



PILLAR 3 DISCLOSURE DOCUMENT

JUNE, 2010

Pillar 3 Board Disclosure Policy

Introduction

This document sets out the Boards policy on the disclosure requirements of the Capital Requirements Directive (CRD) Pillar 3, as set out in BIPRU 11 and as relevant to the size and complexity of the Society. The Society has adopted the standardised approach to credit risk and the basic indicator approach to operational risk.

This policy is approved by the Board and is subject to annual review to ensure that the disclosures, verification and frequency remain appropriate.

Frequency and location of disclosures

In view of the scope and lack of complexity of the Society (in comparison to an international bank for example), the Board has decided that disclosures should be published annually. Full details of how to obtain a copy of the disclosures will be provided on the Society's website and noted in the Society's Annual Report & Accounts.

Materiality and Confidentiality

The Society will consider information as material if its omission or misstatement could change or influence the decision of a user relying on the information for the purposes of making economic decisions. The Society will consider the ownership and confidentiality of all information prior to publication.

Disclosures

The Society will disclose the information as required by BIPRU 11.5, which is subject to the provisions laid down in BIPRU 11.3.5 to 11.3.7, as relevant to the size and complexity of the Society, which includes the following matters as appropriate:

- Scope of application of the directive requirements.
- Risk management objectives and policies.
- Capital resources.
- Information relating to compliance with BIPRU 3,4,6,7 and 10 and the overall Pillar 2 rule.
- Credit risk.
- Standardised credit risk exposures classes.
- Operational risk.
- Interest rate risk.

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Disclaimer

The Pillar 3 disclosures have been prepared purely to comply with BIPRU Chapter 11, in seeking to explain the basis on which the Society has prepared and disclosed certain capital requirements and information about the management of certain risks. They do not constitute any form of Financial Statement and must not be relied upon in making any judgement on the Society. There is no requirement for the disclosures to be externally audited.

1. Introduction

From January 2008 the Dudley Building Society has to comply with the new Capital Requirements Directive (CRD), commonly referred to as Basel 2, governing how much capital all banks and building societies must hold to protect their members, depositors and shareholders. This legislation was introduced by the European Union from the beginning of 2007, and implemented in the UK by our regulator, the Financial Services Authority (FSA).

Dudley Building Society's primary aim is to ensure that we protect our members' savings by having sufficient capital even during a significant economic downturn.

The Capital Requirements Directive, has within its basic structure 3 'Pillars', being:-

Pillar 1 : Minimum capital requirements

Pillar 2 : Assessment of capital requirements by the Firm (ICAAP or Internal Capital Adequacy Assessment Process) and FSA (SREP or Supervisory Review and Evaluation Process).

Pillar 3 : Disclosure; governed by the FSA Handbook (BIPRU Chapter 11) with regards to material items within the Society.

For small societies such as the Dudley, the Pillar 1 assessment is based on a formulaic risk based capital calculation focussing particularly on credit and operational risks to determine the Capital Resources Requirement. The Board of Dudley Building Society has then undertaken a bottom up assessment of all of the risks facing the Society and has established extra capital to be held under Pillar 2. As part of this the Society has undertaken stress tests to determine whether it could maintain capital adequacy in a severe economic downturn.

This policy document deals with the requirements laid down for Pillar 3 (disclosure) and the information provided here is in accordance to the rules laid out in the FSA handbook BIPRU Chapter 11. The Disclosures relate to Dudley Building Society (FSA Number 161294), and all information relates to the Society's assets at 31 March 2010.

2. Risk management policies and objectives

Dudley Building Society is a largely traditional Building Society, developing and retailing financial products, principally in the form of mortgages and savings. These products give rise to a financial asset or liability and are termed financial instruments. As well as mortgages and savings the Society also uses wholesale financial instruments to invest liquid asset balances and raise wholesale funding and to manage the interest rate risks arising from its operations.

The Society looks to manage all the risks that arise from its operations, being credit risk, interest rate risk, liquidity risk and operational risk.

The ways in which we manage these risks include:-

- (i) using forecasting and stress test models to help guide our business models;
- (ii) producing key risk information and indicators to measure and monitor performance;
- (iii) using management and board committees to monitor and control specific risks.

Credit Risk

Credit risk refers to the potential risk that arises from customers (or counterparties) failing to meet their obligations as they fall due. Credit risk arises primarily from loans to our retail customers, loans to our commercial mortgage customers and from liquid assets held by the Treasury department.

The Lending Risk Committee was formed in the Spring of 2010 and is responsible for reviewing the Society's lending policy and monitoring the exposures in accordance with this policy, including exposures to individual counterparties and sector concentration. The Committee recommends lending policy for approval by the full Society board.

The Assets and Liabilities Committee (ALCO) is responsible for recommending limits on Treasury counterparties, country exposures and types of financial instruments for approval by the Society board within regulatory guidelines.

Interest Rate Risk

Interest Rate risk is the risk that the value of, or income arising from, the Society's assets and liabilities varies as a result of changes in interest rates.

Interest rate risk arises from imperfect matching of different interest rate features, re-pricing dates and maturities of mortgages, savings and wholesale products. The Society manages this exposure on a continuing basis, within limits set by ALCO using a combination of on and off-balance sheet instruments. The sensitivity to changes in interest rates impacts the following activities:

1. Management of the investment of reserves and other net non-interest bearing liabilities.
2. Fixed rate funding.
3. Fixed rate mortgage lending and fixed rate treasury lending.

Interest rate swaps are used, where appropriate, to manage the above risks. In addition swaps are used to manage a risk arising from a net exposure to an interest rate basis type e.g. base rate or LIBOR. The Society also monitors prepayment levels on fixed rate mortgages and aims to set the Early Repayment Charge consistent with the interest rate risk exposure.

The Society uses a parallel shift in interest rates of 2% to assess interest rate shock and to establish risk appetite.

Liquidity Risk

The Society's liquidity policy is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding in order to retain full public confidence in the solvency of the Society and to enable the Society to meet its financial obligations. This is achieved through maintaining a prudent level of liquid assets, through wholesale funding and through management control of the growth of the business.

The Society maintains assets in liquid form in such proportion and composition (as determined by ALCO) as will at all times enable it to meet its liabilities as they arise (including any unexpected adverse cash flow).

Operational Risk

Operational risk is the risk of loss arising from failed or inadequate internal processes or systems, human error or other external factors. The risk is managed by the departmental Managers of the Society who have responsibility for putting in place appropriate controls for their area. A quarterly report to the Chief Executive from each departmental Manager acts as a reporting mechanism to the Board, and an annual assessment of all operational risks is carried out and reported.

In order to ensure we have sufficient capital to cover some of these operational risks the Society also maintains a range of insurance policies to cover eventualities such as business interruption, loss of computer systems, crime etc.

To monitor its operational risks the society records all its risks and quantifies these through risk likelihood and impact (together with a reduction in impact from application of the control) to be assigned to each risk. This allows us to establish a residual risk remaining after operation of controls for each business area within the Society.

Business Risk

Business risk is the risk that the Society may not be able to carry out its business plan or its desired strategy and could therefore suffer losses if its income falls.

This is a risk that every business faces, however the Society looks to mitigate this risk by having a diverse range of products so that its income source is not reliant on one product or one area of its business.

Concentration Risk

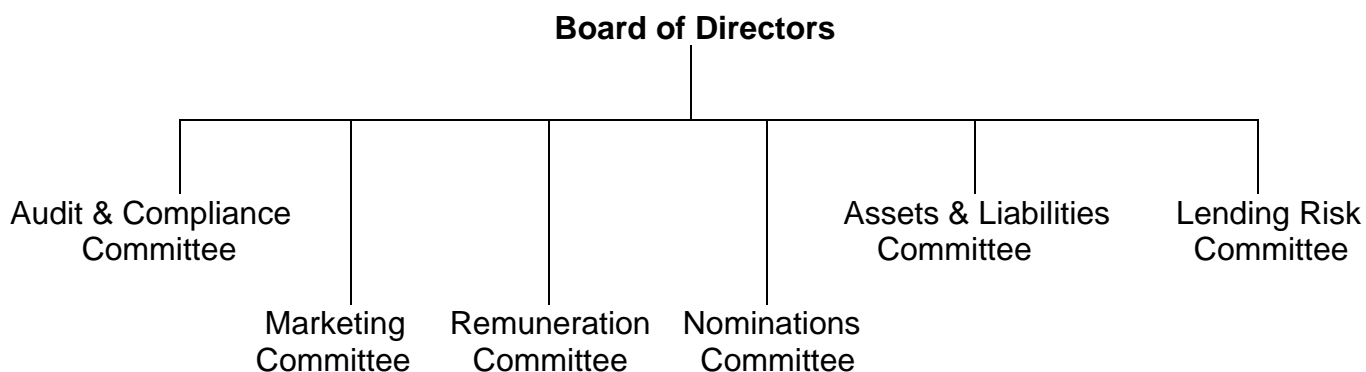
Where a firm's exposure to a single borrower or several borrowers within the same group of companies is large, it risks large losses should the borrower default. Concentration risk is concerned mainly with the fact that in some cases these losses may be sufficient to threaten the solvency of a firm.

However, concentration risk need not just be in the form of large loans to single borrowers, it could include a concentration of "high risk" or high LTV loans, niche lending such as buy-to-lets or industry/sector concentrations, or high levels of business in a certain area of the country, which for the Dudley represents the West Midlands conurbation.

Concentration risk is mitigated where possible by limits set on areas of business, and individual counterparty limits. In a small, local society however the majority of its advances are inevitably in the local area, but this risk is offset by business knowledge about the area.

3. Main Board and Committee Structure

The Society's Management structure is set by the Society's Board of Directors, who have set up a number of Committees to oversee the various sections of the Society's business. The three principal Committees from a Risk Management viewpoint are the Audit and Compliance Committee, the Assets and Liabilities Committee and the Lending Risk Committee, details of which are noted below:-



Audit & Compliance Committee

Composition: 3 non-executive directors selected from a pool of 5.

Main Functions: The Committee supervises the Society's internal audit programme and oversees compliance with the established systems of control, taking account of the relevant internal and external audit recommendations. *(Audit & Compliance Committee receives a report quarterly from Internal Audit on the risk management processes within particular business areas. It also receives a quarterly Risk Report containing Key Risk Indicators and a six monthly Risk and Control assessment).*

The Committee will review, and challenge where necessary, the actions and judgements of management, in relation to the society's Annual Accounts. The Committee liaises with the Society's external auditors concerning the nature and scope of their work and reviews any changes in accounting policy and practice.

Frequency: The Committee meets on a quarterly basis with an additional meeting to deal with the Annual Report and Accounts.

Assets & Liabilities Committee

Composition: 2 non-executive directors and the 2 executive directors.

Main Functions: The Committee is responsible for asset and liability management which includes:

- Ensuring the Board's policies are carried out in relation to the Treasury Risk Management Policy Statement (including limits and approved market instruments).

- Considering the funding requirements of the Society.
- Considering and recommending wholesale and liquidity counterparty credit and other equivalent exposure limits.

Frequency: The Committee meets on a quarterly basis and or other times as considered appropriate.

Lending Risk Committee

Composition: 2 non-executive directors and the 2 executive directors.

Main Functions: The Committee is responsible for monitoring the lending portfolio quality and assessing and recommending changes to Lending Policy and Risk.

Frequency: The Committee meets on a monthly basis.

(Senior staff members are also Committee members of the Assets and Liabilities, and Lending Risk Committees.)

4. Capital Resources

The Capital Resources of the Society principally relate to the reserves of the organisation (Tier 1). The Society has a small amount of Tier 2 capital, being the level of general mortgage provisions maintained in the Society's Balance Sheet.

At 31 March 2010 the Society's capital comprised:-

	£'000
Tier 1 (Capital Balance)	17,030
Tier 2 (General Mortgage Provisions)	<u>655</u>
	<u>17,685</u>

5. Capital Resources integrated into Business Strategy

Dudley Building Society aims to maintain sufficient capital resources to allow it to make advances and provide other financial services. In order to maintain this capital the Society needs to generate and retain profits that will add to the general reserves, the principal source of capital.

Strategy and Planning

The 3 year Strategic Plan and Annual Operating Plan process establishes risk appetites for the various areas of business which the Society conducts.

The Society ensures it has sufficient financial and non-financial resource to meet the Strategic Plan objectives.

Capital Adequacy Assessment Process

In addition to the Strategic Plan and Operating Plan the Society has an Internal Capital Adequacy Assessment Process (ICAAP), which focuses on ensuring capital resources of the Society are sufficient to support its plan both in normal operating and stressed conditions.

This process involves reviewing all business areas with estimates for capital allocation across the Strategic Plan period. The Board then agree (with input from the results of the Society stress models) the economic scenarios to be used in calculating capital requirements.

Finally the Board approves the capital assessment taking into account any areas where they may feel the models and internal assessments do not adequately capture the full risk exposure and holding extra capital where appropriate.

Lending & Business Decisions

The Society translates its overall risk appetite for credit risk into individual lending limits controlling the exposures to be taken on by the Society. The performance against these limits is monitored monthly and reviewed at least annually.

Pricing

Our pricing models also include capital assessment by products. Pricing models are in use for all mortgages launched.

The pricing models provide guidance as to what rate needs to be charged to meet return targets.

6. Risk Weighted Exposure Amounts & Operational Risk Capital

The assets of the Society are allocated risk based exposure amounts in line with the “Standardised Approach” under the Capital Requirements Directive. In addition an evaluation of capital required to cover Operational Risk is calculated under the “Basic Indicator Approach” and determined by reference to the net income of the Society averaged over the last 3 years.

	Asset	Risk Weighted Asset	Capital
			£'000
Treasury Assets			
Claims or contingent claims on central governments or central banks	£4.0m	-	-
Claims or contingent claims on regional governments or local authorities	-	-	-
Claims or contingent claims on institutions	£81.1m	£17.8m	1,422
Total Treasury Assets	£85.1m	£17.8m	1,422
Loans & Advances to Customers			
Claims or contingent claims on corporates	£4.4m	£4.4m	351
Claims or contingent claims secured on real estate property	£225.5m	£82.9m	6,629
Past due items	£4.3m	£4.3m	347
Total Loans & Advances to Customers	£234.2m	£91.6m	7,327
Other Items	£1.3m	£0.8m	73
Total Credit Risk Exposures	£320.6m	£110.2m	8,822
Operational Risk Capital Requirement			710
Total Pillar 1 Capital Requirements			9,532

(Other Items represents cash balances held at branches, off balance sheet financial instruments and other assets, including Fixed Assets)

Counterparty Credit Risk

The purpose of the Society's counterparty treasury credit risk management policy is to ensure that the Society can obtain the best possible return whilst operating within prudent limits in respect of counterparties.

The methodology for establishing counterparty limits involves consideration of the background rating information. The minimum rating required under Fitch ratings are:

- Short term facilities up to and including one year in maturity: bank to whom lending is made to have a short term credit rating of at least F1;
- Facilities over one year and up to and including 5 years in maturity: bank to whom lending is made to have a long term credit rating of at least A.

Replacement values of outstanding hedging instruments are calculated and counterparty limits are adjusted to reflect any off-balance sheet exposure.

Counterparty limits are set based on the Fitch rating, with limits expressed as a percentage of the Society's reserves. New counterparties can only be added provided the appropriate Fitch ratings are in place, and are subject to ALCO approval. Country limits are also set in order to minimise exposure to any one part of the world, except for the UK.

7. "Past Due" (Loans > 3 months in arrears) Exposures by Geographical Region

An analysis of the Society Mortgage Assets, by region of the UK and highlighting arrears in excess of 90 days is noted below:

Geographical Region	Dudley Building Society		
	Mortgages (£'000)		
	Past Due	Performing	Total
North	719	3,253	3,972
Yorkshire & Humberside	12	9,057	9,069
East Midlands	-	18,272	18,272
East Anglia	105	2,656	2,761
Greater London	161	15,118	15,279
South East	-	15,071	15,071
South West	814	4,309	5,123
West Midlands	2,711	139,291	142,002
North West	175	15,222	15,397
Wales	-	1,792	1,792
Total	4,697	224,042	228,738

* Past Due amounts relate to the overall mortgage balances not the amount in arrears.

N.B. In evaluating the above table, no breakdown of the mortgage assets into type is considered appropriate in view of the Society's mortgage assets being principally residential.

8. Provisions

Provisions for losses are based upon an appraisal of loans and advances. Specific provisions are made in respect of properties in possession and in respect of mortgage accounts where arrears represent more than 2.5% of the capital balance and against other assets where book value exceeds the estimated realisable value (based on the Regional Halifax Price Index).

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

General provisions are made where it is considered that there is impairment in the value of assets at the year-end that is not already covered by specific provisions.

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

The general provisions made at the year-end represent the Directors' assessment of the potential losses which, although not yet specifically identified as relating to payment arrears, are known from experience to exist in the Society's loan portfolio.

These provisions have been deducted from the appropriate asset values shown in the balance sheet.

Further details of the level of mortgage provisions can be found in the 2010 Annual Report and Accounts of the Society.

9. Breakdown of Treasury Assets under the Standardised Approach

An analysis of the Society's Treasury Assets at 31 March 2010, based on their Residual Maturity is noted below:-

<u>Long Term Fitch Rating</u>	<u>£000</u> <u>< 3 months</u>	<u>£000</u> <u>< 1 Year</u>	<u>£000</u> <u>> 1 Year</u>	<u>£000</u> <u>Total</u>
AAA to AA-	30,892	24,575	3,993	59,460
AA- to A	22	1,003	-	1,025
Building Societies	15,534	4,018	-	19,552
Government Securities	1,998	1,998	-	3,996
Cash	468	-	-	468
	<u>48,914</u>	<u>31,594</u>	<u>3,993</u>	<u>84,501</u>

10. Conclusion

This disclosure document is intended to provide background information on the Society's approach to risk management as related to maintaining and preserving the capital position of the Society. It also provides asset information and capital calculations under Pillar 1.

In the event that a user of this document has comments or requires further information then they are requested to contact Nigel Bland, Finance Director at nigel.bland@dudleybuildingsociety.co.uk