



**Pillar 3 Disclosures 31 December 2018**

**Approved by the Board: 26 February 2019**

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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.

Through 2018 a handful of amendments to the CRR and consequent Pillar 3 reporting have been made, none of which have had a significant impact on the Group.

### 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 2018 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 Society) 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 on disclosure requirements in June 2016 clarifying an intention to implement the BCBS Pillar 3 recommendations through 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 Society 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 has made no consequent early-adoption of the BCBS templates.

The expected future trend remains towards disclosures that are more granular, more frequent and of significantly increased volume with the most significant revisions including a hierarchy of disclosures through the use of templates, accompanied by specific definitions. The Society 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 aren't expected to be concluded and applicable in advance of 2022 and the Society 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 Society has elected to adopt the provisions and includes in this Pillar 3 reporting both the transitional and fully loaded IFRS 9 capital positions, as required by the CRR amendment. The Society's implementation of IFRS 9, as at 31 December 2018, has not given rise to any significant transitional adjustments due to the relative stability of provisions held against non-defaulted mortgage loans between 31 December 2017 and 31 December 2018. 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 Society 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 2018 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](http://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 Society's Board on 26 February 2019.

### 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 principal subsidiaries:

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

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

For prudential and Pillar 3 reporting purposes, the Group presents its consolidated position as above. 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 Society’s capital strength remains robust at 31 December 2018. Strong profitability (£10.8m) saw the Society’s common equity tier 1 ratio, the primary measure of the Society’s capital strength, improve to 15.7% despite a growing mortgage portfolio and consequent growing risk weighted asset base.

On 18 December 2018, the Society repaid its £10.0m 12.0% Permanent Interest Bearing Shares (PIBS). These PIBS had qualified as a mix of Tier 1 and Tier 2 capital with the PIBS repayment the primary cause of the Society’s reduced Tier 1 and Total capital ratios. The PIBS provided the Society with additional capital strength when issued in 2008 and helped the Society to retain a sufficiently robust capital base despite its 2008 accounting losses. The Society’s repayment of the PIBS in December 2018, following regulatory approval, demonstrates the Society’s improved performance, position and risk since the financial crisis in 2008.

While the Society’s strategy to grow its prime residential mortgage business whilst winding down legacy portfolios is unchanged in 2018, prime growth has now begun to notably exceed legacy divestment. Gross lending for 2018 in excess of £520m and prime net lending in excess of £160m saw the Society’s risk weighted asset base grow to £1,224m in spite of overall balance sheet shrinkage: with reductions in the Society’s zero risk weighted cash balances, low-risk debt securities and fair value hedging adjustments driving the balance sheet’s reduction.

With aspirations for continued balance sheet growth, the Society recognises the ongoing need for robust and effective risk management, mitigation and governance. The Society’s risk management framework is designed to enable the Society to proactively identify and manage risks to support the achievement of the Society’s objectives. It includes monitoring and controlling the significant risks to which the Society is exposed to ensure the security and resilience of the Society. The Society’s 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.

The five year trend for the Group’s capital ratios is shown in the table below and further details are included on page 15 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 2018 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 Society's strategy, risk appetite, and risk management are consistent. To assist the Board, the Society's 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 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 Strategy, Planning and Risk Director 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 is within departments, business units and subsidiaries where Executives, managers and staff have responsibility for risk management and ensuring adequate controls are in place to mitigate risk.
- The second line of defence is provided by the GRC and supporting sub-committees together with oversight of the first line by the Group Risk department.
- The third line of defence is provided by Internal Audit and the Audit Committee, which are responsible for reviewing the effectiveness of the first and second lines of defence.

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 Society's risk profile.

Further details on risk appetite and risk management are given in the Risk Management Report on pages 35 to 38 of the Annual Report and Accounts.

### 4.2 Principal Types of Risk

#### Credit Risk

Credit risk is the risk that a treasury counterparty, debtor or borrower will not be able to meet their obligations as they fall due and the Society's 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 – Lending

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 to the Society.

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 Society's lending policy is subject to review at least annually and the residential mortgage book is subject to ongoing reporting to the Retail Credit 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 Society has a Prudential Risk department that 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 borrower watch lists, arrears trends, breach reports and general market and sector specific information.

### Retail Credit Committee (RCC)

RCC is responsible for credit risk across the Group arising from the retail mortgage portfolio including lending policy, underwriting, limit setting and monitoring, forbearance, possessions, affordability, scorecard effectiveness and efficiency, and residential stress testing.

### Commercial Credit Committee (CCC)

CCC is responsible for credit risk across the Group's non-retail mortgage portfolio including loan strategy, limit monitoring, risk indicators and stress factors, annual reviews and breach reports, loan renegotiations and restructures, monitoring risk trends on the portfolio, and stress testing.

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 – 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 CRR) and International Accounting Standards and details operational limits and guidelines, the Society's risk appetite statement and stress testing requirements.

Treasury counterparty risk is monitored within the Prudential Risk 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 volatile 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 Society investing only in highly rated financial institutions or other building societies with strong capital ratios. The Society 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.

The Society is also subject to market-investment risk across its liquidity portfolios, the risk that the value of the Society's investment falls and the Society is obliged to crystallise that fall in value. The Society does not operate a trading book and mitigates exposure in accounting value swings (and the corresponding liquidity risk of reduced value of liquidity investments) through the use of derivatives.

The London Clearing House (LCH) acts as the Society's appointed central counterparty to treasury swaps originally undertaken with institutional counterparties. Where possible, the Society's derivative contracts are cleared via the LCH however non-centrally cleared derivatives are still held with non-LCH counterparties. See section 7.7 for detail of the Society's 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 or indices. The Society has a Credit Support Annex in place for all derivative counterparties.

### **Investment risk**

Investment risk is the risk that the value of the Society's investments fall and the Society is obliged to crystallise that fall in value. Investment risk is managed as part of the treasury risk process.

### **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 longer-term (typically up to 25 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, and enable 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 Society has complied with the Liquidity Coverage Ratio ("LCR") requirements throughout 2018. LCR 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.

The Society has continued to maintain a significant level of high quality liquid assets throughout 2018, as detailed in the Strategic Report on page 14 of the Annual Report and Accounts. The Society has complied with its Individual Liquidity Guidance throughout 2018.

On a day to day basis liquidity risk is monitored within Treasury and the Prudential Risk department.

The Group's liquidity risk is overseen by the Asset and Liability Committee (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 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 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 Society's activities, including poor consumer outcomes, resulting from poorly designed or targeted products, mis-selling of products, inadequate controls relating to fraud prevention and detection or to prevent money laundering.

The Group has established a conduct risk framework including a Retail Conduct Risk Appetite statement supported by detailed policies relating to compliance, treating customers fairly, fraud, and anti-money laundering.

Compliance with the Retail Conduct Risk Appetite statement is monitored by the Operational Risk Committee (ORC), reporting to the Executive Risk Committee (ERC) with oversight from the GRC. 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.

The Society'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 building society, 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 Society maintains an annual 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, the 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 or where there is 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 requiring greater mitigation.

ERC oversees operational and conduct risk which is then overseen 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 in the banking (or non-trading book) is covered further in section 9. The Group has no exposure to foreign currency and a very small direct net exposure to equities through a small shareholding in Standard Life arising from the de-mutualisation of the insurance company in 2006. At 31 December 2018 these holdings were held on the balance sheet at £0.2m, 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 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.

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 Society'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.

Commercial borrower activity is similarly monitored with large exposure to individual borrowers considered as a source of potential concentration risk. GRC is satisfied at 31 December 2018 that no exposure in any one risk concentration exceeds the Society'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 60% in assets that "match" the liabilities and 40% in "growth" assets linked mainly to equities through a variety of funds including Diversified Growth Funds. The current level of hedging for interest rate risk and inflation risk is at 74%. 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 No 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 to the 2018 Annual Report and Accounts.

The Society was not materially impacted by the High Court's October 2018 clarification on the calculation of Guaranteed Minimum Pensions (GMP) recognising a £0.5m past service charge in respect of GMP equalisation in 2018.

### Solutions Business Risk

The Society's business model includes diversification via the Solutions business, through the Group's subsidiaries Newcastle Strategic Solutions Limited and Newcastle Systems Management Limited. 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 Society 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, inter alia:

- Systems failures (mainframe, internet and telephony);
- Breach of information security/Data Protection Act;
- Failure of Society'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 Society has systems and controls in place to address the risks in the Solutions area including dedicated teams in IT, Finance, Compliance, Financial Crime, technical departments and dedicated relationship and service managers.

Newcastle Strategic Solutions Limited Board oversees third party contract risks, financial performance and operational matters that arise from Newcastle Strategic Solutions Limited. Similarly, the Newcastle Systems Management Limited Board oversees the strategic direction of information technology including risk monitoring, reporting and mitigation across both the Solutions business and the wider Group.

The growth and potential impact of cybercrime is a challenge facing many businesses, not just in the financial services sector. The Society 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 an area which remains under constant review utilising both internal and external expertise to inform our strategy. During 2018 the Group's Solutions business received ISO 27001 Certification for its Information Security Management System.

### 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.

The Group's deferred tax asset recovery is conditional on future profits of the Group. The Society's Audit Committee has assessed the deferred taxation position as at 31 December 2018 and is satisfied that the amount will be recovered through forecast future profits. There are no material uncertainties towards ultimate recovery of the Group's deferred tax asset and this was most recently formally assessed and concluded satisfactorily on by the Group's Board as part of the year-end Going Concern review.

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 Society is or becomes inadequately capitalised to address the risks to which it is exposed. The Society updates its ICAAP 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 vote to leave the European Union (EU) in June 2016 and the prospect of the UK leaving the EU on 29 March 2019 without agreements in place about what its relationship would be like in future, a ‘no-deal Brexit’, has been followed by periods of market volatility, depreciation in the value of Sterling and ongoing uncertainty regarding the UK’s short-term economic outlook. ‘Brexit’ results in uncertainty to the regulatory environment and economic environment more generally.

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 Society has a well-developed risk and compliance structure with the Risk department supported by separate Compliance, Internal Audit and Financial Crime Units. The Society has extensive policies and procedures covering credit risk, conduct, liquidity, interest rate and operational risk which are approved by the Board via sub-committees as appropriate.

The risk governance structure is set out below.

### Risk Governance Structure



### Group Risk Committee (GRC)

GRC reports to the Board and is responsible for all material risks, including both conduct and prudential risks. It is responsible for the Society's risk framework, risk appetite statements and ensuring that these remain consistent with the Society's strategic plan. Terms of reference for GRC are included on the Society's website under governance (<https://www.newcastle.co.uk/about-us/governance/our-committees/>).

The duties of GRC include:

- Oversight of overall risk management framework including the governance of risk management, oversight of the Group's top risks, risk appetite statements, risk policies and the use of stress testing and assessment of the adequacy of reporting of exposures against the risk appetite statements;
- To oversee adherence to Group risk policies and any action taken resulting from material policy breaches or material risk events;
- To oversee the effectiveness of the risk and control framework to manage and mitigate the Group's material risks; and
- To oversee the management of prudential and conduct regulatory matters.

The Committee normally meets at least four times a year and more frequently where required (During 2018 the Committee met five times). It is supported by five Executive committees that meet on a monthly basis, as follows:

**Retail Credit Committee (RCC)** is responsible for credit risk across the Group arising from the retail mortgage portfolio (including residential, retail BTL and equity release) with key duties including:

- Consideration, review and recommendations, at least annually, on the Society's residential lending policy statement (including interest only policy) and arrears and possessions policy (Residential & Retail BTL);
- Monitoring of controls in operation in relation to credit risk management and compliance with lending guidelines set out in SS20/15 (the Building Society Sourcebook);
- Annual consideration of the appropriate lending approach for the Society (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 Society's valuation process including 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 across the Society including implementation of any major changes to the mortgage application or administration processes; and

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- To review on annual basis the Society's legal process including use of solicitors and assessing the effectiveness of the panel and key solicitors utilised during the year.

Through 2018, RCC met monthly.

**Commercial Credit Committee (CCC)** is responsible for credit risk across the Group's non-retail mortgage portfolio with key duties including:

- Consideration, review and recommendations, at least annually, on the Society's Non-Standard lending policy;
- Monitoring of controls in operation in relation to commercial credit risk management;
- Oversight, review and approval of the annual review program for commercial loans, breach reports, maintenance of borrower watch lists, arrears and possessions cases, macro-economic data with regard to the commercial market, and pricing reviews;
- Oversight and approval of annual stress testing to determine the potential losses in a stressed environment;
- Consideration, review and approval of the write-off or recovery of shortfall debts; and
- Consideration, challenge and recommendation in relation to legacy wind down strategy.

Through 2018, CCC met quarterly.

**Operational Risk Committee (ORC)** supports GRC through provision of oversight of operational risk with key duties including:

- 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; and
- 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.

Through 2018, ORC met monthly.

**Asset and Liability Committee (ALCO)** is responsible for all aspects of treasury risk management including liquidity and funding risk, interest rate risk and hedging activity, treasury counterparty credit risk and balance sheet management. Terms of reference for ALCO are included on the Society's website under governance (<https://www.newcastle.co.uk/about-us/governance/our-committees/>).

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 Society's interest rate view, based on changes to the economic outlook and interest rate environment;

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- Annual review of the Society's 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 Society's 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 to scenarios modelled as part of liquidity stress testing and identification of additional scenarios based on best practise and regulatory pronouncements.
- Annual review of the Society's ILAAP;
- Review of compliance with specific guidelines issued by the PRA or FCA; and
- Annual review of treasury and risk staff training.

Through 2018 ALCO met monthly.

**Executive Risk Committee (ERC)** is responsible for 'overlap risks' – risks that go across business areas and in particular for conduct risks and overall stress testing. Key duties include:

- Annual consideration, review and recommendation on the Retail Conduct Risk Appetite Statement, Conduct Rules Policy, Compliance Policy and Plan, Complaints Policy, and Whistle Blowing Policy;
- Monitoring of activity and controls underpinning customer outcomes to ensure compliance with the Society's risk appetite;
- Review of causal factors and root cause analysis of complaints;
- Review of the Retail Conduct Risk Outlook and consideration of the adequacy of any mitigation;
- Review of monthly fraud risk management information, reports of the Money Laundering Reporting Officer, and annual Financial Crime Policy;
- Consideration, review and consequent response to semi-annual stress testing of the Society's vulnerabilities, including recession or other economic scenarios where balance sheet risks, business risks and credit risks may come together;
- Consideration of aspects of the Group's ICAAP not covered by ALCO, CCC or ORC including concentration risk, strategic and business risk, stress tests on Solutions and other Society subsidiaries' incomes and the overall stress tests giving rise to the capital planning buffers; and
- Consideration and recommendation on the Group's Corporate Insurance Policy Statement.

Through 2018 ERC met monthly.

### **Enterprise Risk Committee**

In 2019 the Society expects to implement an Enterprise Risk Committee to support the GRC by overseeing the risk framework for operational, conduct, IT Risk and Business Resilience.

For practical purposes, the Commercial Credit Risk and Retail Credit Risk committees will also be amalgamated into a single Credit Risk Committee.

### 4.4 Other Governance

Further details of the Society's corporate governance arrangements are given on pages 22 to 26 of the 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 strategy.

The Board oversees and approves the Society'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 Group Risk Committee, 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. Further details are given on pages 22 to 23 of the Annual Report and Accounts.

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 Committee's report is included on pages 30 to 34 of the 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 is responsible for oversight of the composition of the Board and to lead 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 Society's governing body and its senior management functions.

### **Newcastle Strategic Solutions Limited (NSSL) Board**

NSSL's Board oversee 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 establish and review a risk appetite statement for NSSL, evaluate and monitor NSSL risk and compliance matters and consider and act upon the findings of any external/ internal audits or reviews. Further details are given on page 24 of the Annual Report and Accounts.

### **Newcastle Systems Management Limited (NSML) Board**

NSML's Board oversee the strategic direction of Information Technology, property management, and associated services, ensuring this is consistent with the Society's agreed corporate strategy for ongoing development and improvement in the business proposition. The NSML Board establish and review a risk appetite statement for NSML, monitor developments in the area of cyber and other technological risk mitigation, ensure that NSML complies with all relevant legislation and act upon the findings of any external/ internal audits or reviews. Further details are given on pages 24 and 25 of the Annual Report and Accounts.

### **Newcastle Financial Advisers Limited (NFAL) Board**

NFAL's Board oversee the strategic direction of the Group's financial advice subsidiary, ensure compliance with all relevant legislation and act upon the findings of any external/ internal audits or reviews. Further details are given on page 25 of the Annual Report and Accounts.

### **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 Strategy, Planning and Risk Director, 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 Society'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.

## Pillar 3 Disclosures

- 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 Society 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 recommendation made by the Financial Reporting Council's UK Corporate Governance Code, responsibility for oversight of the Group's whistle blowing practices will transition to the Group Board.

Further details on the work of the Audit Committee are given in the Audit Committee Report included on pages 27 to 29 of the Annual Report and Accounts.

### 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, the 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, Society 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 2018 was £118.0m. 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 £0.4m; and
- Society holdings of intangible assets at £1.3m lower than the Group's holding.

These combine to increase the Society's available capital by c. £1.7m vs. the Group's position.

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

- Society holdings of mortgage assets at £1.1m lower (RWA) than the Group's holding;
- Society holdings of tangible assets at £25.0m lower (RWA) than the Group's holding;
- Society holding of subsidiary share capital at £28.4m (RWA) (nil at a Group level); and
- Society holding of subsidiary loan and other intercompany assets at £33.1m (RWA) (nil at Group level).

These combine to increase the Society's risk weighted assets by c. £35.4m vs. the Group's position.

Both the Society and Group have operated within the Individual Capital Guidance (ICG) issued by the PRA throughout 2018, 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 31-Dec-18 Group £m	End Point Basel III 31-Dec-18 Group £m	Basel III Transitional 31-Dec-17 Group £m	End Point Basel III 31-Dec-17 Group £m
<b>Tier 1 capital</b>				
Profit and loss reserves	194.8	194.8	185.0	185.0
Deferred tax assets that rely on future profitability excluding those arising from temporary differences~	(1.4)	(1.4)	(2.1)	(2.1)
Defined benefit pensions fund assets	-	-	-	-
FVOCI reserve*	0.5	0.5	1.8	1.8
Additional valuation adjustments**	(0.3)	(0.3)	(0.3)	(0.3)
Intangible assets	(1.7)	(1.7)	(1.9)	(1.9)
Other adjustments	(0.1)	(0.1)	-	-
<b>Common Equity Tier 1 capital</b>	<b>191.8</b>	<b>191.8</b>	<b>182.5</b>	<b>182.5</b>
Permanent Interest Bearing Shares (PIBS)	20.0	20.0	30.0	30.0
PIBS Grandfathering to T2 capital	(12.0)	(20.0)	(15.0)	(30.0)
AFS reserve	-	-	-	-
<b>Total Additional Tier 1 capital</b>	<b>8.0</b>	<b>-</b>	<b>15.0</b>	<b>-</b>
<b>Total Tier 1 capital</b>	<b>199.8</b>	<b>191.8</b>	<b>197.5</b>	<b>182.5</b>
<b>Tier 2 capital</b>				
Collective Impairment allowance	0.6	0.6	3.2	3.2
PIBS Grandfathering to T2 capital	12.0	20.0	15.0	30.0
Subordinated debt	4.6	-	9.5	-
<b>Total Tier 2 capital</b>	<b>17.2</b>	<b>20.6</b>	<b>27.7</b>	<b>33.2</b>
<b>Total capital</b>	<b>217.0</b>	<b>212.4</b>	<b>225.2</b>	<b>215.7</b>

~Deferred tax assets relating to temporary timing differences of £0.9m are held on balance sheet at 31 December 2018 and are not deducted from Common Equity Tier 1, in line with article 48 of the CRR.

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 £9.2m (c. £7.6m 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.

\*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.

\*\*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 above includes full amortisation of the Group's remaining subordinated debt over the Basel III transitional period and transitional grandfathering of the Society's PIBS to Tier 2 Capital from Tier 1 but does not factor in accumulated Group profits over a similar period or other capital transactions that could be undertaken. It presents an end point Basel III position using the 31 December 2018 Group balance sheet only, assuming no other movement in reserves or other capital tier 1 and 2 items.

The following table details the Group's capital flows through 2018. Figures are presented under a Basel III transitional basis.

<b>Basel III Transitional</b>	<b>Group £m</b>
<b>Common Equity Tier 1 capital at 31 December 2017</b>	<b>182.5</b>
Group profit after taxation for the financial year 2018	10.8
<b>Other comprehensive (expense)/income</b>	
Write off of pensions contributions made during the year	(1.1)
Decrease in fair value of debt securities not yet realised through sale	(1.6)
Income tax credit on decrease in fair value of debt securities	0.3
<b>Other movements:</b>	
Decrease in loss based deferred tax asset	0.7
Decrease in net book value of intangible assets	0.2
<b>Common Equity Tier 1 capital at 31 December 2018</b>	<b>191.8</b>
<b>Additional Tier 1 capital at 31 December 2017</b>	<b>15.0</b>
Repayment of £10m PIBS: additional tier 1 portion	(5.0)
PIBS Grandfathering to tier 2 capital	(2.0)
<b>Additional Tier 1 capital at 31 December 2018</b>	<b>8.0</b>
<b>Tier 2 capital at 31 December 2017</b>	<b>27.7</b>
Repayment of £10m PIBS: Tier 2 portion	(5.0)
Reduction in collective provision	(2.6)
Amortisation of capital value of Subordinated debt	(4.9)
Amortisation of subordinated debt issue costs	-
PIBS Grandfathering to T2 capital	2.0
<b>Tier 2 capital at 31 December 2018</b>	<b>17.2</b>
<b>Total capital at 31 December 2018</b>	<b>217.0</b>

The above table illustrates that the core driver of the Society's Common Equity Tier 1 (CET1) capital increase is the Group's profitability through 2018. Ongoing and improved profitability also drives a meaningful decrease to the Group's on balance sheet deferred tax assets that rely on future profitability to be utilised. This decreases 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 £1.1m of contributions made to the scheme via Other Comprehensive Income during 2018. 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.

Volatile markets in the wake of Brexit and other macro-economic drivers of uncertainty have seen the unrealised market value of the Society's debt security investments fall. The Society's general expectation is that it will hold debt security investments until their contractual maturity making decreases in market value 'accounting adjustments' and not reflective of any particular diminution in the ultimate value that the Society expects to take from its investments.

With most of the Society's interest rate derivatives held in effective and formal fair value hedges throughout 2018, the Society's additional valuation adjustments are not significant, primarily reflecting un-hedged portions of the Society's available for sale debt securities held at fair value on balance sheet.

Grandfathering of Tier 1 PIBS into Tier 2 capital and Tier 2 amortisation of the capital value of subordinated debt issued by the Society continues in line with the CRR's transitional arrangements.

The Society's repayment of £10m of 12.0% Permanent Interest Bearing Shares (PIBS) on 18 December 2018 reduced its total capital holdings by £10.0m. The PIBS had qualified under the CRR's 'grandfathering' provisions as Tier 1 capital at a value of £5.0m and Tier 2 capital at a value of £5.0m. The PIBS would have become ineffective for regulatory capital purposes had they not been repaid.

The Society's implementation of IFRS 9's provisioning requirements on 1 January 2018 saw the reclassification of a number of provisions previously considered to be 'general' (collective) in nature to 'stage 1' or 'stage 2' IFRS 9 provisions. The Society does not consider any of its IFRS 9 provisions to be general in nature and the provisions no longer qualify as an add-back to Tier 2 capital under the CRR.

The Society holds £25.0m in subordinated debt that matures on 23 December 2019. For regulatory purposes, the Tier 2 capital value of the debt amortises to £nil on a straight line basis in the five years leading up to its contractual maturity.

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

	<b>31-Dec-18 Group £m</b>
<b>Balance sheet reserves</b>	<b>195.1</b>
<b>Regulatory adjustments</b>	
Loss based deferred tax asset	(1.4)
Intangible assets	(1.7)
Additional valuation adjustment	(0.3)
Other	0.1
<b>Regulatory Common Equity Tier 1 capital</b>	<b>191.8</b>
<b>Balance sheet Subscribed capital</b>	<b>20.0</b>
<b>Regulatory adjustments</b>	
Grandfathering of PIBS under Basel III	(12.0)
<b>Regulatory Additional Tier 1 capital</b>	<b>8.0</b>
<b>Balance sheet subordinated liabilities</b>	<b>25.0</b>
<b>Regulatory adjustments</b>	
Amortisation of capital value of subordinated liabilities under Basel III	(20.4)
Collective impairment allowance	0.6
Grandfathering of PIBS under Basel III	12.0
<b>Regulatory Tier 2 capital</b>	<b>17.2</b>
<b>Total Regulatory capital</b>	<b>217.0</b>

### 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 subordinated debt, collective or 'general' impairment provisions held against the mortgage book and other balance sheet assets, and PIBS that have been moved from Tier 1 capital under Basel II to Tier 2 capital under Basel III.

Fixed term subordinated debt is unsecured and ranks behind the claims of all note holders, depositors, creditors and investing Members of Newcastle Building Society. Further details on subordinated debt are given in Note 24 of the Annual Report and Accounts.

Fixed term subordinated debt is amortised on a straight line basis down to £nil capital value over the final 5 years to maturity of the debt. The Society's remaining £25m (book value) subordinated debt matures on 23 December 2019. Amortisation deductions of £20.4m have subsequently been made in the above Total Regulatory Capital calculations.

### 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 Society's five year strategic plan so that strategy and capital are always in alignment and that the risks arising in pursuit of the Society's 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 2018 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 advisors (as part of the three year audit cycle as set out in the internal audit inspection plan) in order to confirm that the Society's 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-18 Group £m			31-Dec-17 Group £m		
	On Balance sheet	Risk Weighted Assets	Pillar 1 Capital @ 8%	On Balance sheet	Risk Weighted Assets	Pillar 1 Capital @ 8%
	£m	£m	£m	£m	£m	£m
Mortgage Loans Credit Risk	2,772.2	1,019.9	81.5	2,707.3	995.9	79.7
Liquidity Credit Risk	692.4	46.1	3.7	789.8	45.5	3.6
Other Assets	53.8	53.2	4.3	53.9	51.6	4.1
Hedging Instruments~	-	6.7	0.5	-	9.8	0.8
Mortgage commitments**	-	9.5	0.8	-	8.3	0.7
<b>Total Credit Risk (standardised)</b>	-	<b>1,135.4</b>	<b>90.8</b>	-	<b>1,111.1</b>	<b>88.9</b>
Operational Risk (standardised)	-	88.9	7.1	-	81.9	6.5
<b>Total Pillar 1 CRR</b>		<b>1,224.3</b>	<b>97.9</b>		<b>1,193.0</b>	<b>95.4</b>

\*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.

~Being Credit Valuation Adjustments of £2.6m and EADi adjustments of £4.1.

\*\* 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.

## Pillar 3 Disclosures

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-18 Group £m	31-Dec-17 Group £m
<b>Retail exposure</b>		
Residential Lending		74.2
	76.8	
Other Secured Lending		0.3
	0.2	
Past Due Items		0.4
	0.8	
<b>Total retail exposure</b>	<b>77.8</b>	<b>74.9</b>
<b>Commercial exposure</b>		
Commercial Lending		4.7
	3.8	
<b>Total commercial exposure</b>	<b>3.8</b>	<b>4.7</b>
<b>Liquidity and collateral exposure</b>		
Deposits with Qualifying Money Market Funds	0.1	-
Covered Bonds	0.9	1.1
Residential Mortgage Backed Securities (RMBS)	2.2	2.5
Failed institution exposures (net of provisions)	-	-
Initial Margin posted to central counterparties	0.4	-
<b>Total liquidity and collateral exposure</b>	<b>3.6</b>	<b>3.6</b>
<b>Other on balance sheet exposure</b>		
Fixed and other assets	4.3	4.1
<b>Total other on balance sheet exposure</b>	<b>4.3</b>	<b>4.1</b>
<b>Off balance sheet exposure</b>		
Mortgage commitments	0.8	0.7
Derivative CVA and EADi	0.5	0.8
<b>Total off balance sheet exposure</b>	<b>1.3</b>	<b>1.5</b>
<b>Operational Risk</b>		
Operational risk under standardised approach	7.1	6.1
<b>Total operational risk</b>	<b>7.1</b>	<b>6.1</b>
<b>Total Pillar 1 capital requirement</b>	<b>97.9</b>	<b>94.9</b>

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 2018 interest rate environment, the rate shocks for interest rate reductions communicated to ALCO have also included smaller shocks at -10bp and -20bp during 2018 with the Committee also stressing the impact of longer term interest rate changes on collateral balances.

At 31 December 2018 the Group held excess capital over and above the Pillar 1 minimum regulatory requirement of £119.1m (2017: £129.8m).

The reduction reflects continued improvement in the Group's Common Equity Tier 1 capital strength, primarily through Group profits over offset by reductions in the capital value of the Group's capital instruments: with £15.0m in capital value either repaid (£10.0m PIBS) or amortised for regulatory purposes (£5.0m subordinated debt, see section 5.4 above).

The reduction is compounded by a 'larger' balance sheet (higher risk legacy divestment has continued through 2018 but is over offset by the Group's volume of 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 Society 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 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%.

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

The Society also holds a specific PRA supervisory buffer, which is reduced by the CRDIV Buffer, where applicable, to ensure no duplication in capital requirements to cover the same risks.

The Society is required to meet at least 56% of its ICG by post-buffer Common Equity Tier 1 and has operated satisfactorily to this requirement throughout 2018. The Society 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 UK 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 Society'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	As at	As at
	31-Dec-18	31-Dec-18	31-Dec-17
	Group £m	Group £m	Group £m
<b>Mortgage assets</b>			
Residential Mortgages	2,222.2	2,297.8	2,146.5
Housing Associations	461.4	424.7	498.0
Other secured lending	4.1	3.3	4.8
Commercial Real Estate Loans	43.3	38.8	47.7
Serviced Apartments	20.4	19.6	21.1
<b>Total mortgage assets</b>	<b>2,751.2</b>	<b>2,784.2</b>	<b>2,718.1</b>
<b>Treasury</b>			
Deposits with central governments or central banks	245.3	223.7	266.8
Cash collateral pledged to derivative counterparties	213.3	200.4	226.2
Deposits with multilateral development banks	-	-	-
Deposits with Qualifying Money Market Funds	4.3	8.5	-
Corporate	-	-	-
Institutions	-	-	-
Covered bonds	127.8	117.4	138.1
RMBS	147.9	138.5	157.2
Failed institution exposures (written down value)	0.1	0.1	0.1
Cash in hand and equivalent cash items	2.6	3.8	1.4
<b>Total treasury</b>	<b>741.2</b>	<b>692.4</b>	<b>789.8</b>
<b>Total</b>	<b>3,414.4</b>	<b>3,476.6</b>	<b>3,351.9</b>

### 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 incorporates 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 Group Risk Committee and, in between reviews, the profile and profitability of mortgage completions and mortgage pipeline is reviewed in the context of 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 the riskier the loan;
- 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 pricing limits, and subject to minimum benchmarks for Return on Capital Employed (the benchmarks vary according to the risk profile of the mortgage product with higher risk requiring a higher return).

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 £73m in 2018, due to redemptions. There has been no loss experience on the portfolio since this area of business commenced and no Housing Association loans are past due or impaired.

### 7.4 Commercial Credit Risk

Commercial lending is split between lending to low risk housing associations detailed above, residential investment lending (commercial Buy to Let) and commercial investment lending (secured on commercial real estate). An analysis of loans within the commercial lending book is given in note 32 of the Annual Report and Accounts.

The Group has not undertaken new commercial lending since 2008 but the Commercial Lending and Prudential Risk departments continue to monitor the performance of the portfolios through annual reviews, and key risk management information, including borrower watchlists, arrears trends and breach reports.

The Society grants forbearance to commercial borrowers in exceptional circumstances in 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.

Generally the Society expects commercial investment loans to be repaid on maturity given the strategy of winding down the portfolio but will grant forbearance when this is also in the best interests of the Society e.g. providing the borrower with a little more time to sell the security property following a tenant renewal. Further details are given in Note 30 of the Annual Report and Accounts.

In 2018 the Society granted forbearance to two commercial loans with total balances of £0.5m. There has been no requirement identified to hold a specific provision against either of these loans.

Credit risk capital for the Society's commercial lending under Pillar 1 is determined by reference to the Standardised methodology. Risk weights of 100% are applied to lending secured on commercial real estate and risk weights of 35% or 100%, depending on LTV, are applied to residential lending. Exposures to housing associations are risk weighted at 35% or 100% depending on LTV.

The following table provides an analysis of commercial lending exposure by industry sector at 31 December for the Group:

<b>Commercial lending</b>	<b>31-Dec-18 Group £m</b>	<b>31-Dec-17 Group £m</b>
Housing Associations	424.7	498.0
Serviced apartments	19.6	21.1
<b>Loans secured on commercial real estate</b>		
Retail	17.6	21.8
Office Industrial	9.4	4.8
Industrial	8.5	16.3
Hotel/leisure	2.8	4.4
Other	0.5	0.4
<b>Total commercial lending</b>	<b>483.1</b>	<b>566.8</b>

### 7.5 Geographical Distribution

The geographical distribution of all mortgage assets at 31 December 2018 is as follows:

	31-Dec-18					Total Balances Group £m
	Residential Mortgages	Housing Associations	Other Secured Lending	Commercial Real Estate	Serviced Apartments	
	Group £m	Group £m	Group £m	Group £m	Group £m	
UK	2,279.8	424.7	3.3	38.8	19.6	2,766.2
Jersey	2.8	-	-	-	-	2.8
Gibraltar	15.2	-	-	-	-	15.2
<b>Total</b>	<b>2,297.8</b>	<b>424.7</b>	<b>3.3</b>	<b>38.8</b>	<b>19.6</b>	<b>2,784.2</b>

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-18 Exposure
Cumbria	1.5%
North East	16.1%
East Anglia	2.0%
East Midlands	6.9%
Gibraltar	0.7%
Greater London	13.1%
Jersey	0.1%
North West	9.0%
Northern Ireland	0.1%
Scotland	8.7%
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 2018:

	31-Dec-18				Total Group £m
	On demand Group £m	< 12 months Group £m	1-5 years Group £m	> 5 years Group £m	
Mortgage Assets	5.3	82.0	281.6	2,415.3	<b>2,784.2</b>

### 7.7 Treasury Credit Risk

The Group has exposures to banks, building societies, other financial institutions, sovereigns and asset backed securities in its non-trading book treasury portfolio. The Group does not operate a trading book. Exposures in the treasury portfolio are held for liquidity purposes or in the case of fair value exposures on derivatives, for hedging purposes. The Group's policy is to maintain overall 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 Society's 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 Group Risk Committee. The Society also uses market information and Credit Default Swap spreads 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.

During 2018 the Group implemented a Common Equity Tier 1 based treasury credit risk limit, formalising 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 2018 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 2018 has continued to mitigate the credit risk associated with derivative transactions. Note 32 of the 2018 Annual Report and Accounts gives further details on fair value measurement and valuation of derivatives.

## Pillar 3 Disclosures

The table below includes the Group derivative asset exposure to counterparties at 31 December 2018. 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. Financial collateral received is cash collateral that the Group has received to mitigate its year end exposure to derivative counterparties.

	Gross fair value presented in the Balance Sheet	Offsetting financial collateral (received*)/pledged not meeting the offsetting criteria of IAS32	Net Collateralised Position	Net position under Master Netting Agreements not meeting the offsetting requirements of IAS 32 (pre-collateral)
	£m	£m	£m	£m
<b>Financial assets</b>				
Interest rate swaps	3.5	-	3.5	-
<b>Financial liabilities</b>				
Interest rate swaps	(178.3)	200.3	22.0	(175.3)

The future credit exposure of the Group's derivative assets at 31 December 2018 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 EBA published its Commission Implementing Regulation (EU) 2016/1799 laying down implementing technical standards with regard to the mapping of credit risk assessments of external credit assessment institutions for credit risk in October 2016. The EBA's mapping with respect to Standard & Poor's, Fitch, and Moody's aligned with the PRA's interim mapping of ECAIs' credit assessments, as previously used by the Society for the purpose of assigning capital risk weightings (primarily to liquidity exposures to institutions).

The Group's Treasury Risk department monitors forthcoming regulatory standards pertaining to CRD IV: Liquidity 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, designed to ensure that financial institutions hold sufficient highly liquid assets on hand to weather short term liquidity disruptions, are monitored routinely by Treasury Risk.

### 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 Liquidity Coverage Ratio. At 31 December 2018 the Group held a Liquidity Coverage Ratio of 179%. This is in excess of the current minimum requirement of 100% set by regulators. This is calculated with reference to a liquidity buffer of £392.8m and net liquidity outflows of £220.6m.

The Basel Committee on Banking Supervision 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 2018 was 144%, well in excess of the expected minimum holding of 100%

## Pillar 3 Disclosures

The table below shows the Group's credit risk exposures to Treasury counterparties at 31 December 2018.

Risk Weighting (credit quality step)	S&P rating and Fitch IBCA	Moody's Rating	31-Dec-18 Group £m	31-Dec-17 Group £m
<b>Central banks and Central Governments</b>				
0%	AAA-AA-	Aaa to Aa3	223.7	266.8
<b>Cash collateral pledged to derivative counterparties</b>				
0%	Cash collateral pledged to derivative counterparties only		200.4	226.1
<b>Multilateral Development Banks</b>				
0%	AAA-AA-	Aaa	-	-
<b>Financial Institutions</b>				
20%	AAA-AA-	Aaa to Aa3	8.5	-
<b>Asset Backed Securities</b>				
20%	AAA-AA-	Aaa to Aa3	138.5	157.2
<b>Covered Bonds</b>				
10%	AAA-AA-	Aaa to Aa3	117.4	138.1
<b>Central banks: Failed institutions</b>				
Failed institutions	150%		0.1	0.1
<b>Cash in hand and equivalent cash items</b>				
0%			3.8	1.4
<b>Total</b>			<b>692.4</b>	<b>789.7</b>

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 exposure prior to credit mitigation.

At 31 December 2018 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 said entities with exposures contractually denominated in Stirling.

Treasury Exposures	31-Dec-2018 Group £m	31-Dec-2017 Group £m
UK	681.3	789.8
Europe (excluding UK)*	8.7	0.0
North America	2.3	0.0
	<b>692.4</b>	<b>789.8</b>

\*Includes £8.5m in Irish exposures with respect to the Society's subsidiary 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 2018 is as follows:

Treasury assets	31-Dec-18			Total Group £m
	< 12 months Group £m	1-5 years Group £m	5-10 years Group £m	
Central banks and Central Government*	143.8	-	79.9	223.7
Cash collateral pledged to derivative counterparties	200.4	-	-	200.4
Qualifying Money Market Funds	8.5	-	-	8.5
Multilateral Development Banks	-	-	-	-
Net Icelandic exposure	0.1	-	-	0.1
Financial institutions	-	-	-	-
Residential Mortgage Backed Securities	14.8	123.7	-	138.5
Covered Bonds	6.3	111.1	-	117.4
Cash in hand and equivalent cash items	3.8	-	-	3.1
<b>Total</b>	<b>378.5</b>	<b>234.0</b>	<b>79.9</b>	<b>692.4</b>

\*Includes UK Government Gilts at a fair value of £73.9m.

### 7.8 Impairment Provisions

The Group's policy with respect to accounting for impairment of financial assets is given in Note 1 of the 2018 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.

When assessing movement in credit risk it is the change in the risk of default occurring that is key, 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 Society 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 coupled with the Society's extensive internal expertise to facilitate a robust and compliant implementation. Best practice guidance issued by consolidated 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 Society's IFRS 9 impairment response.

For further detail of the Group's application of IFRS 9, see note 32 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 ever been undertaken.

	2018 £m	2018 %
Neither past due nor impaired	2,030.2	99.3
Past due up to 3 months but not impaired	10.8	0.5
Impaired and past due 3 to 6 months	2.0	0.1
Impaired and past due over 6 months	2.2	0.1
In possession	0.1	0
	<b>2,045.3</b>	<b>100.0</b>

#### Retail BTL mortgage book

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

	2018 £m	2018 %
Neither past due nor impaired	199.4	99.2
Past due up to 3 months but not impaired	0.9	0.5
Impaired and past due over 6 months	0.3	0.2
In Possession	0.1	0.1
	<b>200.7</b>	<b>100.0</b>

#### Specialist residential book

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

	2018 £m	2018 %
Neither past due nor impaired	42.6	88.3
Impaired and past due up to 3 to 6 months	5.6	11.7
	<b>48.2</b>	<b>100.0</b>

### Commercial lending book

The commercial lending book comprises loans secured on commercial property and loans to Housing Associations. Loans secured on serviced apartments totalling £19.6m have been excluded from the table below as they reflect only small individual loans of a retail nature. Loans to Housing Associations totalling £424.7m have been excluded from the table below as no loans to Housing Association were past due or impaired at 31 December 2018.

	2018 £m	2018 %
Neither past due nor impaired	27.0	69.7
Not past due but impaired	11.8	30.3
	<b>38.8</b>	<b>100.0</b>

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

Reconciliation table	Loss allowance at 1 January 2018 £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 2018 £000
<b>Prime residential</b>						
Stage 1	83.7	21.6	(4.2)	24.0	(76.7)	48.4
Stage 2	131.1	100.7	(7.9)	(57.5)	24.5	190.9
Stage 3	350.4	3.3	(32.7)	562.2	52.2	935.4
Total	565.2	125.6	(44.8)	528.7	-	1,174.7
<b>Buy to Let</b>						
Stage 1	0.7	0.5	(0.1)	2.0	(1.9)	1.2
Stage 2	2.7	1.0	(0.1)	(1.5)	2.0	4.1
Stage 3	0.4	-	-	(0.4)	-	-
Total	3.8	1.5	(0.2)	0.1	0.1	5.3
<b>Commercial</b>						
Stage 1	1,322.0	-	-	3.0	-	1,325.0
Stage 2	-	-	-	-	-	-
Stage 3	7,598.0	-	20.0	487.0	-	8,105.0
Total	8,920.0	-	20.0	490.0	-	9,430.0
<b>Housing Association</b>						
Stage 1	-	-	-	-	-	-
Stage 2	-	-	-	-	-	-
Stage 3	-	-	-	-	-	-
Total	-	-	-	-	-	-
<b>Serviced Apartments</b>						
Stage 1	-	-	-	-	-	-
Stage 2	-	-	-	-	-	-
Stage 3	-	-	-	-	-	-
Total	-	-	-	-	-	-
<b>Policy Loans</b>						
Stage 1	-	-	-	-	-	-
Stage 2	360.6	-	(174.9)	113.0	(298.6)	0.1
Stage 3	21.8	-	-	-	298.6	320.4
Total	382.4	-	(174.9)	113.0	-	320.5
<b>Total</b>						
Stage 1	1,406.4	22.1	(4.3)	29.0	(78.6)	1,374.6
Stage 2	494.4	101.7	(182.9)	54.0	(272.1)	195.1
Stage 3	7,970.6	3.3	(12.7)	1,048.8	350.8	9,360.8
Total	9,871.4	127.1	(199.9)	1,131.8	-	10,930.5

Against equity release mortgages not accounted for under IFRS 9 the Society holds provisions of £1.1m. For further information see Note 4 to the 2018 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. The Society has mortgage indemnity insurance in place for all new lending higher than 80% LTV, and for loans that fall outside of the standard lending policy.

#### Commercial Mortgages

Commercial property is the Group's main source of collateral and means of mitigating credit risk inherent in its commercial mortgage portfolio. Collateral for the majority of commercial loans comprises first legal charges over freehold and long leasehold property but guarantees and debentures may also be taken as security as well as cash on deposit. The Society will also seek assignment of rents from tenant covenants. Guarantees and other off-balance sheet security are not used in the calculation of Pillar 1 capital requirements therefore the exposure values before and after credit risk mitigation are identical. For property-based lending, supporting information such as professional valuations are an important tool to help determine the suitability of the security property and, in the case of investment lending, generating the cash to cover interest and repay the advance. All valuations are undertaken by members of an approved panel of external valuers with specialist experience where required. The Society has an in-house team working on the wind down of the commercial portfolio and this team is supplemented by the comprehensive use of external valuers and property experts that provide options analyses. The Society will pursue recovery of all shortfalls incurred where this is identified as being feasible and appropriate. The Society also ensures that appropriate insurance is taken out to protect security properties.

## 8. Operational Risk

Operational risk is defined on page 10.

The Society calculates the Operational Risk Capital Requirement (ORCR), for Pillar I capital, 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.

The Basel Committee on Banking Supervision is currently reviewing the adequacy of the capital requirements framework, with draft proposals to replace the previous Basic Indicator and Standardised Approach to calculating operational risk capital requirements with a new 'revised standardised approach'. See section 1.2 for further detail.

### 8.1 Capital Requirement

At 31 December 2018, the Group's ORCR equated to 12.1% of net income (12.1% in 2017). 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 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 of the Society's derivatives are designated as hedging derivatives in formal accounting hedge 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 32 of the Annual Report and Accounts gives details of the derivative financial instruments held at 31 December 2018.

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 strategy meetings to review hedging activity and assess the impact on sensitivity (both in terms of 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 and 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.

## Pillar 3 Disclosures

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 monthly the Group's interest rate risk exposure to ALCO.

The Group has established a risk appetite for 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 is shown below:

	<b>+2%</b>	<b>-2%</b>
	<b>£m</b>	<b>£m</b>
<b>At 31 December 2018</b>		
Next 12 months	<b>2.4</b>	<b>(2.4)</b>
Next 2 years	<b>3.3</b>	<b>(3.3)</b>
Next 3 years	<b>5.5</b>	<b>(5.5)</b>

Details of the derivatives used to manage associated 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 2018 are given in note 32 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 £0.2m at 31 December 2018.

## 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 on pages 30 to 34 of the 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 Society's Remuneration Policy.

The Society's Remuneration Report and Policy was last voted on in April 2018. Member approval was given to the 31 December 2017 Directors' Remuneration Report (90.48% approval with 14,298 votes for, 1,504 against and 300 withheld). Member approval was given similarly to the Directors' Remuneration Policy (89.83% approval with 14,175 votes for, 1,605 against and 323 withheld).

At the 2019 AGM there will be separate votes on the Remuneration and Remuneration Policy (which will both be on an advisory basis.) We will take the views of our members seriously, as expressed through the advisory votes, and will consider the results carefully to determine what action, if any, is appropriate.

### 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		Number	*Fixed Remuneration	Variable Remuneration Note 1	Total Remuneration
				£000	£000	£000
Executive Directors	CEO,	2018	4	775	19	794
	Finance Director & Deputy CEO, Strategy Planning & Risk Director Customer Director	2017	4	781	19	800
Other Directors	HR Director,	2018	4	484	9	493
	MD NSML, MD NSSL, Chief Finance Officer (Note 2)	2017	3	290	9	299
Control Functions	Compliance,	2018	7	436	16	452
	Underwriting, Internal Audit, Customer Outcomes, Treasury Balance Sheet Management	2017	7	476	14	490
Total		2018	15	1,695	44	1,739
		2017	14	1,547	42	1,589

**Notes:**

Note 1: Variable remuneration reflects participation in the Group's annual Corporate Bonus Scheme.

Note 2: David Samper joined the Society in November 2018 and was appointed to the Board as the Group's Chief Financial Officer on 20 December 2018. Prior to his Board appointment David was considered to be part of the Group's Code Staff with his remuneration included within the other directors sub category above. This category also includes remuneration paid to the Society's Interim Finance Director during 2018.

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 2018 and consists solely of Non-Executive directors. The Chairman of the Committee is John Morris, the other members are David Buffham, 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 Society'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 senior managers to continue to run the Society successfully. The Society's Remuneration Policy, therefore, focuses on rewarding our 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 Society of the calibre necessary to oversee the operations of the Society. Basic salaries are normally set by taking into account salary levels within similar sized financial services organisations and the market as a whole, so as to attract and retain the skill levels that are appropriate to operate an organisation of the Society's complexity.

A 2.5% pay increase was received by all colleagues in April 2018.

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 Society'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

#### Performance Related Bonuses

In recognition of the continued progress and achievements of the Society's 2018 corporate key performance indicators (KPI's), the Remuneration Committee approved a bonus payment under the Society's Corporate Bonus Scheme at the end of 2018. The payment is to be made to all eligible staff. 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 through the Group's annual appraisal process determines where in the eligible range individuals fall. The majority of staff received a 4% bonus with a small portion receiving an enhanced bonus payment of 8%. A small number of colleagues did not qualify for a bonus payment. Variable remuneration is limited to discretionary participation in the Society's Corporate Bonus Scheme and none of the Society's staff or Non-Executive

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Directors hold any interest in Shares or Options relating to the Group's subsidiary companies. There is a requirement under Para 14 of the Society's Rules 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.

No formal approved ratio between fixed and variable remuneration is currently applicable to the Society's Code staff.

The KPI's underpinning the 2018 Corporate Bonus Scheme include:

- Financial performance covering Group profitability, capital, liquidity and credit risk;
- Solutions business performance including complying with contract service level agreements;
- Staff satisfaction and staff turnover;
- Customer satisfaction and providing excellent service; and
- Management, within risk appetite, of the Group's top 10 risks.

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.

Sales related incentive and bonus schemes were removed from the Society's business in January 2013, with the exception of those staff employed by the Society's subsidiary company 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 outwith the Society's agreed risk appetite. The Remuneration Committee has monitored the operation of these bonus schemes throughout 2018 to ensure compliance with the Code and the Society's remuneration policy statement.

For further information around the Group's management body including qualifications and experience, directorships held, recruitment and diversity policies, and committee representation, please refer to the 2018 Annual Report and Accounts available at <https://www.newcastle.co.uk/about-us/media-centre/financial-results/>.

During 2018 the Remuneration Committee considered proposals for the introduction of a new Executive Bonus Scheme effective from January 2019. For further details see the Remuneration Committee Report in the 2018 Annual Report and Accounts.

### 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. Against the Group’s derivative liabilities cash collateral is pledged to the underlying counterparties 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 Society’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 2018 (2017: £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 2018 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	
		010	of which: issued by other entities of the group	of which: central bank's eligible	040	of which: central bank's eligible	060	of which: issued by other entities of the group	of which: central bank's eligible	090	of which: central bank's eligible
			020	030		050		070	080		100
<b>10</b>	<b>Assets of the reporting institution</b>	<b>818.4</b>		<b>612.1</b>			<b>2,879.3</b>		<b>439.4</b>		
20	Loans on demand	5.9					152.4		143.8		
30	Equity instruments										
40	Debt securities	0.0		0.0	0.0	0.0	329.0		295.6	329.0	257.5
50	of which: covered bonds						117.3		117.3	117.3	79.3
60	of which: asset-backed securities	0.0		0.0	0.0	0.0	138.4		105.0	138.4	105.0
70	of which: issued by general governments						73.2		73.2	73.2	73.2
80	of which: issued by financial corporations						0.0			0.0	
90	of which: issued by non-financial corporations						0.0			0.0	
100	Loans and advances other than loans on demand	612.1		612.1			2,160.1		0.0		
110	of which: mortgage loans	612.1		612.1			2,160.1		0.0		
120	Other assets	200.3					237.8				

\*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 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):

<b>F 32.04 - SOURCES OF ENCUMBRANCE (AE-SOU)</b>						
		Matching liabilities, contingent liabilities or securities lent		Assets, collateral received and own debt securities issued other than covered bonds and ABSs encumbered		
		010	of which: from other entities of the group	030	of which: collateral received re-used	of which: own debt securities encumbered
			020		040	050
<b>10</b>	<b>Carrying amount of selected financial liabilities</b>	<b>381.0</b>		<b>812.5</b>		
20	Derivatives			200.3		
30	of which: Over-The-Counter					
40	Deposits	381.0		612.1		
50	Repurchase agreements	381.0		612.1		
60	of which: central banks	381.0		612.1		
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					
<b>120</b>	<b>Other sources of encumbrance</b>	<b>0.0</b>		<b>5.9</b>		
130	Nominal of loan commitments received					
140	Nominal of financial guarantees received					
150	Fair value of securities borrowed with non cash-collateral					
160	Other			5.9		
<b>170</b>	<b>TOTAL SOURCES OF ENCUMBRANCE</b>	<b>381.0</b>		<b>818.4</b>		

Encumbrance % at 31 December 2018: 22.1%

## 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 Society considers its leverage risk appetite 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 2018 capital position under Basel III reporting including the existing transitional position and the end point position. The impact of Basel III on the Society is mainly in relation to Permanent Interest Bearing Shares (PIBS) which move from tier 1 to tier 2 capital over a transitional period. The un-wind of the Society's subordinated debt under Basel III is similar to the position under Basel II. Other changes that have impacted the Society 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 available for sale reserve in capital.

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

The Society 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 Society limits its risk of excessive leverage through off-balance sheet holdings.

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Leverage ratio – Group (Point in time at 31 December)	31-Dec-18		31-Dec-17	
	Transitional Basel III £m	End point Basel III £m	Transitional Basel III £m	End point Basel III £m
Common Equity Tier 1 capital (1)	191.8	191.8	182.5	182.5
Additional Tier 1 capital	8.0	-	15.0	0
Total Tier 1 capital	199.8	191.8	197.5	182.5
Additional Tier 2 capital (2)	17.2	20.6	27.7	33.2
Total capital	217.0	212.4	225.2	215.7
Total assets	3,518.4	3,518.4	3,551.0	3551
Off balance sheet commitments	26.6	26.6	22.7	22.7
Potential future exposure (current exposure method, applying netting rules) – Derivatives	4.1	4.1	4.4	4.4
Fair value adjustments (3)	179.4	179.4	210.1	210.1
Total exposures	3,728.47	3,728.47	3,788.20	3,788.20
<b>Leverage ratio (Tier 1 capital/ total exposures)</b>	<b>5.4%</b>	<b>5.1%</b>	<b>5.2%</b>	<b>4.7%</b>
<b>Capital ratios</b>				
Total RWAs	1,224.30	1,224.30	1,193.00	1,193.00
<b>Common Equity Tier 1 capital ratio</b>	<b>15.7%</b>	<b>15.7%</b>	<b>15.3%</b>	<b>15.3%</b>
<b>Tier 1 capital ratio</b>	<b>16.3%</b>	<b>15.7%</b>	<b>16.6%</b>	<b>15.3%</b>
<b>Solvency ratio</b>	<b>17.7%</b>	<b>17.3%</b>	<b>18.9%</b>	<b>18.1%</b>

1. Deferred tax assets in respect of trading losses are expected to be zero at the Basel III end point. Also profits in respect of future periods are not included in this figure – therefore the end point Basel III leverage ratio is expected to be higher than the figure disclosed above.
2. The above includes full amortisation of the subordinated debt over the Basel III transitional period but does not factor in accumulated Group profits over a similar period or other capital transactions that could be undertaken. It presents an end point Basel III position using the 31 December 2018 Group balance sheet only assuming no movement in reserves or other capital tier 1 and 2 items.
3. Total assets above reflect the group's total assets per the 2018 report and accounts excluding fair value adjustments for hedged risk and the fair value of derivative assets held on the balance sheet.

The Group's leverage ratio, calculated as the simple arithmetic mean of the monthly leverage ratio over a quarter, sits at 5.5% for the quarter to December 2018 under the Basel III transitional basis and at 5.2% under the fully loaded Basel III end point. The December 2018 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)		Subordinated Debt
1	Issuer	Newcastle Building Society	Newcastle Building Society	Newcastle Building Society
2	Unique identifier (e.g. CUSIP, ISIN, or Bloomberg identifier for private placement)	GB0006361371	GB0006371529	XS0178286901
3	Governing law(s) of the instrument	English	English	English
<b>Regulatory treatment</b>				
4	Transitional Basel III rules (1)	Additional Tier 1 / Tier 2	Additional Tier 1 / Tier 2	Tier 2
5	Post-transitional Basel III rules (2)	Tier 2	Tier 2	Tier 2
6	Eligible at solo/group/group & solo (3)	Group	Group	Group
7	Instrument type (types to be specified by each jurisdiction)	PIBS	PIBS	Subordinated Debt
8	Amount recognised in regulatory capital (Currency in millions, at of most recent reporting date)	10	10	4.6
9	Par value of instrument	10	10	25
9a	Issue price	100.32%	100.45%	99.87%
10	Accounting classification	Liability - amortised cost	Liability - amortised cost	Liability - amortised cost
11	Original date of issuance	22-Jun-93	15-Sep-92	31-Oct-03
12	Perpetual or dated	Perpetual	Perpetual	Dated
13	Original maturity date	No maturity	No maturity	23-Dec-19
14	Issuer call subject to prior supervisory approval	No	No	Yes
15	Optional call date, contingent call dates and redemption amount	No issuer call	No issuer call	Issuer call date 23 December 2014 (par)
16	Subsequent call dates, if applicable	n/a	n/a	n/a
Coupons/dividends				
17	Fixed or floating dividend/coupon	Fixed	Fixed	Fixed
18	Coupon rate and any related index	10.75%	12.63%	3.85%
19	Existence of a dividend stopper (4)	Yes (5)	Yes (5)	No
20	Fully discretionary, partially discretionary or mandatory	Partially discretionary	Partially discretionary	Mandatory
21	Existence of a step up or other incentive to redeem	No	No	Yes (6)
22	Noncumulative or cumulative	Noncumulative	Noncumulative	Noncumulative
23	Convertible or non-convertible (7)	Nonconvertible	Nonconvertible	Nonconvertible

24	If convertible, conversion trigger(s)	n/a	n/a	n/a
25	If convertible, fully or partially	n/a	n/a	n/a
26	If convertible, conversion rate	n/a	n/a	n/a
27	If convertible, mandatory or optional conversion	n/a	n/a	n/a
28	If convertible, specify instrument type convertible into	n/a	n/a	n/a
29	If convertible, specify issuer of instrument it converts into	n/a	n/a	n/a
30	Write-down feature	None contractual, statutory via bail-in	None contractual, statutory via bail-in	None contractual, statutory via bail-in
31	If write-down, write-down trigger(s)	n/a	n/a	n/a
32	If write-down, full or partial	n/a	n/a	n/a
33	If write-down, permanent or temporary	n/a	n/a	n/a
34	If temporary write-down, description of write-up mechanism	n/a	n/a	n/a
35	Position in subordination hierarchy in liquidation (specify instrument type immediately senior to instrument)	Subordinated debt	Subordinated debt	Senior unsecured (8)
36	Non-compliant transitioned features	No	No	Yes
37	If yes, specify non-compliant features	n/a	n/a	Step-up reset rate

(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 capital values of the Society's subordinated debt issue is amortising straight line to nil over its remaining 5 years to maturity/call date.

(3) The Newcastle Building Society accounting and regulatory groups are the same.

(4) 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.

(5) 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.

(6) The Society's 2019 subordinated debt reached its optional reset date in 2014.

(7) On 10 May 2010 the Society announced that a Capital Agreement (the Agreement) had been approved by holders of certain classes of the Society's existing subordinated debt and permanent interest bearing shares. The Agreement involved adding a conversion feature such that the relevant instruments would convert into profit participating deferred shares (PPDS) should the Society's core tier 1 capital ratio fall below 5%. In return for this feature an increase in coupon was agreed for each instrument. The Agreement further contained an upper trigger point for core tier I ratio whereby relevant instruments would cease to be convertible and the coupon uplift would fall away if the Society's ratio exceeded 12%. In August 2014 the Society announced that it had exceeded the 12% Ceiling Trigger set out in the Capital Agreement. In accordance with the Agreement the instruments are no longer convertible and the coupon uplift has been removed, in addition the remaining unamortised capital exchange costs totalling £0.5m have been written off.

(8) On a winding up, the subordinated notes rank behind the claims against the Society of all depositors, creditors and investing Members (other than holders of deferred shares i.e. PIBS) of the Society.

### 14. IFRS 9 transitional adjustments

#### 14.1 IFRS 9 election

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 Society elected to adopt the transitional provisions and is required to report certain capital information under both a transitional and a fully loaded IFRS 9 basis as part of its Pillar 3 disclosures.

The Society's 1 January 2018 implementation of the provisioning requirements of IFRS 9 did not coincide with any significant increase to its balance sheet provisions with the Society's legacy mortgage book already well provisioned against anticipated risk of loss at 31 December 2017. A sundry Common Equity Tier 1 capital add back of c. £6,000 is included throughout these Pillar 3 workings to reflect the beneficial impact of the IFRS 9 transitional adjustments to the 'day 1' impact of the Society's application of IFRS 9.

Through 2018, the Society's provision requirements, as informed by its provisioning models, have remained relatively static. Provisions held against non-defaulted loans on a macro basis have decreased slightly, leading to a £nil IFRS 9 transitional adjustment to the Society's Common Equity Tier 1 capital for provision movements during the year.

The following table is provided to satisfy the EBA's guidelines on uniform disclosures under article 473a of Regulation (EU) No 575/2013 as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds. While the 2018 application of transitional provisions has had no notable impact, the table will, across the transitional period, provide information allowing meaningful analysis of the Group's rolling transitional adjustments.

		31-Dec-18
		Group £m
Available capital amounts		
1	Common Equity Tier 1 (CET1) capital	191.8
2	Common Equity Tier 1 (CET1) capital as if IFRS 9 or analogous ECLs transitional arrangements had not been applied	191.8
3	Tier 1 capital	199.8
4	Tier 1 capital as if IFRS 9 or analogous ECLs transitional arrangements had not been applied	199.8
5	Total capital	217.0
6	Total capital as if IFRS 9 or analogous ECLs transitional arrangements had not been applied	217.0
Risk weighted assets (amounts)		
7	Total risk-weighted assets	1,244.3
8	Total risk-weighted assets as if IFRS 9 or analogous ECLs transitional arrangements had not been applied	1,244.3
Capital ratios		
9	Common Equity Tier 1 (as a percentage of risk exposure amount)	15.7%

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10	Common Equity Tier 1 (as a percentage of risk exposure amount) as if IFRS 9 or analogous ECLs transitional arrangements had not been applied	15.7%
11	Tier 1 (as a percentage of risk exposure amount)	16.3%
12	Tier 1 (as a percentage of risk exposure amount) as if IFRS 9 or analogous ECLs transitional arrangements had not been applied	16.3%
13	Total capital (as a percentage of risk exposure amount)	17.7%
14	Total capital (as a percentage of risk exposure amount) as if IFRS 9 or analogous ECLs transitional arrangements had not been applied	17.7%
	Leverage ratio	
15	Leverage ratio total exposure measure	3,728.5
16	Leverage ratio	5.4%
17	Leverage ratio as if IFRS 9 or analogous ECLs transitional arrangements had not been applied	5.4%

### 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 for the Society is the accumulation of retained profits at 31 December 2018. 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 Newcastle Building 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 process.

**Risk Weighted Assets (RWA)** – The value of assets, after adjustment, under Basel III rules to reflect the degree of risk they represent. The Society 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 Society has no material exposure to wrong way risk as at 31 December 2018.