration risk arising in the treasury portfolio.

Where a counterparty is downgraded to a level below the acceptable rating then the counterparty and related limit is removed from the treasury dealing approved counterparty list. Where there are existing investments, the Treasurer will recommend to the Chief Executive (and in their absence to the Chief Financial Officer) whether they should be sold, if possible, or allowed to run to maturity with ALCO and GRC to be notified of the decision.

The Group has in place a Common Equity Tier 1 based treasury credit risk limit, which formalises the maximum capital requirements that the Group would accept from exposures to treasury counterparties.

All limits are monitored against the sum of on and off-balance sheet exposures. The risk of a default from a derivative counterparty is minimised as all derivative exposures are covered by a Credit Support Annex (CSA) whereby, in the event of a positive mark-to-market valuation, the counterparty must post cash collateral to the Group. The Group similarly places cash collateral with its derivative counterparties in the event of a negative mark-to-market valuation. The Society does not hold an external credit rating and cash collateralisation of the Group's exposures to and with counterparties mean there would be no impact to the cash collateral postings required at 31 December 2019 in the event of a perceived decrease in the Society's credit worthiness. Continued use of the LCH to facilitate the Group's derivative transactions through 2019 has continued to mitigate the credit risk associated with these exposures.

Note 31 of the 2019 Annual Report and Accounts gives further details on fair value measurement and valuation of derivatives.

The table below includes the Group derivative exposure to counterparties at 31 December 2019. The gross fair value presented in the balance sheet reflects the fair market value of the Group's interest rate swap assets and are in line with the cost to replace the relevant contracts. The Group has ISDA agreements in place with all counterparties, which allow it to net swap assets and liabilities at a counterparty level, and Credit Support Annexes which provide for the receipt of collateral to mitigate any remaining exposure.

	Gross positive fair value or net carrying amount	Netting benefits	Netted current credit exposure	Collateral held	Net credit exposure
	£m	£m	£m	£m	£m
Derivatives	0.1	0.1	0.0	0.0	0.0

The potential future credit exposure of the Group's derivative assets at 31 December 2019 is £1.4m, derived by applying a multiple based on the underlying contracts' residual maturities to the notional value of the contract.

The Group uses external credit assessments provided by Standards & Poor's, Fitch, and Moody's. These are recognised by the PRA as eligible external credit assessment institutions (ECAI's) for the purpose of calculating credit risk requirements under the standardised approach. For all credit exposures that are assessed, the risk weight is dependent on the level of the assessment (i.e. the credit rating). An 8% capital requirement is then applied as per the standardised approach.

The Group's Treasury Risk department monitors forthcoming regulatory standards closely. The Group monitors actual and forecast anticipated liquidity holdings over the planning horizon with cash-flow forecasts considered each month by ALCO. The CRD's liquidity coverage requirements, are monitored routinely by the Balance Sheet Management department.

Liquidity Coverage Ratio and Net Stable Funding Ratio

The Group holds sufficient liquid assets, including high quality liquid assets required to cover Pillar 2 risks, throughout its forecast horizon to remain compliant with the Basel Committee on Banking Supervision's (BCBS) Liquidity Coverage Ratio. At 31 December 2019 the Group held a Liquidity Coverage Ratio of 179%.This is in excess of the current minimum requirement of 100% set by regulators. The ratio is calculated with reference to a liquidity buffer of £536.7m and net liquidity outflows of £299.1m.

The BCBS Net Stable Funding Ratio is defined as the amount of available stable funding relative to the amount of required stable funding. The Group's Net Stable Funding Ratio at 31 December 2019 was 136%, well in excess of the expected minimum holding of 100%

The table below shows the Group's credit risk exposures to Treasury counterparties at 31 December 2019.

Risk Weighting	S&P rating and Fitch IBCA	Moody's Rating	31-Dec-19 Group £m	31-Dec-18 Group £m
Central banks and Central Governments				
0%	AAA-AA-	Aaa to Aa3	309.1	223.7
Cash collateral pledged to derivative counterparties				
0%	-	-	219.7	200.4
Multilateral Development Banks				
0%	AAA-AA-	Aaa	5.0	-
Financial Institutions				
20%	AAA-AA-	Aaa to Aa3	9.8	8.5
Asset Backed Securities				
20% or 10%	AAA-AA-	Aaa to Aa3	146.6	138.5
Covered Bonds				
10%	AAA-AA-	Aaa to Aa3	169.8	117.4
Central banks: Failed institutions				
Failed institutions 150%			0.0	0.1
Cash in hand and equivalent cash items				
0%			2.5	3.8
Total			**862.5**	**692.4**

The Group calculates an 8% capital requirement based on the risk weighted assets for the above treasury assets. There is no material difference between the Group's exposures stated above and the Group's exposures prior to credit mitigation.

At 31 December 2019 the Society had no direct treasury exposures to counterparties based in the Eurozone. Exposures to multi-national institutions resulting from cash collateral pledged to derivative counterparties contractually arise via the UK arm of those entities with exposures contractually denominated in Sterling.

Treasury Exposures	31-Dec-2019 Group £m	31-Dec-2018 Group £m
UK	845.3	681.3
Europe (excluding UK)[1]	9.8	8.7
North America	2.4	2.4
Multilateral Development Banks	5.0	-
	862.5	**692.4**

1. Includes £9.8m in Irish & Luxembourg exposures with respect to the Society's subsidiaries' investments in qualifying money market funds. All other non-UK treasury exposures reflect collateral pledged to derivative counterparties, as noted above.

The residual maturity of these treasury exposures at 31 December 2019 is as follows:

Treasury assets	31-Dec-19			
	< 12 months Group £m	1-5 years Group £m	5-10 years Group £m	Total Group £m
Central banks and Central Government[1]	255.4	-	53.7	**309.1**
Cash collateral pledged to derivative counterparties	219.7	-	-	**219.7**
Qualifying Money Market Funds	9.8	-	-	**9.8**
Multilateral Development Banks	-	5	-	**5.0**
Residential Mortgage Backed Securities	14.4	132.2	-	**146.6**
Covered Bonds	43.7	126.1	-	**169.8**
Cash in hand and equivalent cash items	2.5	-	-	**2.5**
Total	**545.5**	**263.3**	**53.7**	**862.5**

1. Includes UK Government Gilts at a fair value of £53.8m and Treasury Bills at a fair value of £43m.

7.8 Impairment Provisions

The Group's policy with respect to accounting for impairment of financial assets is given in Note 1 of the 2019 Annual Report and Accounts. Practical application of this policy is achieved as follows:

Under IFRS 9, the Group conducts a forward looking assessment of impairment. Expected credit losses are recognised across applicable financial assets based on whether there has been a significant increase in credit risk since the asset's origination.

Movement in credit risk is determined on the basis of the change in the risk of default, not the change in the amount of any expected credit loss.

Assets are assessed on an individual basis with a forward looking assessment undertaken to support the recognition 'now' of future potential losses. While losses are provided for, assets are only formally written off when the Group no longer holds any expectation of subsequent receipt, typically at the conclusion of a negotiation or sale.

Implementation and ongoing administration of high quality IFRS 9 impairment models requires significant management experience and judgement, both in assessing historic performance trends and factors and in projecting these into uncertain future economic environments. External professional modelling assistance has been combined with the Group's extensive internal expertise to facilitate a robust and compliant implementation. Best practice guidance issued by professional audit and accountancy firms, IFRS implementation guidance, and banking centric governance and modelling guidance from European and domestic authorities form the foundation of the Group's IFRS 9 impairment response.

For further detail of the Group's application of IFRS 9, see note 31 of the Annual Report and Accounts.

7.9 Past Due and Impaired Loans

Past due is defined as loans where the borrowers' contracted payments have not been received by the due date. The amounts shown as past due represent the full amount of the loan outstanding, and not just the amount that is past due.

An analysis of loan portfolios, by past due and impaired status, is given below:

Prime residential mortgage book
The prime residential mortgage book consists of traditional residential loans to homeowners. No sub-prime or self-certification lending has never been undertaken.

	31 January 2019 £m	31 January 2019 %
Neither past due nor impaired	2,491.7	99.2
Past due up to 3 months but not impaired	13.0	0.5
Impaired and past due 3 to 6-months	4.8	0.2
Impaired and past due over 6-months	2.3	0.1
In possession	0.8	0.0
	2,512.6	**100**

Retail BTL mortgage book

The Retail BTL mortgage book consists of buy-to-let individuals with balances < £1m (including legacy business).

	31 January 2019 £m	31 January 2019 %
Neither past due nor impaired	293.5	99.4
Past due up to 3 months but not impaired	1.3	0.4
Impaired and past due over 6-months	0.4	0.1
In possession	0.2	0.1
	295.4	**100**

Specialist residential book

The Specialist residential mortgage book consists of portfolio investor buy-to-let (including loans > £1m) and residential investment loans.

	31 January 2019 £m	31 January 2019 %
Neither past due nor impaired	29.0	77.9
Impaired and past due 3 to 6-months	5.0	13.4
LPA receivership	3.2	8.7
	37.2	**100**

Commercial lending book

The commercial lending book comprises loans secured on commercial property and loans to Housing Associations. Loans secured on serviced apartments totalling £18.2m have been excluded from the table below as none are were past due or impaired as at 31 December 2019. Loans to Housing Associations totalling £396.6m have been excluded from the table below as no loans to Housing Associations were past due or impaired at 31 December 2019.

	31 January 2019 £m	31 January 2019 %
Neither past due nor impaired	26.2	87.2
Not past due but impaired	3.8	12.8
	30.0	**100.0**

Allowance for losses on loans and advances to customers under IFRS 9

Reconciliation table	Loss allowance at 1 January 2019 £000	Increases due to origination and acquisition £000	Decreases due to derecognition £000	Changes due to change in credit risk (net) £000	Transition between stages £000	Loss allowance at 31 December 2019 £000
Prime residential						
Stage 1	47.2	50.4	(5.7)	147.2	(136.2)	102.9
Stage 2	186.8	203.0	(13.0)	84.9	(25.7)	436.0
Stage 3	935.4	73.5	(10.6)	(84.6)	161.9	1,075.6
Total	**1,169.4**	**326.9**	**(29.3)**	**147.5**	**0.0**	**1,614.5**
Buy to Let						
Stage 1	1.2	3.8	(0.1)	8.9	(6.8)	7.0
Stage 2	4.1	10.4	0.0	2.9	6.8	24.2
Stage 3	0.0	8.6	0.0	0.0	0.0	8.6
Total	**5.3**	**22.8**	**(0.1)**	**11.8**	**0.0**	**39.8**
Commercial						
Stage 1	1,325.0	0.0	0.0	(1,100.0)	0.0	215.0
Stage 2	0.0	0.0	0.0	0.0	0.0	0.0
Stage 3	8,105.0	0.0	(7,100.0)	516.2	0.0	1,521.2
Total	**9,430.0**	**0.0**	**(7,100.0)**	**(583.8)**	**0.0**	**1,736.2**
Housing Association						
Stage 1	0.0	0.0	0.0	0.0	0.0	0.0
Stage 2	0.0	0.0	0.0	0.0	0.0	0.0
Stage 3	0.0	0.0	0.0	0.0	0.0	0.0
Total	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Serviced Apartments						
Stage 1	0.0	0.0	0.0	0.0	0.0	0.0
Stage 2	0.0	0.0	0.0	0.0	0.0	0.0
Stage 3	0.0	0.0	0.0	0.0	0.0	0.0
Total	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Policy Loans						
Stage 1	0.0	0.0	0.0	0.0	0.0	0.0
Stage 2	0.1	0.0	(0.1)	0.0	0.0	0.0
Stage 3	320.4	0.0	(320.4)	0.0	0.0	0.0
Total	**320.5**	**0.0**	**(320.5)**	**0.0**	**0.0**	**0.0**
Total						
Stage 1	**1,373.4**	**54.2**	**(5.8)**	**(353.9)**	**(143.0)**	**924.9**
Stage 2	**191.0**	**213.4**	**(13.1)**	**87.8**	**(18.9)**	**460.2**
Stage 3	**9,360.8**	**82.1**	**(7,431.0)**	**(168.4)**	**161.9**	**2,005.4**
Total	**10,925.2**	**349.7**	**(7,449.9)**	**(434.5)**	**0.0**	**3,390.5**

Against equity release mortgages not accounted for under IFRS 9 the Society holds provisions of £1.5m. For further information see Note 14 to the 2019 Annual Report and Accounts.

7.10 Credit Risk Mitigation

The Group's core credit risk mitigation is to perform a full assessment of the borrower's ability to service the mortgage and obtaining adequate security for the loan advanced.

Residential Mortgages

Residential property is the Group's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolio. All mortgage lending activities are supported by an appropriate form of valuation from the Society's approved panel of valuers. All residential property must be insured to cover property risks and this may be done via a third party. Additional protection is also afforded to borrowers through optional income protection insurance. Mortgage indemnity insurance is in place for all new lending higher than 80% LTV, and for loans that fall outside of the standard lending policy.

8. Operational Risk

Operational risk is defined on page 10.

The Operational Risk Capital Requirement (ORCR) for Pillar I capital is determined under the standardised approach as defined by the CRR. The ORCR is calculated by taking the Group's three year average net interest and other income, split across discrete business lines, and applying percentages representing the regulators' assumed risk inherent in these business lines.

8.1 Capital Requirement

At 31 December 2019, the Group's ORCR equated to 12.1% of net income (12.1% in 2018). The Group's reducing commercial net interest income, a direct result of reducing commercial balances in line with the Group's strategic plan, attract a higher operational risk weighting (15% weighting) than the Group's growing 'retail' (residential) net interest income (12% weighting). The Group's income has been split into 3 separate material business lines (retail, commercial and asset management) and the operational risk percentages as set out in Article 317 of the CRR are applied to calculate the base ORCR.

The ORCR provides the base for assessing the capital required for operational risk. A full assessment of the risks facing the Society and Group has been completed for the purposes of Pillar 2 and add-ons identified where it is felt that the Pillar 1 capital requirement is insufficient. The Group seeks to mitigate operational risk by implementing a strong control environment and ensuring adequate insurance cover is in place across all known high risk areas. For further detail see section 4 of this document, 'Risk Management'.

9. Market Risk

9.1 Market Risk Overview

The principal market risk to which the Group is exposed is interest rate risk.

9.2 Interest Rate Risk in the Non-trading Book

Interest Rate Risk arises on mortgages, savings and treasury instruments due to timing differences on re-pricing of assets and liabilities and the imperfect matching on interest rates between different asset and liability types. This risk is managed using financial instruments including derivatives. Natural hedging strategies are also utilised e.g. matching two year fixed rate mortgages with two-year fixed rate bonds.

The Group's risk appetite for interest rate risk is documented in the treasury policy and standards and includes limits for the maximum adverse impact on net interest margin, maximum economic value at risk, basis risk, as well as limits to minimise gaps in specific time buckets.

9.3 Use of Derivatives

Derivatives are only used to limit the extent to which the Group will be affected by changes in interest rates or other indices which affect fair values or cash flows. Derivatives are therefore used exclusively to hedge risk exposures although not all derivatives are designated in formal hedge accounting relationships.

The principal derivatives used by the Group are interest rate exchange contracts, most commonly in the form of interest rate swaps and basis risk swaps. The Group uses derivatives in accordance with the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes and, accordingly, they are used exclusively to reduce the risk of loss arising from changes in interest rates. Note 31 of the Annual Report and Accounts gives details of the derivative financial instruments held at 31 December 2019.

The Group's treasury policy sets out processes and controls in place to manage interest rate risk, including:

- Monthly discussion and agreement at ALCO of the Group's interest rate view;
- Day to day review of exposures and market outlook by both the Treasury and Balance Sheet Management team and fine-tuning of ALCO's view as appropriate;
- All new mortgage and savings ranges are reviewed by the Balance Sheet Management team to assess the impact on interest margin and determine appropriate hedging activity;
- Regular treasury hedging meetings to review hedging activity and assess the impact on sensitivity (both in terms of a 200bp shock and margin impact for current year). Larger and non-parallel interest rate shifts incorporating behavioural assumptions are also undertaken quarterly and reported to both ALCO ad GRC;
- Review of results of stress testing and resultant impact on annual profitability and overall value sensitivity;
- Review of basis risk under static modelling scenarios; and
- Monthly review of interest rate risk exposures and hedging by the Balance Sheet Management team, to review actual outcomes against plans for the month and allow hedging proposals to be formed.

In assessing interest rate risk exposures relating to fixed-rate assets and liabilities, it is necessary to make assessments of likely prepayment rates. The risk of prepayment assumptions being inaccurate is mitigated if too low, by additional unexpected early redemption charges, and if too high through additional interest income or funding.

The Group uses interest rate gap sensitivity analysis to assess exposure to interest rate risk. This analysis shows the Group's exposure to interest rate risk in terms of the net risk after taking account of management action to hedge inherent exposures. The Group's Balance Sheet Management Department is responsible for reporting the Group's interest rate risk exposure monthly to ALCO.

The Group has defined its risk appetite for the sensitivity to a 200bp parallel shift in interest rates both in terms of impact on reserves and annual net interest income. The impact for a 200bp parallel shift as at 31 December 2019 is shown below:

	+2% £m	**-2% £m**
At 31 December 2019		
Next 12 months	**4.1**	**(0.5)**
Next 2 years	**4.6**	**0.2**
Next 3 years	**8.9**	**(0.3)**

Details of the derivatives used to manage interest rate risks are given in the Risk Management Report in the Annual Report and Accounts and further details on the derivative financial instruments held at 31 December 2019 are given in note 31 of the Annual Report and Accounts.

The Group has no material direct exposure to equity risk holding only a small portfolio of shares with a value of £0.4m (2018: £0.2m) at 31 December 2019.

10. Remuneration

10.1 Remuneration Committee

The Remuneration Committee has responsibility for ensuring compliance with the Regulators' Remuneration Code and for approving disclosures included in this report in relation to remuneration. Further details are available within the Remuneration Committee Report in the 2019 Annual Report and Accounts.

The Committee does not consult with the Society's Members on its Executive Remuneration Policy but takes into account feedback given by Members. The Committee has for a number of years, invited Members to vote on the annual remuneration report, and Members have always voted in favour. In 2014, the Society voluntarily elected to adopt some of the changes to remuneration reporting that apply to UK listed companies and one of the factors that the Committee took into consideration was the opportunity to give Members a chance to vote on the Group's Remuneration Policy.

The Society's Remuneration Report and Policy was last voted on in April 2019. Member approval was given to the 31 December 2018 Directors' Remuneration Report (91.50% approval with 14,412 votes for, 1,339 against and 300 withheld). Member approval was given similarly to the Directors' Remuneration Policy (90.88% approval with 14,302 votes for, 1,436 against and 312 withheld).

10.2 Code Staff

Code Staff are currently defined as categories of staff including senior management, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management, or whose professional activities have a material impact on the Group's risk profile. The table below shows the aggregate remuneration for Code Staff in relation to their services to the Society and Group:

Category	Typical Functions	Year	Number in Category During the Year	Fixed Remuner-ation £000s	Other Taxable Benefits £000s	Variable Remuner-ation[1] £000s	Total Remuner-ation £000s
Executive Directors	Chief Executive Officer Chief Financial Officer Customer Director Strategy Planning & Risk Director	2019	4	760	109	232	1,101
		2018	4	673	102	19	794
Other Executives	HR Director MD NSSL Chief Information Officer Interim Finance Director	2019	3	333	54	102	489
		2018	4	484	60	9	553
Control Function	Compliance, Underwriting, Internal Audit, Customer Outcomes, Treasury, Balance Sheet Management	2019	8	469	80	36	585
		2018	7	436	65	16	517
Total		**2019**	**15**	**1,562**	**243**	**370**	**2,175**
		2018	**15**	**1,593**	**227**	**44**	**1,864**

1. Variable remuneration reflects participation in the Group's Executive Bonus Scheme for Executive Directors and other members of the Executive Committee and the Group's annual Corporate Bonus Scheme for all other code staff.

No introductory incentive payments were made during the financial year.

10.3 Decision Making Process for Determining the Remuneration Policy

The Remuneration Committee considers and makes recommendations to the Board on Executive remuneration and conditions of employment, and also on the general framework of colleague bonus schemes. The Committee met four times during 2019 and consists solely of Non-Executive directors. The Chairman of the Committee is John Morris, the other members are Bryce Glover, Karen Ingham and Anne Shiels. The Chairman, Chief Executive and HR Director (except for items relating to their remuneration) also attend meetings but are not members of the Committee. The Company Secretary acts as Secretary to the Committee. The Committee is responsible for the Group's remuneration policy although, with the exception of Executive Directors, Executives and those designated as Code Staff, on a day to day basis, the responsibility has been delegated to the Chief Executive for practical reasons.

The Committee's terms of reference are available online at https://www.newcastle.co.uk/about-us/governance/our-committees/

The Board believes remuneration should be sufficient to attract, retain and motivate colleagues and senior managers to continue to run the Group successfully. The Remuneration Policy, therefore, focuses on rewarding our colleagues and Executives in line with the achievement of our goals set out in the strategic plan and Corporate Key Performance Indicators whilst continuing to provide value for money for our Members.

10.4 Design Structure of the Remuneration System

Basic Salaries

Remuneration packages are normally set at a level to attract, motivate and retain Executives, Officers and staff of the calibre necessary to oversee the Group's operations. Basic salaries are normally set by taking into account salary levels within similar sized financial services organisations and the market as a whole.

The 2019 pay rise for all colleagues ranged from 0% to 12%, with an average 3.39% received by all colleagues.

Executive Directors, Executives and other Code Staff receive salaries. Non-Executive directors are paid fees set at a level appropriate to reflect the skills and time required to oversee the Group's operations and progress. They receive a base fee and additional fees depending upon the Board Committees on which they sit or chair.

Benefits

All staff, including Executive Directors and Executives are eligible for membership of the Newcastle Building Society Group Personal Pension Scheme, which is a defined contribution scheme. All Code Staff receive a range of taxable benefits, which include a motor vehicle or cash equivalent, private health care, relocation benefits and the ability to participate in a concessionary mortgage scheme. No Executive participated in the concessionary mortgage scheme during the year. Life cover for a lump sum on death in service is also provided of four times basic salary.

10.5 Link between Pay and Performance

Key changes to the Directors' Remuneration Policy for 2019

In February 2019, the Board approved the introduction of an Executive Bonus Scheme in relation to 2019 performance. The key driver for the introduction of the Executive Bonus Scheme was to ensure that the Group continues to attract, retain and motivate senior managers in an increasingly competitive market place. The Executive Bonus Scheme applies to the Group's Executive Directors and other members of the Executive Committee.

As the introduction of the Executive Bonus Scheme constituted a material change to our Remuneration Policy, Members were invited to make an advisory vote on the Policy at the 2019 AGM, and this received a 90.88% vote in favour of the Policy

Performance Related Bonuses

Throughout 2019, the Group operated an Executive Bonus Scheme that applied to Executive Directors and other members of the Executive Committee and a Corporate Bonus Scheme that applied to all other colleagues.

In agreeing the level of Executive bonus, the Remuneration Committee considers performance and a mix of financial and non-financial measures as well as personal objectives.

The Executive Bonus Scheme is dependent on performance, and a mix of financial and non-financial measures, together with personal objectives, form the key metrics of the Executive Bonus Scheme. Should all metrics be met, on target bonus payments are set at 30% of base salary with a maximum bonus potential of 50% of base salary for exceptional business and personal performance. The Executive Bonus Scheme is paid in three equal parts, with the first payment in the year after the bonus is earned and the remainder over the following two years. Payment of any deferred award is subject to review by the Remuneration Committee and approval by Board (the first payment was approved on 25 February 2020) and may be reduced or cancelled as appropriate. Please see the Remuneration report in the 2109 Annual Report and Accounts for 2019 awards under the Executive Bonus scheme.

In agreeing the level of colleague corporate bonus for the year, the Committee considers the Group's delivery of the Corporate Key Performance Indicators (KPIs) which include profitability, underlying business performance, people and customer satisfaction. Progress against the corporate KPI's is formally reviewed by the Remuneration Committee at the end of the financial year with progress being monitored by the Board on a monthly basis.

The Remuneration Committee approved a bonus payment under the Corporate Bonus Scheme at the end of 2019. The payment is to be made to all eligible staff (excluding Executive Committee colleagues). Determined against achievement of the current year's KPIs, there is no consequent deferral of the bonus payment or vested element. Individual colleague performance, as assessed though the Group's annual appraisal process determines where in the eligible range individuals fall. The majority of staff received a 5% bonus with a small portion receiving an enhanced bonus payment of 10%. A small number of colleagues did not qualify for a bonus payment.

Variable remuneration is limited to discretionary participation in the Group's Bonus Schemes and none of the Group's staff or Non-Executive Directors hold any interest in Shares or Options relating to the Group's subsidiary companies. There is a requirement under the Society rule 14 to have deposits to the value of not less than £1,000 in a Society share account in order to qualify as a Director. This means all Directors are Members of the Society. There are no requirements for a Director to own shares in the Society's Subsidiary companies.

Sales related incentive and bonus schemes were removed from the Group's business in January 2013, with the exception of those staff employed by Newcastle Financial Advisers Limited (NFAL). The bonus schemes which operate within NFAL are set in such a way as to ensure that they promote both good customer outcomes and the financial strength of the Group, do not reward failure and do not encourage any employee to take risks outside the Group's agreed risk appetite. The Remuneration Committee has monitored the operation of these bonus schemes throughout 2019 to ensure compliance with the Code and the remuneration policy statement.

For further information on the Group's management body including qualifications and experience, directorships held, recruitment and diversity policies, and committee representation, please refer to the 2019 Annual Report and Accounts available at https://www.newcastle.co.uk/about-us/media-centre/financial-results/.

11. Encumbrance

The European Banking Authority defines encumbrance to mean "pledging an asset or entering into any form of transaction to secure, collateralise or credit enhance any transaction from which it cannot be freely withdrawn."

The Group makes use of interest rate swaps to mitigate its exposure to interest rate risk as detailed in section 9 of this Pillar 3 report. Cash collateral is pledged to counterparties against the Group's derivative liabilities to reduce their exposure to the Group. Similarly, cash collateral is received by the Group against its derivative assets to reduce the Group's exposure to counterparties. Offsetting collateral is pledged in line with underlying Credit Support Annexes with the Group's financial counterparties. Cash collateral pledged is considered to be encumbered as it is no longer under the legal ownership or control of the Group. Collateral posted is measured against counterparty mark-to-market values and may not reflect the Group's internal valuation of its financial instruments.

The Group also makes use of repurchase agreements with banks in order to access funding. Non cash financial asset collateral, typically debt securities, is pledged to secure the funding with the assets pledged encumbered throughout the duration of the repurchase agreement in place.

There were no debt securities pledged as collateral under repurchase agreements with banks that were considered to be encumbered at 31 December 2019 (2018: £nil at fair value).

In the ordinary course of business, the Group may access market-wide facilities provided by central banks secured against non-cash collateral, including mortgage assets. Use of the facilities encumbers the assets pledged as collateral throughout the duration of the facility use.

To secure funding, the Group enters into legal agreements where cash and other financial assets are pledged as collateral to reduce counterparty exposure to the Group. Counterparties are assigned primary legal charge over the agreed collateral assets in the unlikely event of a default.

The Group's encumbrance position as at 31 December 2019 is included in the following table. All figures are presented in £millions. The tables below present comparable information to the EBA Disclosure on asset encumbrance templates A and C. The following table is an extract of table F 32.01 – Assets of the reporting institution (AE-ASS):

F 32.01 - ASSETS OF THE REPORTING INSTITUTION (AE-ASS)

		Carrying amount of encumbered assets			Fair value of encumbered assets		Carrying amount of non-encumbered assets			Fair value of non-encumbered assets	
			of which: issued by other entities of the group	of which: central bank's eligible		of which: central bank's eligible		of which: issued by other entities of the group	of which: central bank's eligible		of which: central bank's eligible
		010	020	030	040	050	060	070	080	090	100
10	**Assets of the reporting institution**	**811.0**		**584.9**			**3601.0**		**465.6**		
20	Loans on demand	6.4					215.7		206.0		
30	Equity instruments										
40	Debt securities	0.0		0.0	0.0	0.0	416.4		259.6	416.4	259.6
50	of which: covered bonds						*169.8*		*90.7*	*169.9*	*90.7*
60	of which: asset-backed securities	*0.0*		*0.0*	*0.0*	*0.0*	*146.6*		*74.0*	*146.6*	*74.0*
70	of which: issued by general governments						*95.0*		*94.9*	*94.9*	*94.9*
80	of which: issued by financial corporations						*5.0*			*5.0*	
90	of which: issued by non-financial corporations						*0.0*			*0.0*	
100	Loans and advances other than loans on demand	584.9		584.9			2,710.2		0.0		
110	of which: mortgage loans	*584.9*		*584.9*			*2,710.2*		*0.0*		
120	Other assets[1]	219.7					258.7				

1. Derivative financial liabilities are a source of encumbrance with cash collateral pledged against these liabilities included as 'other assets' for the purpose of Pillar 3 reporting. The other assets category also includes deferred tax assets, plant, property and equipment and prepayments and accrued income. None of these are deemed available for encumbrance in the normal course of business.

The following is an extract of table F 32.04- Sources of Encumbrance (AE-SOU):

F 32.04 - SOURCES OF ENCUMBRANCE (AE-SOU)

		Matching liabilities, contingent liabilities or securities lent		Assets, collateral received and own debt securities issued other than covered bonds and ABSs encumbered		
			of which: from other entities of the group		of which: collateral received re-used	of which: own debt securities encumbered
		010	020	030	040	050
10	**Carrying amount of selected financial liabilities**	**351.0**		**804.6**		
20	Derivatives			219.7		
30	of which: Over-The-Counter					
40	Deposits	351.0		584.9		
50	Repurchase agreements	*351.0*		*584.9*		
60	of which: central banks	*351.0*		*584.9*		
70	Collateralised deposits other than repurchase agreements					
80	of which: central banks			*0.0*		
90	Debt securities issued					
100	of which: covered bonds issued					
110	of which: asset-backed securities issued					
120	**Other sources of encumbrance**	**0.0**		**6.4**		
130	Nominal of loan commitments received					
140	Nominal of financial guarantees received					
150	Fair value of securities borrowed with non cash-collateral					
160	Other			6.4		
170	**TOTAL SOURCES OF ENCUMBRANCE**	**351.0**		**811.0**		

Encumbrance % at 31 December 2019: 18.4%

12. Basel III: leverage ratio and transition

12.1 Leverage ratio

An underlying feature of the financial crisis was the build-up of excessive on and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while maintaining their risk-based capital ratios. At the height of the crisis, the market forced the banking sector to reduce its leverage in a manner that amplified downward pressure on asset prices. This deleveraging process exacerbated the feedback loop between losses, falling bank capital, and shrinking credit availability.

The Basel III reforms introduced a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to:

- restrict the build-up of leverage in the banking sector to avoid destabilising deleveraging processes that can damage the broader financial system and the economy; and
- reinforce the risk-based requirements with a simple, non-risk-based backstop measure.

The Basel Committee is of the view that:

- a simple leverage ratio framework is critical and complementary to the risk-based capital framework; and
- a credible leverage ratio is one that ensures broad and adequate capture of both on and off balance sheet leverage of banks.

The leverage risk appetite is considered on an annual basis with particular ratios agreed as appropriate across business as usual and stressed scenarios separately.

12.2 Transition

Basel III came into force on 1 January 2014 alongside a number of transitional provisions.

The table below shows the 31 December 2019 capital position under Basel III reporting including the existing transitional position and the end point position. The impact of Basel III is mainly in relation to Permanent Interest Bearing Shares (PIBS) which move from tier 1 to tier 2 capital over a transitional period. All remaining subordinated debt issues have matured in December 2019. Other changes that have impacted the Group from 1 January 2014 include the deduction from Common Equity Tier 1 capital of deferred tax assets relating to trading losses, deductions in respect of intangible assets held on balance sheet and inclusion of the FVOCI reserve in capital.

The impact of Basel III has been reflected in the Group capital plans and the ICAAP.

The Group makes use of natural hedging through matching funding against lending in place of structured derivative based interest rate risk mitigation wherever appropriate. With a consequently relatively muted holding of derivative financial instruments for risk purposes and no trading book, the Group limits its risk of excessive leverage through off-balance sheet holdings.

Leverage ratio – Group (Point in time at 31 December)	**2019 Transitional Basel III £m**	**End point Basel III[1] £m**	**2018 Transitional Basel III £m**	**End point Basel III £m**
Common Equity Tier 1 capital	201.6	201.6	191.8	191.8
Additional Tier 1 capital	6.0	-	8.0	0
Total Tier 1 capital	207.6	201.6	199.8	191.8
Additional Tier 2 capital	14.4	20.4	17.2	20.6
Total capital	222.0	222.0	217.0	212.4
Total assets[2]	4,227.0	4,227.0	3,518.4	3518.4
Off balance sheet commitments	43.4	43.4	26.6	26.6
Potential future exposure (current exposure method, applying netting rules) – Derivatives	3.0	3.0	4.1	4.1
Fair value adjustments	186.6	186.6	179.4	179.4
Total exposures	4,460.0	4,460.0	3,728.5	3,728.5
Leverage ratio (T1/ total exposures)[3]	**4.7%**	**4.5%**	**5.4%**	**5.1%**
Capital ratios at 31 December				
Total RWAs	1,446.8	1,446.8	1,224.3	1,224.3
CET1 ratio	**13.9%**	**13.9%**	**15.7%**	**15.7%**
Tier 1 ratio	**14.3%**	**13.9%**	**16.4%**	**15.7%**
Solvency ratio	**15.3%**	**15.3%**	**17.7%**	**17.3%**

1. The balances disclosed as the Basel III end point, do not factor in expected accumulated Group profits or the utilisation of deferred tax assets in respect to trading losses by the end point of the transitional arrangement. Rather, it presents an end point Basel III position using the 31 December 2019 Group balance sheet, assuming no movement in reserves or other capital tier 1 and 2 items. Therefore the end point Basel III leverage ratio is expected to be higher than the figure disclosed above.

2. Total assets above reflect the group's total assets per the 2019 report and accounts, excluding fair value adjustments for hedged risk and the fair value of derivative assets held on the balance sheet.

3. The Group's leverage ratio, calculated as the simple arithmetic mean of the monthly leverage ratio over a quarter, sits at 4.7% for the quarter to December 2019 under the Basel III transitional basis and at 4.5% under the fully loaded Basel III end point. The December 2019 leverage position is comparable to the quarter to December average due to increasing Tier 1 capital through Q4 profits being offset by a growing balance sheet (and risk weighted asset) base.

13. Capital instruments key features

	Disclosure template for main features of regulatory capital instruments	Permanent Interest Bearing Shares (PIBS)	
1	Issuer	Newcastle Building Society	Newcastle Building Society
2	Unique identifier (e.g. CUSIP, ISIN, or Bloomberg identifier for private placement)	GB0006361371	GB0006371529
3	Governing law(s) of the instrument	English	English
	Regulatory treatment		
4	Transitional Basel III rules[1]	Additional Tier 1 / Tier 2	Additional Tier 1 / Tier 2
5	Post-transitional Basel III rules	Tier 2	Tier 2
6	Eligible at solo/group/group & solo[2]	Group	Group
7	Instrument type (types to be specified by each jurisdiction)	PIBS	PIBS
8	Amount recognised in regulatory capital (Currency in millions, at of most recent reporting date)	10	10
9	Par value of instrument	10	10
9a	Issue price	100.32%	100.45%
10	Accounting classification	Liability - amortised cost	Liability - amortised cost
11	Original date of issuance	22-Jun-93	15-Sep-92
12	Perpetual or dated	Perpetual	Perpetual
13	Original maturity date	No maturity	No maturity
14	Issuer call subject to prior supervisory approval	n/a	n/a
15	Optional call date, contingent call dates and redemption amount	No issuer call	No issuer call
16	Subsequent call dates, if applicable	n/a	n/a
	Coupons/dividends		
17	Fixed or floating dividend/coupon	Fixed	Fixed
18	Coupon rate and any related index	10.75%	12.63%
19	Existence of a dividend stopper[3]	Yes[4]	Yes[4]
20	Fully discretionary, partially discretionary or mandatory	Partially discretionary	Partially discretionary
21	Existence of a step up or other incentive to redeem	No	No
22	Noncumulative or cumulative	Noncumulative	Noncumulative
23	Convertible or non-convertible	Nonconvertible	Nonconvertible

24	If convertible, conversion trigger(s)	n/a	n/a
25	If convertible, fully or partially	n/a	n/a
26	If convertible, conversion rate	n/a	n/a
27	If convertible, mandatory or optional conversion	n/a	n/a
28	If convertible, specify instrument type convertible into	n/a	n/a
29	If convertible, specify issuer of instrument it converts into	n/a	n/a
30	Write-down feature	None contractual, statutory via bail-in	None contractual, statutory via bail-in
31	If write-down, write-down trigger(s)	n/a	n/a
32	If write-down, full or partial	n/a	n/a
33	If write-down, permanent or temporary	n/a	n/a
34	If temporary write-down, description of write-up mechanism	n/a	n/a
35	Position in subordination hierarchy in liquidation (specify instrument type immediately senior to instrument)	Subordinated debt	Subordinated debt
36	Non-compliant transitioned features	No	No
37	If yes, specify non-compliant features	n/a	n/a

1. PIBS transition out of AT1 capital into Tier 2 capital in line with the CRR's 'grandfathering' rules, falling fully to T2 capital instruments under fully implemented Basel III.

2. The Newcastle Building Society accounting and regulatory groups are the same.

3. Should the Board pass a resolution delaying or requiring a reduction in the interest payment on an interest payment date and the Society is unable to issue Payment PIBS or Payment Successor securities, the Society shall not pay interest or dividend on any other class of Deferred Shares of the Society, other than any Mandatory PIBS, for a period of 12 months following the passing of such resolution.

4. Interest in respect of the PIBS shall not be paid or credited in respect of any interest period if the Society has at any time before the date for payment of the interest cancelled the payment of any interest or dividend upon any other shares of any class other than deferred shares, or any deposit (including subordinated debt) with the Society.

Glossary of Terms

Arrears – A customer is in arrears when they are behind in their mortgage payments. A customer is 3 months in arrears when they have missed the equivalent of 3 monthly mortgage payments

Basel III – The third of the Basel Accords, issued by the Basel Committee on Banking Supervision, which are a long term package of changes that will strengthen regulatory standards for capital and liquidity. The standards started to be phased in from 1 January 2014. Basel III became law in the EU Capital Requirements Directive, and was implemented in the UK via the PRA / FCA Handbooks.

Capital Conservation Buffer is designed to ensure that a degree of excess capital is built up and retained, rather than used to support additional growth or further activities, during periods of non-stress which can be drawn down on if losses are incurred in the future. The Capital Conservation Buffer is being phased-in in equal increments of 0.625% each year until its final level of 2.5% in 2019 from a starting point in 2016 of 0.625%.

Capital Planning Buffer – An amount of capital, calculated against a firm's risk weighted assets that must be held in addition to the firm's ICG. Designed to require excess capital to be held during non-stressed conditions that is then available in times of potential future loss.

Common Equity Tier 1 Capital – Defined by the PRA as general reserves or qualifying capital instruments which is the accumulation of retained profits at 31 December 2019. Deferred taxation is deducted from the retained profits to calculate the final Common Equity Tier 1 Capital position.

Countercyclical Buffer – An amount of capital, calculated against a firm's risk weighted assets that must be held in addition to the firm's ICG. Able to be varied over time to allow the ongoing provision of essential services, such as the supply of credit, to the real economy during times of stress.

Counterparty Credit Risk – This is the risk that a counterparty to a transaction could default before final settlement of the transaction.

Credit Risk - The risk that a customer or counterparty is unable to honour their repayment obligations as they fall due.

CRR – Capital Resources Requirement, this is the minimum amount of capital resources that a financial institution must hold as set out in Basel III Pillar 1 rules.

ICAAP – Internal Capital Adequacy Assessment Process. The Group's own assessment of the levels of capital that it needs to hold in respect of the risks it faces under a business as usual scenario and a variety of stress scenarios.

ICG – Individual Capital Guidance, guidance from the PRA on the minimum level of capital that must be held. This does not include capital buffers- against which the Group must also hold capital.

Impaired loans – Loans where an event has occurred which indicates the Group does not expect to collect all the contractual cash flows due, or expects to collect them later than they are contractually due.

Interest Rate Risk – This is the exposure to adverse movements in interest rates.

Material – The CRR considers information in disclosures shall be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions.

Operational Risk – The risk of loss arising from inadequate or failed internal processes, people and systems or from external events.

Past due – Loans on which payments are overdue including those on which partial payments are being made.

PIBS – Permanent Interest Bearing Shares, these are unsecured, deferred shares that are a form of Tier 1 and Tier 2 capital at 31 December 2018. PIBS rank behind the claims of all subordinated debt holders, depositors, payables and investing Members of the Society.

Pillar 1 – Pillar 1 of the Basel III framework addresses the total minimum capital requirements for Credit, Market and Operational Risks.

Pillar 2 – This is the part of the Basel III framework which sets out the process by which financial institutions review their overall capital adequacy. Supervisors then evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments. This includes all risks, including Pillar 1 risks. The ICG is an outcome from Pillar 2.

Pillar 3 – This is the part of the Basel III framework which sets out the disclosure requirements for firms to publish details of their risks, capital and risk management. This report is the outcome of the Pillar 3 fprocess.

Risk Weighted Assets (RWA) – The value of assets, after adjustment, under Basel III rules to reflect the degree of risk they represent. The Group measures RWA using the standardised approach.
Standardised Approach – the basic method used to calculate credit risk capital requirements under Basel III. For Credit risk, the risk weights used in the calculation are based on the underlying risk and are determined by supervisory parameters. For operational risk, an average of three year historical net income is multiplied by a factor of 12-18%, depending on the underlying business being considered.

Stress Testing – Various techniques used to gauge the potential vulnerability to exceptional but plausible events.

Subordinated debt – A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing Members (other than holders of PIBS).

Tier 1 Capital – Tier 1 capital is divided into Common Equity Tier 1 and Additional Tier 1 capital. Common Equity Tier 1 capital is defined above. Additional Tier 1 capital includes qualifying instruments such as PIBS.

Tier 2 Capital – Comprises the Group's qualifying subordinated debt and collective impairment allowance (for exposures treated on a Basel III standardised basis).

Wrong way risk - Defined by the PRA as a situation where there is an adverse correlation between the counterparty's probability of default and the mark-to-market value of an underlying transaction. The Group has no material exposure to wrong way risk as at 31 December 2019.