

Melton Mowbray Building Society

Pillar 3 Disclosure Document

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1 Introduction

The legislative framework, the Capital Requirements Directive (CRD), referred to as Basel 2, governs how much capital a bank or building society must hold to protect their members, depositors and shareholders. It was introduced by the European Union from the beginning of 2007.

In the UK, this is being implemented by our regulator, the Financial Services Authority (FSA).

The Melton Mowbray Building Society Group adopted Basel 2 on 1 January 2007.

The CRD has three key elements, called “Pillars”, which are:

- Pillar 1 - Minimum Capital Requirements
- Pillar 2 - Supervisory Review Process
- Pillar 3 – Disclosure

This document deals with the requirements laid down for Pillar 3 (disclosure) and the information provided here is in accordance with the rules and guidance contained in Chapter 11 of the BIPRU FSA Handbook.

All figures within this document are correct as at 31 December 2008.

2 Risk Management Policies and Objectives

The Melton Mowbray Building Society Group is primarily a retailer of financial products, mostly in the form of mortgages and savings. These products give rise to a financial asset or liability and are termed financial instruments.

As well as mortgages and savings, the Group also uses wholesale financial instruments to invest liquid asset balances and to manage the interest rate risks arising from its operations.

The most significant risks to which the Group is exposed are liquidity, credit and interest rate, which are explained further below. The Group has a formal structure for managing these, including established risk limits, reporting lines, mandates and other control procedures. This structure is reviewed regularly by the Assets & Liabilities Committee (ALCO) which is charged with responsibility for managing and controlling the balance sheet exposures of the Group.

Liquidity Risk

Liquidity risk is the risk of failing to meet demands and commitments to provide funds to customers and other third parties. The Group's policy is to maintain sufficient liquid funds at all times to ensure that liabilities can be met as they fall due. The objective of liquidity management is to help smooth mismatches between maturing assets and liabilities thereby maintaining public confidence in the solvency of the Group.

Credit Risk

Credit risk is the risk of default by counterparties to transactions. This includes borrowers defaulting on their contractual mortgage repayments as well as treasury counterparties failing to repay the Group's liquidity investment and the interest due.

All loan applications are assessed with reference to the Group's lending policy. This contains details of the required financial capabilities of the borrower and limits upon exposures to individual or connected borrowers. Changes to the lending policy are approved by the Board.

Appropriate liquidity investment limits have been established by the Board for individual treasury counterparties and sectors. These are contained in the Group liquidity policy. The Group subscribes to Fitch ratings in order to receive financial assessments of treasury counterparties. ALCO ensures that these limits are monitored.

Interest Rate Risk

Interest rate risk arises from imperfect matching of different interest rate features, re-pricing dates and maturities of mortgage and savings products. The Group manages this risk on a continuing basis, within limits set by ALCO, using interest rate swap and cap contracts as appropriate.

The effects of this risk are monitored by way of a “gap” analysis which is reviewed at each ALCO and Board meeting.

Operational Risk

Operational risk is the risk of a loss arising from failed or inadequate internal processes or systems, human error or other external factors. The risk is managed by individual managers who have the responsibility for establishing appropriate controls for their area of responsibility. All managers are asked to contribute to quarterly risk review meetings, as part of the Risk Review Process, which reviews existing risks and records new risks on a Risk Grid, detailing mitigating actions taken to reduce the exposure to that risk.

In order to ensure that the Group has sufficient capital to cover some of these operational risks a range of insurance policies have been established to cover potential eventualities such as business interruption, loss of computer systems, crime, fire etc.

Competition Risk

Competition risk is the risk to earnings and capital due to competitors introducing new products which compete with the Group’s existing products.

This risk is faced by all businesses and the Group aims to mitigate this risk by its diversification strategy to ensure that its income source is not dependent upon one product or one area of its business.

Concentration Risk

Concentration risk is the risk due to a large exposure to a single borrower, or several borrowers which are connected, causing a large loss should the borrower default. Concentration risk would also arise in situations where significant loans are in one geographical area or of the same type e.g. buy to let.

The Group monitors areas of potential concentration to ensure that the total lending is appropriate for our size and sets tranches which limit the total lending in specialist areas.

Regulatory Risk

Regulatory risk is the risk to earnings and capital from non compliance with statutory requirements or best practice.

The Group has prepared and adopted practices and procedures relevant to all regulatory and other activities to ensure full compliance is maintained.

Pension Obligation Risk

Pension obligation risk is the risk to earnings and capital due to the Group, as employer and funder of last resort to the defined benefit pension scheme, where the Group was required to make significant contributions. The employee pension scheme is in substantial surplus and the Board of Directors regularly monitor the surplus and the terms of the pension benefit to ensure it does not face a requirement to fund contributions.

3 Board and Committee Structure

The Board comprises 6 Non-Executive and 2 Executive Directors and holds at least 7 formal meetings each year.

Audit & Compliance Committee comprises 3 Non-Executive Directors and meets 4 times each year. This Committee considers systems of procedure and control, risk assessment, audit and accounting matters, and monitors compliance with regulatory requirements.

Assets & Liabilities Committee comprises 2 Executive Directors and senior members of the executive management team and meets each month. This Committee considers the principal business policies of the Group including those relating to lending, treasury management and financial risk and monitors the Groups exposures to these risks.

4 Risk Assessment Process

The Group has drawn up a risk assessment template. This is a mechanism to:

- Capture and describe the different types of risk likely to affect the Group
- Allocate “business owners” to manage the risk exposures identified
- Act as a vehicle to highlight those activities which carry the highest risk to the Group so that resources can be prioritised accordingly.

Each risk identified or reviewed will be considered as follows:

- The most appropriate line manager will be asked to explain their assessment of the potential impact of the risk and what mitigation measures are in place
- A consensus view is established of the likelihood of the risk being realised and the potential impact arising. Scores are allocated against likelihood and impact (1 to 9) which when multiplied together gives a risk score.
- Risk scores are monitored and managed against a “traffic light” system with management emphasis placed against those risks shown as “red”.

The Director of Risk and Compliance presents the resulting risk assessment grid to the quarterly Audit & Compliance Committee.

5 Group Overview

Melton Mowbray Building Society has 3 subsidiary companies which are fully consolidated into the Melton Mowbray Building Society Group. These are:

- MBS Lending Limited. This is a specialist mortgage lending company which commenced trading in August 2007 acquiring mortgage assets for re-sale (where the market permits) or to hold on book. The first asset sale was completed in February 2008 at a price in excess of book value.
- MMBS Services Limited. This company provides both Independent Financial Advice and mortgage packaging on behalf of specialist lenders and commenced trading in Autumn 2006.
- MMBS Trading Limited. This is a property management company.

These subsidiaries are a wholly owned by the Melton Mowbray Building Society and all their funding comes from the Society.

The use of a subsidiary companies allows improved balance sheet management. In addition mortgages within MBS Lending Limited do not convey membership rights to the borrower.

The table below shows the total Group assets and those of each subsidiary company along with the percentage of the Group total.

	Assets	% of Group
	£m	
Melton Mowbray Building Society Group	438.7	
MBS Lending Limited	26.9	6.1%
MMBS Services Limited	2.1	0.5%
MMBS Trading Limited	1.2	0.3%

There are no current or foreseen material, practical or legal impediment to the prompt transfer of capital resource between Melton Mowbray Building Society and any subsidiary undertaking.

6 Capital resources

The capital resources of the Group are as follows:

	£ m
Tier 1 Capital General Reserve	30.1
Less Pension Reserve	(2.0)
Tier 2 Capital (Revaluation Reserve)	0.9
Less Deductions (Intangible Assets)	(0.9)
Total Capital Resources	28.1

The Group has significant capital, which is derived from the reserves of the Group.

The gross capital of the Group is the sum of general and revaluation reserves and totals £31.0 million. This represents 7.68% of the shares and borrowings of the Group as at 31 December 2008. This gross capital ratio illustrates the extent to which the Group is funded by retained earnings compared to shares and borrowings. Gross capital provides a financial buffer against any losses which might arise from the Group's activities and therefore protects investors.

The above table shows the deduction of the pension reserve and the value of intangible assets from the general and revaluation reserves to determine the total capital resources available for Basel 2 calculations.

7 Risk Weighted Exposure Amounts

The risk weighted assets and their Pillar 1 capital at 8% for each standardised exposure class are:

Standardised Exposure Classes	Risk Weighted Assets	Pillar 1 Capital
	£m	£m
Residential Mortgages (35% weighting)	102.7	8.2
Residential Mortgages (over 35% weighting)	5.3	0.4
Fully Secured On Land (Commercial)	5.5	0.5
Liquidity	23.8	1.9
Total	138.1	11.0

In addition the Group is required to provide capital against its operational risks. Operational risk is the risk of loss arising from failed or inadequate internal processes or systems, human error or other external events.

The Group has decided to adopt the basic indicator approach in order to calculate the capital required to provide for operational risk, which is £1.0 million.

This is based upon 15% of the Group's average net interest plus net fees over the previous 3 years.

8 Counterparty Credit Risk

The Group Lending Policy contains exposure limits to sectors and individual counterparties. This enables the Group to obtain the best possible return from its liquidity investments whilst operating within prudent limits in respect of counterparties.

The Group subscribes to and makes use of Fitch Ratings and the individual exposure limits of rated banks and building societies are based on the individual counterparties' long and short term rating. In addition the Group may invest up to £1 million with other building societies and local authorities.

New limits and counterparties are approved by the Assets & Liabilities Committee. Individual counterparties are withdrawn by the Executive following receipt of an adverse Fitch report or other adverse market intelligence.

The credit risk capital requirements associated with hedging instruments are based upon 0.5% of the nominal value of those with over 12 months plus their replacement values.

Details of outstanding hedging instruments of the Group are:

Swaps - Nominal Value	£60.0 million
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9 Commercial Asset Overview

The group exposure to mortgage loans is as follows:

	£ m
Fully Secured on Residential Property (prime)	264.2
Fully Secured on Residential Property (sub prime)	25.3
Fully Secured on Residential Property (prime buy to let)	10.3
Fully Secured on Land and Property (commercial)	5.5
Total	305.3

The Group operates predominantly within the East Midlands. The Group has the following geographic exposure:

	£ m
East Midlands	168.8
North East	28.4
Anglia	5.0
West Midlands	23.6
South	12.5
North West	14.6
South East	23.9
South West	10.7
Other (Including Greater London)	17.8
Total	305.3

The total undrawn loans for the group at 31 December 2008 was £4.8 million.

10 Arrears Review

Past due loans are defined as loans which are 3 months or more in arrears.

Impaired loans are defined as those which are more than one month but less than 3 months in arrears.

The breakdown of Group loan exposures is as follows:

	Past Due	Impaired	Performing	Total
	£m	£m	£m	£m
Group Loans	2.5	4.9	297.9	305.3

This confirms the Group's view that the mortgage loan books are of a very high quality and are performing well.

There are 3 loans where the borrower is more than 12 months in arrears.

11 Provisions

Provisions for losses are based upon a year end appraisal of loans.

Specific provisions are made in respect of anticipated losses on loans, not only where properties are in the possession of the Group, but also on a case by case basis where arrears are greater than 2.5% of the balance outstanding.

In addition, the Directors have considered other material cases in arrears to identify additional specific provisions.

The amounts so provided are the amounts needed to reduce the book value of loans to their expected realisable values.

General provisions are made to cover losses which, although not yet specifically identified, are anticipated from past experience to potentially exist in the Group's portfolio of loans.

The amount charged in our Group Income and Expenditure account comprises amounts written off during the year, less recoveries, and the net change in the ongoing provision.

The following provisions have been deducted from the appropriate asset values in the balance sheet. Both the balance sheet and the provisions can be found in the 2007 Report and Accounts.

	Specific	General	Total
	£,000	£,000	£,000
At 1 January 2008	0	197	197
Income and Expenditure Account	435	85	520
At 31 December 2008	435	282	717

12 Analysis of Liquidity

The Group's liquidity is invested in deposit accounts, certificates of deposit and floating rate notes from authorised counterparties.

The Group liquidity policy statement sets exposures to sectors, individual counterparties and a minimum maturity profile.

Individual exposure limits are set by reference to their Fitch rating.

Under the standardised approach, investments with counterparties which have a Fitch rating of at least -AA or a residual maturity of less than 3 months are risk weighted at 20%. Investments with counterparties which have a Fitch rating of less than -AA or no rating are risk weighted at 50% if their residual maturity is greater than 3 months.

An analysis of the Group Liquidity at 31 December 2008 is below:

Counterparty Risk Weight	Risk Weight	Pillar 1 Capital
	£m	£m
20%	22.8	1.6
50%	1.0	0.6
Total	23.8	1.9

13 Interest Rate Risk

The following table describes the significant activities of the Group, the related risks associated with them and the types of derivatives which are typically used in managing such risks. These risks could also be managed by using on balance sheet products.

Activity	Risk	Type of Hedge
Fixed rate savings products	Sensitivity to changes in interest rates	Interest rate swaps
Fixed and capped rate mortgage lending	Sensitivity to changes in interest rates	Interest rate swaps and caps

The interest rate “gap” report summarises the fixed rate exposures of the Group into relevant time periods (time buckets) and calculates the effect of up to a 3% movement in interest rates. This result is limited to 3% of capital. This calculation is performed monthly and reviewed by the Board at their regular meetings.

An example of the Group’s “gap” report is attached. This shows the assets and liabilities in each time bucket so that the gap can be identified. As can be seen from the line “CUM. GAP”, the cumulative gap is below £1 million which indicates that the Group’s fixed rate exposures are well hedged.