Pillar 3 Disclosures
31 December 2013

Approved by the Board: 23 April 2014

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1. Overview

1.1 Background

The European Union Capital Requirements Directive (CRD), commonly referred to as Basel II (named after the Basel Committee on Banking Supervision), was introduced on 1 January 2007. Implementation of the CRD in the UK was by way of rules introduced by the Financial Services Authority (the FSA) in the FSA Handbook. From 1 April 2013 the FSA has been split between the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) and the PRA and FCA sourcebooks now offer the current basis of and technical criteria on disclosure.

Among the Basel II requirements are disclosure requirements for banks and building societies operating under the revised capital adequacy framework which are known as Pillar 3 and are designed to promote market discipline by providing market participants with key information on a firm's risk exposures and risk management processes. The disclosure requirements aim to complement the minimum capital requirements described under Pillar 1 as well as the supervisory review process of Pillar 2.

Basel III, in the form of the new Capital Requirements Directive and Regulation ("CRD IV") came into force on 1 January 2014, including a number of transitional provisions. For detail of the impact the revised Basel III requirements have had on the Society and Group see section 10 on page 35.

1.2 Policy

This document has been prepared in accordance with the requirements set out in BIPRU 11: Disclosure (Pillar 3) of the FCA and PRA Handbook.

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 2013 and based on the most recently published Annual Report and Accounts.

This report will be prepared on an annual basis and will be published on the Newcastle Building Society website (www.newcastle.co.uk), as soon as is practicable after 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 23 April 2014.

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 Services Limited
- Newcastle Mortgage Loans (Jersey) Limited
- Newcastle Portland House Limited
- Kings Manor Properties Limited
- Newcastle Strategic Solutions Limited
- Newton Facilities Management Limited

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

For prudential and Pillar 3 reporting purposes, the Society solo consolidated Newcastle Mortgage Loans (Jersey) Limited at 31 December 2013. 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 16 of the Group's audited Annual Report and Accounts.

3. Risk Management

3.1 Background

The Society's Group Risk Committee oversees the management of risk across the Group and is supported by the Group Risk Department and various sub-committees.

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 Group Risk Committee and supporting sub-committees together with oversight by the Group Risk Department.

- The third line of defence is provided by Business Assurance 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 setting out how risk is managed across the Group, including specific risk appetite statements. The risk appetite statement outlines for each 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 29 to 31 of the Annual Report and Accounts.

3.2 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. Credit risk arises primarily on retail and commercial loans, and on treasury assets held for liquidity purposes. 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.

For retail lending the Group operates manual underwriting procedures to prudent policy criteria, including restrictions on loan to value, income multiples and affordability criteria. The Group does not undertake sub-prime or self-certification lending.

The Commercial Risk department continues to monitor the performance of the commercial and residential investment portfolios through annual reviews and key risk management information, including tenant and borrower watchlists, arrears trends, breach reports and general market and sector specific information. The Society has a number of committees established to oversee risk within the commercial portfolio including Commercial Credit Committee, Risk and Recovery Committee (a sub-committee of the Commercial Credit Committee with a remit to approve breach

reports and annual reviews for loans within a defined mandate), Watch Committee (an operational committee with a remit for recommending the strategy for loans in the commercial portfolio) and the Provisioning Committee (a committee with a remit to consider recommendations in relation to provisions for commercial loans).

A collections team operates, which has a more targeted approach to collections and recovery for commercial and Buy to Let (“BTL”) portfolio borrowers, featuring a rapid response where difficulties are identified such as late payments, tenant failure, ratings downgrades and general negative market news.

The Society has a Credit Risk Management Information department that monitors and reports credit risk within the mortgage portfolio, including stress testing.

Credit risk on liquid assets is controlled via the operation of 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. The Society supplements ratings agency information with more extensive credit assessment procedures for counterparty limits including market information and movement on credit default swap (CDS) spreads for countries and individual counterparties. Treasury counterparty risk is monitored within Treasury Middle Office in accordance with the treasury policy. All treasury counterparty ratings, CDS spreads and market information are monitored in real time and prompt action is taken where volatile market conditions require a tightening of criteria. Additionally, the Society has made use of the London Clearing House (LCH) throughout 2013, with the LCH acting as a central counterparty to treasury deals originally undertaken with institutional counterparties. 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.

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 balanced. The Society has continued to invest in liquidity of the highest quality and further details are provided within the Strategic Report on page 10. The Society has complied with the Individual Liquidity Guidance issued by the PRA throughout 2013.

Conduct Risk

Conduct risk is the risk of poor consumer outcomes, resulting from poorly designed or targeted products, miss-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 was monitored by the Executive on a monthly basis in 2013 (see below for details of change subsequent to the year-end) and by the Group Risk Committee on a quarterly basis. The Group has a Product Approval Committee which approves all products. Included in the terms of

reference for the Product Approval Committee is consideration of risks to consumer outcomes arising from products or services.

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.

Operational risk was overseen by the Executive Committee throughout 2013. A newly established Conduct and Operational Risk Committee has overseen operational and conduct risk from February 2014 (the Executive Committee retains ownership, as the first line of defence, for operational and conduct risk). The Group Risk Committee also monitors operational and conduct risk on a quarterly basis.

The Group has an established operational risk framework with an Operational Risk Policy that sets out the framework for operational risk, including 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 Business Assurance 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.

Market Risk
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 8. The Group has no exposure to foreign currency and only a very moderate 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 2013 these holdings were held on the balance sheet at £0.3m, 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.

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 a geographic concentration within the North East of England of less than a quarter of its residential mortgage book, reflecting the largest geographic concentration of mortgages held within a single region.

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. The Group Risk Committee 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. The Group Risk Committee is satisfied at 31 December 2013 that no exposure in any one risk concentration exceeds the Society's risk appetite.

Pension 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 management, regularly review reports prepared by the Scheme's independent actuary 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 ICAAP.

The Society accounted for its defined benefits pension scheme in 2013 in line with International Accounting Standard ("IAS") 19R, a revision to the previous IAS 19 covering employee benefits. Key assumptions made in calculating the year end obligation include assumed future discount, RPI, CPI and mortality rates. For further detail see Note 31 to the Annual Report and Accounts 2013.

Solutions Business Risk

The Society's business model includes diversification via the Newcastle Strategic Solutions business. This increases the exposure to operational risk, particularly in relation to IT systems capability and human error.

The Society established the Newcastle Strategic Solutions business in 1997, whereby the Society provides outsourced services, such as internet banking, IT services, and 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 Unit, Technical Departments and dedicated relationship and service managers. A separate Newcastle Strategic Solutions Board exists to oversee third party contract risks, financial performance and operational matters.

The Prepaid Cards Division of the Solutions business was sold in December 2011. Further details are given in Note 10 on page 46 of the Annual Report and Accounts.

Deferred taxation

Changes to the Group's calculation of Tier 1 Capital as a result of the implementation of Basel III reporting requirements will contain 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 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 Audit Committee has assessed the deferred taxation position as at 31 December 2013 and is satisfied that the amount will be recovered through forecast future Group profits.

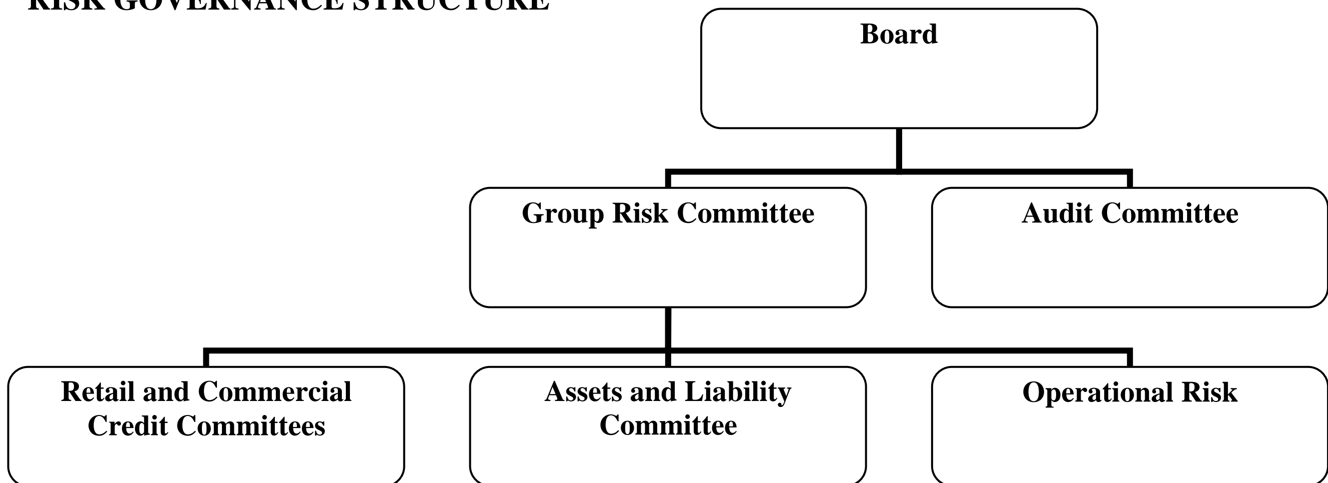
See section 10 for details of the impact of Basel III on the Group capital position.

3.3 Risk Governance

The Society has a well developed risk and compliance structure with the Credit Risk, Treasury Risk and Operational Risk functions supported by separate Compliance, Business Assurance and Financial Crime Units. The Society has extensive policies and procedures covering financial risk, credit risk 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



The Group Risk Committee is a Board Committee that has responsibility, under its detailed terms of reference, for considering and co-ordinating the approach to risk management across the Group in the following key areas:

- Oversight of overall risk appetite, risk management strategy and framework, including oversight of both prudential and conduct risk appetites;
- Oversight of compliance with risk policy statements and approval of changes to those policies on an annual basis, or more frequently where market conditions require;
- Oversight of the Retail and Commercial Credit Committees, and of the Asset and Liability Committee;
- Oversight of Operational Risk and the governance of Operational Risk by the Executive and the newly established Conduct and Operational Risk Committee;
- Review and assessment of the adequacy of risk management information to monitor and control risks;
- Approval of new initiatives and projects, including the risks those initiatives and projects expose the Group to and the amount of capital required to cover those risks;
- Consideration and approval of the top risks for the Society and Group including low likelihood, high impact risks;
- Approval and recommendation to the Board of both the Internal Capital Adequacy Assessment Process (ICAAP) and the Individual Liquidity Adequacy Assessment (ILAA); and
- Consideration and approval of stress testing scenarios including reverse stress tests.

The Group Risk Committee normally meets six times a year and is supported by four Executive committees that meet on a monthly basis, as follows:

The Retail Credit Committee is responsible for credit risk across the Group arising from the retail mortgage portfolio as follows:

- Review of lending policy statements and compliance therewith;
- Review of risk metrics and management information for the retail mortgage portfolio;
- Review and approval of arrears and possessions policy (including breach policies) and compliance therewith;
- Sanction of larger loans in accordance with the lending policy statement;
- Review and approval of new types of mortgage products including ensuring return on capital employed meets internal benchmarks and that risks have been effectively considered and mitigated;
- Performance review of underwriters, panel managers and brokers;
- Review of credit risk profile of existing retail mortgage book including trends on arrears (both historical and against the market), losses and capital requirements;
- Review of key economic data impacting credit risk including trends on unemployment, house prices, arrears rates, affordability, inflation and confidence indices;
- Review of credit control activity levels including customer contact volumes, forbearance measures granted, disturbed payment patterns and changes in behavioural scoring. This includes reviewing the effectiveness of forbearance measures granted to customers;
- Review and approval of stress testing assumptions and outputs including monitoring of trends;
- Review of arrears and possessions reports including causal
- factors and lessons learned; and
- Review of Mortgage Indemnity Guarantee (MIG) policy arrangements.

The Commercial Credit Committee is responsible for credit risk across the Group’s non-retail mortgage portfolio as follows:

- Review of non-retail policies and compliance therewith;
- Review of risk metrics and management information for the non-retail mortgage portfolio;
- Monitor compliance with controls and limits set out in the policies;
- Review of credit risk profile of existing mortgage book including trends on arrears, losses and capital requirements;
- Review of key performance indicators in relation to the delivery of the commercial strategy;
- Review of risk indicators and risk factors. This includes review of tenant and borrower watch-lists and sector specific reports;
- Approval of annual reviews, breach reports, loan renegotiations and restructures, in accordance with the delegation of authorities;
- Review and approval of stress testing assumptions and outputs including monitoring of trends;
- Review of key trends in commercial property markets including values, yields and levels of activity; and
- Approval of changes to the Risk Grade Scorecard and monitoring the effectiveness thereof.

Operational Risk has been overseen by the Executive Committee (see below) until February 2014, and thereafter by a Conduct and Operational Risk Committee (CORC). Its remit includes:

- Review of operational risk policy and other related risk and compliance policy statements;
- Monitoring compliance with policies;

- Review of risk indicators in risk dashboards including risk event trends across the business, actions being taken on significant risk events, and status of project risks;
- Review of conduct risk indicators, via monthly dashboards, including in relation to Compliance monitoring, Mortgage Conduct of Business (MCOB), Treating Customers Fairly, Complaints, Information Security and Fraud monitoring;
- Approval of corporate insurance policy statement, status of claims and effectiveness of policies at mitigating operational risk; and
- Review of business continuity policy, disaster scenarios and results of annual disaster recovery test.

The Asset and Liability Committee (ALCO) is responsible for all aspects of treasury risk management including liquidity risk, interest rate risk, treasury counterparty credit risk and balance sheet management. The ALCO terms of reference cover the following areas:

- Review of Treasury Policy and compliance therewith;
- Review of treasury dealing strategy and compliance with risk appetite statement;
- Management of balance sheet assets and liabilities;
- Review of risk dashboards covering all aspects of treasury, liquidity, funding and interest rate risk, including basis risk;
- Setting of interest rate view;
- Review of wider treasury markets and economic backdrop to assess the impact on the Society's funding and liquidity requirements;
- Detailed review and agreement of cashflow requirements across the business on a rolling 24 month basis;
- Monitoring of interest rate risk and hedging activity, including profit performance;
- Review of treasury counterparty limits and country limits including assessing the impact of ratings changes;
- Review of funding including sources, mix and compliance with limits;
- Review of contingency funding plans;
- Review of liquidity requirements and compliance with limits;
- Review and approval of results of liquidity stress testing scenarios; and
- Review and approval of product pricing including rate changes, mix of new business and maturity defence strategy.

3.4 Other Governance

Full details of the Society's corporate governance arrangements are given on pages 21 to 24 of the Annual Report and Accounts.

The Board

The Board is responsible for agreeing the overall strategy for the Society, 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 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 21 to 24 of the Annual Report and Accounts.

In addition to the Group Risk Committee and sub-committees detailed above, the Board has four other committees which are noted below.

Remuneration Committee
This 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 27 and 28 of the Annual Report and Accounts. In addition, section 9 of this report sets out the remuneration disclosures as required under BIPRU 11.5.18 which have been approved by the Remuneration Committee.

Nominations Committee
This Committee advises on the structure of the Board including succession planning, on nominations to it and the re-election of Board members retiring by rotation.

Newcastle Strategic Solutions (NSSL)
NSSL oversees all aspects of the Solutions 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.

Audit Committee
This 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, Internal Audit 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 financial control: The Audit Committee works closely with the Group Risk Committee to ensure that management and staff take appropriate responsibility for business 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 Business Assurance Department and reflects the Audit Committee's primary available resource. The Committee retains the authority to obtain outside legal or independent professional advice as it sees fit.

The Committee approves and reviews the Internal Audit work programme and results and ensures the Internal Audit Department maintains sufficient access to the Board, management and the books and records of the Society. 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 and ensure appropriate management responsiveness to audit findings and recommendations given.

External audit: The Audit Committee oversees the Group's relationship with the external auditors, including appointment, reappointment, 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.

Further details on the work of the Audit Committee are given in the Audit Committee Report included on pages 25 and 26 of the Annual Report and Accounts.

3.5 Risk Appetite

The Board approved risk appetite statements consider profit and loss in a moderate stress scenario; capital adequacy in a severe stress; and the existence of tail risks – low likelihood, high impact risks. They also consider measures relating to the fair treatment of customers and conduct risk. They set out limits and escalation triggers in relation to liquidity, Solutions business, credit risk, operational risk, compliance monitoring, and complaints. Policies, including credit risk policies, treasury policies and operational risk policies, and the Retail Conduct Risk Appetite statements, set limits to ensure that the Society complies with its Board approved risk appetite statements.

The risk appetite statements are subject to annual review and approval by the Board and performance against the risk appetites is monitored on a quarterly basis by the Board.

The Group acknowledges that the risk appetites across the business may change depending on the economic cycle and market conditions. The overall risk appetite in terms of capital and profit put at risk will remain the same but as an adverse cycle approaches the detailed risk appetites will be adapted to achieve the overall risk appetite objectives.

4. Capital Resources

The Society and Group has operated within the Individual Capital Guidance (ICG) issued by the PRA throughout 2013.

4.1 Total Capital Available

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

	Group £m 2013	Group £m 2012
Tier 1 capital		
Core Tier 1 capital	167.1	165.6
Permanent Interest Bearing Shares	29.7	29.7
Total Tier 1 capital	**196.8**	**195.3**
Tier 2 capital		
Collective Impairment allowance	6.1	6.2
Subordinated debt	46.2	53.0
Total Tier 2 capital	**52.3**	**59.2**
Total Capital Available	**249.1**	**254.5**

The TCA of the Society on a solo consolidation basis is not materially different to that on a Group basis so only Group figures have been disclosed.

4.2 Tier 1 Capital

Tier 1 capital comprises profit and loss reserves being the accumulation of retained profits, and permanent interest bearing shares (PIBS). Profit and loss reserves constitute the Group's Core Tier 1 capital, the key measure of focus under new capital regulations (see section 10). 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 28 of the Annual Report and Accounts.

4.3 Tier 2 Capital

Tier 2 capital comprises subordinated debt and collective impairment provisions against the mortgage book.

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 27 of the Annual Report and Accounts.

Fixed term subordinated debt is amortised over the remaining 5 year life of the issue for capital reporting purposes and held at carrying value in the financial report and accounts. Amortisation deductions of £12.8m have been made in the above TCA calculations.

Under PRA Rules, qualifying subordinated notes cannot exceed 50% of the total of Tier 1 capital, and Tier 2 capital cannot exceed Tier 1 capital.

4.4 Capital Exchange

In May 2010, the Society announced that it had reached an agreement with holders of certain classes of the Society's existing subordinated debt and permanent interest bearing shares leading to a material strengthening of the Society's capital position (the Capital Agreement).

As a result of the Capital Agreement, in addition to the £167.1 million of core tier 1 capital disclosed above at 31 December 2013, the Society also has £45 million of contingent core tier 1 capital. The Capital Agreement has therefore strengthened the Society's capital position, providing 3.2% of contingent core tier 1 capital in addition to the existing 11.9% core tier 1 capital ratio as at 31 December 2013. Further details are given in Note 27 of the Annual Report and Accounts.

4.5 Capital Impact of Basel III

Basel III is part of the continuous effort made by the Basel Committee on Banking Supervision to enhance the banking regulatory framework. The Basel III text was released in December 2010 with the first wave of rules and guidance becoming effective from 1 January 2014. It seeks to improve the banking sector's ability to deal with financial and economic stress, improve risk management and strengthen transparency. A focus of Basel III is to improve resilience at the individual organisation level in order to reduce the risk of system wide shocks.

These rules are in the process of being implemented in the UK by the issue of policy statements for inclusion in the PRA and FCA Handbook.

See section 10 for details of the impact of Basel III capital requirements on the Group.

5. 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.

5.1 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 three 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 process is presented to and approved by the Board via the Group Risk Committee. The last ICAAP was prepared as at 31 December 2013 and was approved by the Group Risk Committee in April 2014. These disclosures include extracts from ICAAP and are based on the final financial results of the Society and Group contained in the 2013 Annual Report and Accounts.

The ICAAP covers all material risks to determine the capital requirement over a three-year 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 Society and Group ICAAP is subject to regular review by Internal Audit and external advisors 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 Society's ICAAP is subject to the Supervisory Review and Evaluation Process by the PRA.

5.2 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:

Group Pillar 1	**2013**		2012	
	Risk Weighted Assets	**Capital @ 8%**	Risk Weighted Assets	Capital @ 8%
	£m	**£m**	£m	£m
Mortgage Loans Credit Risk	1,198.1	95.9	1,271.4	101.7
Liquidity Credit Risk	71.2	5.7	141.2	10.6
Other Assets	44.1	3.5	58.9	4.7
Hedging Instruments	8.6	0.7	11.2	0.9
Mortgage commitments	6.5	0.5	5.3	0.4
Total Credit Risk (standardised)	1,328.5	106.3	1,488.0	118.3
Operational Risk (standardised)	71.4	5.7	66.5	5.3
Total Pillar 1 CRR	**1,399.9**	**112.0**	1,554.5	123.6

Risk weighted assets and capital are analysed at 31 December by exposure class as defined in chapter 3 BIPRU as follows:

Exposure Class	Capital @ 8%	
	2013	2012
	£m	£m
Retail Exposures		
Residential Lending	71.5	73.5
Other Secured Lending	1.6	1.2
Past Due Items	1.0	2.5
Commercial Exposures		
Commercial Lending	21.8	24.5
Other Exposure Classes		
Deposits with central governments or central banks	-	-
Deposits with multilateral development banks	-	-
Financial Institutions	-	2.9
Covered Bonds	1.6	2.7
Residential Mortgage Backed Securities ("RMBS")	3.9	4.3
Icelandic exposures (net of provisions)	0.2	0.7
Other		
Fixed and other assets	4.7	6.0
Operational Risk (standardised)	5.7	5.3
Total Pillar 1 CRR	**112.0**	**123.6**

There is no Pillar I requirement in respect of market risk as the Society and Group does not have 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.

At 31 December 2013 the Group held excess capital over and above the Pillar 1 minimum regulatory requirement of £137.1m (2012: £130.2m).

The capital requirements of the Society on a solo consolidated basis are not materially different to that on a Group basis so only Group figures have been disclosed.

6. 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.

6.1 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:

Mortgage Assets	Average to Dec-13 £m	As at Dec-13 £m	As at Dec-12 £m
Residential Mortgages	2,422.4	2,427.4	2,417.4
Other secured lending	16.3	12.7	19.7
Commercial Loans	280.4	267.1	293.8
Serviced Apartments	24.1	24.0	24.2
	2,743.2	**2,731.2**	**2,755.1**
Treasury:			
Deposits with central governments or central banks	502.3	494.3	510.3
Deposits with multilateral development banks	45.5	34.9	56.1
Corporate	-	-	-
Institutions	50.3	2.8	97.8
Covered bonds	133.3	100.8	165.8
RMBS	256.6	241.4	271.7
Icelandic exposures	3.6	1.6	5.5
Cash in hand and equivalent cash items	7.2	7.3	7.1
	999.8	**883.1**	**1114.3**
Total	**3,743.0**	**3,614.3**	**3,869.4**

6.2 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 manual underwriting using core credit score and affordability criteria. The Group risk appetite incorporates limits for concentration risk arising from, inter alia, larger loans, 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 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 defaults within the first 12 months of completion to identify causal factors and inform policy generally.

The key areas covered in lending policy are:

- Formal approval process;
- Use of scorecard including cut-offs;
- Types of property acceptable as security;
- Valuation requirements including use of approved valuers;
- Limits on minimum and maximum advances;
- LTV limits by exposure and type;
- Exposure limits;
- Underwriting criteria;
- Restricted criteria for existing interest only mortgages (NB the Society ceased new interest only lending in 2012);
- Separate limits for buy to let lending (NB the Society ceased BTL lending in April 2008);
- Mandates and delegation of authorities;
- MMR compliant consideration of affordability;
- Monthly credit risk dashboard with key indicators including arrears, possessions and dynamic delinquency;
- Ongoing monitoring including credit control and complaints;
- Monitoring of effectiveness of forbearance measures; and
- Robust and fair arrears management processes.

In addition, all mortgage products are strictly controlled through ALCO approval and subject to minimum benchmarks for Returns on Capital Employed.

The Group does not offer and has never offered sub-prime or self certified mortgages. The predecessor Society, Universal, acquired mortgage books containing small amounts of sub-prime and self certification mortgage assets. Due to performance and seasoning in the years since acquisition the acquired sub-prime assets are no longer considered to be sub-prime lending in the balance sheet.

Credit risk under Pillar 1 is calculated using the Standardised methodology in line with BIPRU 3.4. 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.

6.3 Other Secured Lending

The Society has a small portfolio of loans secured on traded endowment policies which is reducing over time. The Society has not undertaken any new lending of this type since 2008 and balances are falling by 20% - 25% per annum currently, due to maturities and redemptions. Loss experience on the portfolio has been low since this area of business commenced in 2001.

6.4 Commercial Credit Risk

Commercial lending is split between lending to low risk housing associations, residential investment lending (commercial BTL) and commercial investment lending (secured on commercial real estate). An analysis of loans within the commercial lending book is given on page 70 of the Annual Report and Accounts.

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

The Society grants forbearance to commercial borrowers 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. In Note 33 on page 70 of the Annual Report and Accounts, details are given of forbearance granted to commercial borrowers in 2013.

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:

Commercial lending	**2013**	**2012**
	£m	**£m**
Housing Associations	744.3	791.0
Serviced apartments	24.0	24.2
Loans secured on commercial real estate:		
Retail	146.2	160.5
Office Industrial	37.7	42.6
Industrial	50.7	56.5
Student Accommodation	12.8	12.7
Hotel/leisure	19.1	19.9
Other	0.6	1.6
	1,035.4	**1,109.0**

6.5 Geographical Distribution

The geographical distribution of all mortgage assets at 31 December 2013 is as follows:

Mortgages	Residential Mortgages £m	Other Secured Lending £m	Commercial* £m	Total Balances £m
UK	2,375.0	12.7	291.1	2,678.8
Jersey	13.4	-	-	13.4
Gibraltar	39.0	-	-	39.0
	2,427.4	**12.7**	**291.1**	**2,731.2**

* Commercial includes serviced apartments.

6.6 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.

Residual maturity of mortgage assets at 31 December 2013:

	On demand £m	< 12 months £m	1-5 years £m	> 5 years £m	Total £m
Mortgage Assets	10.5	200.9	338.5	2,181.3	**2,731.2**

6.7 Treasury Credit Risk

The Group has exposures to banks, building societies, 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 liquidity including a liquid asset buffer of high quality unencumbered assets in line with the Individual Liquidity Guidance issued by the PRA.

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 partly based on external credit ratings and the Society's assessment of the credit risk. Institutions, including building societies which do not have external ratings, are individually assessed and 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 Finance Director whether they should be sold, if possible, or allowed to run to maturity with ALCO and GRC to be notified of the decision.

All limits are monitored against the sum of on and off-balance 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 exposure value to the Counterparty is derived by adding the net market value of the contract (replacement cost) to the contract's potential credit exposure, which is derived by applying a multiple based on the contract's residual maturity to the notional value of the contract. The total exposure value on counterparty credit risk exposures at 31 December 2013 was:

Derivative Exposures	**£m**
Total exposure excluding CSA deposits	19.6
CSA Netting	(8.9)
Total exposure	**10.7**

The Group uses external credit assessments provided by Standards & Poors, 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 table below shows the Group’s credit risk exposures to Treasury counterparties at 31 December 2013.

Risk Weighting (credit quality step)	S&P rating and Fitch IBCA	Moody's Rating	2013 £m	2012 £m
Central banks and Central Governments				
0%	AAA-AA-	Aaa	494.3	510.3
			494.3	**510.3**
Multilateral Development Banks				
0%	AAA-AA-	Aaa	34.9	56.1
			34.9	**56.1**
Financial Institutions				
20%	AAA-AA-	Aa1 to Aa3	-	41.1
50%	A+ to A-	A1 to A3	-	45.1
50%	BBB+ or lower	Baa1 or lower	-	5.0
50%	Unrated		2.7	6.6
			2.8	**97.8**
Asset Backed Securities				
20%	AAA-AA-	Aa1 to Aa3	241.4	271.7
50%	A+ to A-	A1 to A3	-	-
50%	BBB+ or lower	Baa1 or lower	-	-
			241.4	**271.7**
Covered Bonds				
20%	AAA-AA-	Aa1 to Aa3	100.8	165.8
50%	A+ to A-	A1 to A3	-	-
50%	BBB+ or lower	Baa1 or lower	-	-
			100.8	**165.8**
Central banks: Icelandic Exposure				
Icelandic 150%			1.6	5.5
			1.6	**5.5**
Cash in hand and equivalent cash items				
Cash in hand and equivalent cash items 0%			7.3	7.1
			7.3	**7.1**

There is no material difference between the Group’s exposures stated above and the Group’s exposure prior to credit mitigation. The Group’s exposure to Icelandic banks is stated net of provisions of £18.9m, as detailed in section 6.9.

The geographical distribution of treasury exposures as at 31 December 2013 is set out in the table below. At 31 December 2013 the Society had no exposures to counterparties based in Greece, Portugal, Italy, Belgium or Spain.

Treasury Exposures	**2013**	**2012**
	£m	**£m**
UK	807.3	972.1
Multilateral development banks	34.9	56.1
Europe (excluding UK)	19.0	54.3
North America	6.3	9.7
Rest of the World	15.6	22.1
	883.1	**1114.3**

The residual maturity of these treasury exposures at 31 December 2013 is as follows:

Treasury assets	**< 12 months**	**1-5 years**	**5-10 years**	**Total**
	£m	**£m**	**£m**	**£m**
Central banks and Central Government	398.40	25.9	70.0	494.3
Multilateral Development Banks	5.1	29.8	-	34.9
Icelandic	1.6	-	-	1.6
Financial institutions	2.8	-	-	2.8
Residential Mortgage Backed Securities	31.9	205.1	4.4	241.4
Covered Bonds	-	96.3	4.5	100.8
Cash in hand and equivalent cash items	7.3	-	-	7.3
	447.1	**357.1**	**78.9**	**883.1**

6.8 Impairment Provisions

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or group of assets is impaired. An asset is impaired 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. Impairment loss is calculated as the difference between the assets' carrying value and the present value of the estimated cash flows from those assets.

Objective evidence can be defined as one or more events occurring after initial recognition of the asset, that have a bearing on estimated future cash flows of the financial asset or group of assets. Objective evidence may include indications that the borrower or group of borrowers are experiencing significant financial difficulty, default or delinquency in interest or principal repayments, failure of the tenant, and other indicators of potential breach or future default.

The Group first assesses whether objective evidence of impairment exists for financial assets. Assets that are separately significant are considered individually, and if there is no objective evidence of impairment, are grouped together with assets of similar credit risk characteristic and collectively assessed. Assets that are individually assessed for impairment, and for which an impairment loss is recognised, are not included in a collective assessment of impairment.

Residential and commercial loans are assessed individually for impairment and those not individually impaired are assessed collectively in the light of national or local economic conditions that correlate with defaults on assets in the group. Note 1 of The Annual Report and Accounts shows the accounting policy adopted for impaired assets.

6.9 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.

	2013	**2013**
	£m	**%**
Neither past due not impaired	1,529.0	98.5
Past due up to 3 months but not impaired	13.6	0.9
Impaired and past due 3 to 6 months	5.0	0.3
Impaired and past due over 6 months	3.7	0.2
In possession	0.1	0.1
	1,551.4	**100.0**

Specialist residential book

The Specialist residential mortgage book consists of buy-to-let and residential investment loans.

	2013	**2013**
	£m	**%**
Neither past due nor impaired	100.5	76.4
Past due up to 3 months but not impaired	20.9	15.9
Not past due but impaired	2.5	1.9
Impaired and past due over 6 months	1.6	1.2
LPA receivership	3.1	2.4
In possession	2.9	2.2
	131.5	**100.0**

Commercial lending book

The commercial lending book comprises loans secured on commercial property and loans to Housing Associations. Loans secured on serviced apartments totalling £24.0m have been excluded from the table below as they reflect only small individual loans of a retail nature.

	2013 £m	2013 %
Neither past due nor impaired	191	71.5
Not past due but impaired	38.1	14.3
Impaired and past due 3 to 6 months	4.9	1.8
Impaired and past due over 6 months	16.8	6.3
Impaired LPA receivership	16.3	6.1
	267.1	**100.0**

Allowance for losses on loans and advances to customers

	Loans fully secured on residential property		Loans fully secured on land		Other loans		**Total**	
	Individual £m	Collective £m	Individual £m	Collective £m	Individual £m	Collective £m	**Individual £m**	**Collective £m**
Balance at 1 January 2013	2.3	0.6	18.7	5.5	0.3	0.1	21.3	6.2
Charge / (write-back) for the year	0.8	(0.2)	6.1	-	-	-	6.9	(0.2)
Written off during the year	(1.6)	-	(4.2)	-	-	(0.1)	(5.8)	(0.1)
Interest suspended	0.2	-	2.0	-	-	-	2.2	-
At 31 December 2013	**1.7**	**0.4**	**22.6**	**5.5**	**0.3**	**-**	**24.6**	**5.9**

Allowance for losses on loans and advances to banks

	2013 £m
Balance at 1 January 2013	19.7
New provisions during the year	-
Amounts released during the year	(0.8)
At 31 December 2013	**18.9**

At 31 December 2013 the Society had loans and advances to Icelandic banks totalling £23.4m (2012: £25.4m), against which allowance for losses of £18.9m (2012 £19.7m) has been made. The Society sold its exposure to Glitnir in October 2013 and received the funds subsequent to the year-end. Book value reflected the final agreed sales price less disposal costs.

6.10 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 funds 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.

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 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 in-house experts and a debt recovery team dedicated to commercial loans which are supplemented by the comprehensive use of external valuers and property experts that provide options analysis. The Society ensures that appropriate insurance is taken out to protect security properties.

7. Operational Risk

Operational risk is defined on page 7.

The Society calculates the Operational Risk Capital Requirement (“ORCR”), for Pillar I capital, under the standardised approach, as defined by the PRA. 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.

7.1 Capital Requirement

The Group has adopted the standardised approach to operational risk under Pillar 1 which produces an overall ORCR equating to 12.3% of net income at 31 December 2013 (12.4% in 2012). The Group’s income has been split into 4 separate business lines and the operational risk percentages as set out in BIPRU 6.4.15 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.

8. Market Risk

8.1 Market Risk Overview

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

8.2 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 value at risk, basis risk, as well as limits to minimise gaps in specific time buckets.

8.3 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. The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, basis risk swaps, interest rate options and interest rate caps. 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 33 on pages 64 to 71 of the Annual Report and Accounts gives details of the derivative financial instruments held at 31 December 2013.

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 to act as a basis for liquidity investment and hedging decisions for the coming month;
- Day to day review of exposures and market outlook by both the Treasury and Balance Sheet Risk teams and fine-tuning of ALCO's view as appropriate, with agreement from the Group Finance Director;
- All new mortgage and savings ranges are reviewed by the Balance Sheet Risk 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);
- Review of results of stress testing and resultant impact on annual profitability and overall value sensitivity;
- Review of basis risk under static and dynamic modelling scenarios; and
- Monthly review of interest rate risk exposures and hedging by the Balance Sheet Risk team, to review actual outcomes against plans for the month and allow hedging proposals to be formed.

In assessing interest rate risk exposures relating to fixed-rate mortgage assets it is necessary to make assessments of likely prepayment. 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. These effects broadly offset each other; although timing of cash flow differs (early repayment charges not received in year 1 will be offset by additional margin over several years).

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. These are as follows:

	Limit £m	**Actual £m**
+200bp shock – impact on net interest margin (guideline)	(5.0)	3.3
+200bp shock to gap sensitivity	(14.9)	5.7

Due to the low interest rate environment experienced over the last year, the rate shocks for interest rate reductions reported to ALCO were amended to -10 and -20bp.

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 2013 are given in Note 33 on pages 64 to 71 of the Annual Report and Accounts.

9. Remuneration

9.1 Remuneration Committee

The Remuneration Committee has responsibility for ensuring compliance with the Regulators' Remuneration Code and for approving the Pillar III disclosures in relation to remuneration. Further details are available within the Remuneration Committee Report on pages 27 and 28 of the Annual Report and Accounts.

9.2 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, 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:

	Typical Functions	Number of code staff	Fixed Remuneration £'000 (Note 1)	Variable Remuneration £'000 (Note 2)	**Total 2013 £000**	Total 2012 £000
Executive Directors	CEO, Finance Director, Business Services Director	3	508	-	**508**	689
Sales & Marketing Executives	Sales & Marketing	2	205	5	**210**	214
Control Functions	Business Assurance, Risk Management, Compliance, Underwriting	4	301	7	**308**	340
Other Executives	Treasury, Information Technology, Operations, Human Resources	4	366	8	**374**	375
Total		**13**	**1,380**	**20**	**1,400**	**1,618**

Note 1 – includes base salary, benefits and pension contributions. The Business Services Director resigned on 11 April 2013 and received compensation for loss of office which is not included in the figures above of £135,000. Further details are given on pages 21 and 28 of the Annual Report and Accounts.

Note 2 – variable remuneration reflects bonuses paid in line with the performance related bonus scheme documented below.

There were no amounts of deferred remuneration awarded, paid out or reduced through performance adjustments during the financial year. No sign on payments were made during the financial year.

9.3 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 staff bonus schemes. The Committee met 3 times during 2013 and consists solely of non-executive directors; Catherine Vine-Lott (Chairman), David Buffham, Richard Mayland and John Morris. 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.

9.4 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 skills levels that are appropriate to operate an organisation of the Society's complexity.

A 1.5% across the board pay increase was received by all staff in April 2013. The Executive Directors elected not to receive their pay award in 2013.

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 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.

9.5 Link Between Pay and Performance

Performance Related Bonuses

In recognition of the continued progress and achievements of the Society's 2013 corporate key performance indicators (KPI's), the Remuneration Committee approved a modest payment of a maximum 2.5% under the Society's Corporate Bonus Scheme at the end of 2013. The payment was made to all staff, with the exception of the Chief Executive and Finance Director who declined the offer of payment. There are no separate bonus schemes for Executive Directors.

The KPI's underpinning the Corporate Bonus Scheme are based on the following:

- Financial performance covering profitability, capital, liquidity and control of costs;
- Focus on Members including achievement of service levels, customer satisfaction, dealing with complaints and numbers of accounts opened;
- Achievement of staff engagements strategies and improved employee satisfaction;

- Success of the Solutions business, including profitability and efficiency; and
- Delivery of key projects and targets for legacy portfolio wind-down and de-risking of the business.

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 Services Limited (NFSL). The bonus schemes which operate within NFSL are set in such a way as to ensure that they promote both good customer outcomes and the financial strength of the Society, do not reward failure and they 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 2013 to ensure compliance with the Code and the Society's Remuneration Policy Statement.

10. Basel II and Basel III leverage ratios

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 strong 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.

Basel III came into force on 1 January 2014 alongside a number of transitional provisions. At 31 December 2013 the Group is required to report on the capital position in line with Basel II requirements.

The Group presents below the 31 December 2013 capital position under Basel II reporting (applicable until 31 December 2013) alongside the Basel III leverage ratio calculated over this Basel II capital and exposure measure. The leverage ratio disclosed is not at this stage fully aligned with either the CRR or with the January 2014 Basel definition. Additionally, the leverage ratio has been recalculated under Basel III transitional requirements, using the 1 Jan 2014 Basel III transitional position for the Group 31 December 2013 Core Equity Tier 1 and Exposure positions. Finally, the Basel III closing position (post-transitional period) leverage ratio is presented for the Group 31 December 2013 Core Equity Tier 1 and Exposure positions.

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 impact the Society from 1 January 2014 include the deduction from Core Tier 1 capital of deferred tax assets relating to trading losses, a different calculation of risk weights on equity release mortgage assets and inclusion of the available for sale reserve in capital.

The impact of Basel III has been reflected in the Society’s medium and long term capital plans and the ICAAP.

Further details of the Basel III position, had this been applied to the Society at 31 December 2013, are included in the following tables.

Leverage ratio – Group			
£m	Actual Basel II	Transitional Basel III	End point Basel III
General Reserve	167.1	167.1	167.1
Capital Instruments: Permanent Interest Bearing Shares	29.7	24.9	-
Tier 1 Capital	196.8	192.0	167.1
Deferred tax assets that rely on future profitability excluding those arising from temporary differences	-	(7.4)	*(7.4)
AFS reserve	-	-	0.8
Total regulatory adjustments to Tier 1 Capital	-	(7.4)	(6.6)
Total Tier 1 Capital	196.8	184.6	160.5
Total assets (average over quarter to 31 December 2013)	3,657.2	3,657.2	3,657.2
Receivables for cash collateral posted in derivative transactions	11.1	11.1	11.1
Potential future exposure (current exposure method, applying netting rules) – Derivatives	10.7	10.7	11.8
Total exposures	3,679.0	3,679.0	3,680.1
Leverage ratio	**5.4%**	**5.0%**	**4.4%**

*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.

Capital ratios at 31 December 2013 – Group		
£m	Actual Basel II	Transitional Basel III
Total Tier 1 Capital shown in the table above	196.8	184.6
Subordinated Debt	46.2	44.3
Collective Impairment Allowance	6.1	6.1
Total Capital	249.1	235.0
Total Risk Weighted Assets £m	1,399.9	1,351.0
CET1 ratio	11.9%	11.8%
Tier 1 ratio	14.1%	13.7%
Solvency ratio	17.8%	17.4%

Glossary of Terms

Basel II Framework – The second of the Basel Accords, issued by the Basel Committee on Banking Supervision, which defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses, Basel II became law in the EU Capital Requirements Directive, and was implemented in the UK via the FSA Handbook.

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 will be phased in from 1 January 2014.

BIPRU – The prudential sourcebook for Banks, Building Societies and Investment Firms. This sets out the FCA's/ PRA's Capital requirements.

Core 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 2013.

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 II 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.

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

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

PIBS – Permanent Interest Bearing Shares, these are unsecured, deferred shares that are a form of Tier 1 capital at 31 December 2013. 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 II framework addresses the total minimum capital requirements for Credit, Market and Operational Risks.

Pillar 2 – This is the part of the Basel II 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 II 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 II rules to reflect the degree of risk they represent. The Society measures RWA using the standardised approach.

Securitisation – this is a transaction or scheme whereby the credit risk of an asset or a pool of assets is transferred to an external undertaking.

Standardised Approach – the basic method used to calculate credit risk capital requirements under Basel II. 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).

Supranational financial institution – a supranational financial institution is formed and capitalised by two or more central governments to promote economic development for specified member countries.

Tier 1 Capital – Tier 1 capital is divided into Core Tier 1 and Other Tier 1 capital. Core Tier 1 capital is defined above. Other 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 II 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 2013.