



Pillar 3 Disclosure Document

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1. Introduction

Legislative framework

The Capital Requirements Directive (CRD), commonly referred to as Basel 2, governs the amount of capital all financial institutions must hold to protect their depositors and shareholders. The CRD was introduced by the European Union from the beginning of 2007. In the UK this is implemented by our regulator, the Financial Services Authority (FSA).

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

This new framework takes into account a number of key aspects of the Cambridge Building Society's operation which are set out in more detail below. These include risk management, governance, and key aspects of credit risk and operational risk; which are disclosed in this document.

The Capital Requirements Directive sets out 3 main segments, known as Pillars, being:

- Pillar 1 – Minimum capital requirements
- Pillar 2 - Assessment of capital requirements by the Building Society and the FSA
- Pillar 3 - Disclosure

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

Building Society approach

Cambridge Building Society has used the approach known as the standardised approach to calculate the Pillar 1 minimum capital requirements. This is based on a prescribed formula focusing on credit and operational risks.

The Board has then undertaken a detailed assessment of all the risks facing the Society and has established additional capital, which must be held under Pillar 2. This includes detailed stress tests of credit risks and financial forecasts to determine whether additional capital is required to mitigate these risks, including in a severe economic downturn.

Coverage

This disclosure document applies to the following trading entities on a fully consolidated basis:

Cambridge Building Society FSA Number 157223

- ↳ Cambridge IT Services Ltd (Holding Company, wholly owned by the Society)
 - ↳ Cambridge Services Ltd (50% ownership of the Administration centre)
 - ↳ Cambridge Property Services Ltd (50% ownership of the Administration centre)
- The Partnership of Cambridge Services Ltd, Cambridge Property Services Ltd (Ownership of IT assets)

The above subsidiaries activity is limited to the ownership of the administration centre and certain IT equipment.

All the figures within this document are correct as at 31st December 2008 unless stated other wise.

2. Risk management policies and objectives

Cambridge Building Society is primarily a producer and retailer of financial products, mainly in the form of mortgages and savings. As well as mortgages and savings the Society also uses wholesale financial instruments to invest liquid asset balances and manage interest rate risks arising from its operations. Building Societies operate in a highly competitive market and with significant uncertainties arising from the general economic environment. Therefore, the management of risk and strategic direction are key activities, vital for the success of the business.

The current market conditions have presented unprecedented challenges to the Society and the financial markets. However, the Society's strong financial position, being predominantly retail funded, provides a solid foundation. The Society is confident in its business strategy and in meeting its objectives despite difficulties that the wider market may present.

The Society has a formal risk management structure in place with established risk policy statements, including risk limits, reporting lines, mandates, a risk review process and other control procedures. This structure is reviewed on a regular basis by the board.

The Society maintains a policy of low exposure to risk so as to maintain public confidence and to allow the achievement of corporate objectives.

The principal risks, detailed below, are continually assessed and managed by the management team.

Margin risk

A principal risk is the ability to maintain competitive interest rates whilst ensuring the continued financial strength of the Society. This risk is heightened in the current period of historically low interest rates. The board, through the Corporate Planning process, manages this risk by setting financial objectives, which are regularly reviewed. One key objective is the control of expenses to support competitive interest rates and maintain a level of retail funds that will substantially support mortgage advances.

Market risk

The primary market risk faced by the Society is exposure to movements in interest rates, reflecting the mismatch between the dates on which interest receivable on assets and interest payable on liabilities are next reset or, if earlier, the instruments' maturity. For example fixed rate mortgages and fixed rate investment bonds. The Society manages this risk on a continuing basis, within limits set by the Assets & Liabilities Committee using a combination of on and off-balance sheet instruments. This includes the use of interest rate swaps, used to manage prudentially the risk arising from fixed rate mortgages. The board receives an appropriate report on a monthly basis, which includes the use of a parallel shift in interest rates of 3% to assess interest rate shock against a strict policy limit determined by the board.

Credit risk

Credit risk is the risk that unexpected losses may arise as a result of the Society's borrowers or market counterparties failing to meet their obligation to repay.

The Mortgage Credit Committee and the Assets & Liabilities Committee are responsible for approving and monitoring the Society's credit exposures which they do through a formal review and approval of the Society's lending and treasury policies. The minutes of these committees are reviewed by the board. All loan applications are assessed with reference to the Society's lending policy.

The Mortgage Committee has oversight of the Executive Underwriting Committee and receives reports on credit quality and performance of the Society's mortgage lending. The Assets & Liabilities Committee recommends limits on Treasury counterparties, country and sector exposures, and types of financial instruments used to the board.

Liquidity risk

Liquidity risk is the risk that the Society will be unable to meet its financial obligations as they fall due.

The Society has policies in place to ensure that it maintains sufficient funds in a liquid form at all times so that the Society can meet its liabilities as they fall due and thus maintain full public confidence in the solvency of the Society. This is achieved through maintaining a prudent level of liquid assets, through modest wholesale funding facilities and through control of the growth of the business. The Assets & Liabilities Committee is responsible for the development and implementation of the liquidity policy and the setting of appropriate maturity and exposure limits. During 2008, in response to the credit crisis, the Society substantially increased its 8 day liquidity policy limit and hence the proportion of funds held in the form of 8 day liquidity. These funds are maintained consistently above both the policy and statutory limits. A series of liquidity stress tests are performed each month to confirm that limits remain appropriate.

Operational risk

This relates to the risk of loss arising from inadequate or failed internal processes or systems, human error or external events.

All such risks are identified, assessed, carefully monitored by individual business areas, which have the responsibility of putting in place appropriate controls. Risks and controls are reviewed on a regular basis via a formal risk management structure, which includes an executive risk committee reporting to the board.

In order to mitigate 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, fixed assets, fidelity, professional indemnity, etc.

To monitor its operational and other risks the society uses a software application, which allows a value, a likelihood and an impact to be assigned to each risk. These values are recorded both before controls and with controls in place, which allows the society to manage the both the effectiveness of controls and any residual risk.

Concentration risk

Concentration risk is the risk arising from the lack of diversification in the Society's business. This includes large exposures to a single counterparty or borrower, or exposures to "higher risk" concentrations such as high loan to value loans, or niche lending for example buy to let loans or industry/sector concentrations.

The society monitors all of these areas carefully to ensure that lending is appropriate for our position and size. This includes, where appropriate, the setting of limits which means, inter alia, that the society is not exposed at all to single counterparty or borrower large exposures.

The Society, as a regional building society, has a geographic concentration in our core lending area. This is carefully managed by managing loan to value risk and is tested by increasing the economic stresses in respect of the areas of concentration. As a result the society holds slightly higher capital to mitigate possible greater reductions in asset values in this region than otherwise would be the case.

Pension obligation risk

Pension risk is the risk that there may be a shortfall in respect of pension benefits due to employees/former employees within a defined benefit scheme.

The society has a defined benefit pension scheme which closed to new members on 31st July 2001. The possibility exists of additional funding requirements arising from increased longevity increasing scheme liabilities, from falling equity markets and/or interest rates affecting investments or the value of future liabilities. A specific amount of capital is set aside to cater for the possibility of such eventualities.

Residual Risk

The Society holds a capital allocation for risks that are not currently foreseen or measured and which are in excess of the minimum required by the FSA.

3. Board and Board Committee structure

The Board has delegated authority to five principal Board Committees:

Audit and Compliance Committee

Composition: The Committee is made up of four non-executive directors, and is attended by the chief executive, head of finance and the audit & compliance manager, by invitation. The committee also meets with the external auditors at least once per year

Main functions:

The role of the Audit and Compliance committee is to review the integrity of financial statements, to review the effectiveness of internal controls and compliance and risk management systems, to monitor and review the effectiveness of the internal audit function and to consider and recommend to the board (for approval by the members) the appointment or reappointment of the external auditors.

It also:

- reviews the internal audit programme and ensures that the internal audit function is adequately resourced and has appropriate standing in the Society;
- receives a report on the results of internal audit's work and monitors management's responsiveness to internal audit's findings and recommendations;
- oversees the Society's relationship with the external auditor and monitors the content of the external auditor's annual management letter and management's response;
- reviews arrangements established by management for compliance with regulatory requirements; and
- receives quarterly reports from the Compliance Officer and in relation to Financial Crime.

Frequency; The Committee meets quarterly, or more frequently as considered appropriate.

Assets & Liabilities Committee

Composition: The Committee is made up of four directors, one of whom is the Chief Executive.

Main functions: Formulate and recommend to the Board:

- a risk appetite relating to treasury and balance sheet structural risk, assessing the capital needs of the Society's present and proposed activities.
- a policy relating to Treasury credit risk including exposures to counterparties, sectors, instruments, etc.,
- a liquidity policy,
- a non-retail funding policy,
- a balance sheet structure policy, including limits relating to interest basis assets, monitoring activity against the above policies.

The committee also assess the effect on the Society's capital of the competitive squeeze on margins, the mismatch between interest characteristics of assets and liabilities, capital and solvency directives issued by regulatory bodies.

Frequency; meets 5 times a year with additional meetings if required

Mortgage Credit Committee

Composition: The Committee is made up of four members, two of whom will be non-executive directors.

Main functions:

- Approve the credit quality of the mortgage book involving trend analysis based on risk profile.
- Assess the quality of underwriting decisions.
- Approve changes to the lending policy as recommended by the Mortgage Underwriting Committee including underwriting mandates.
- Recommend to the Board the Society's high level policy on lending (residential and commercial).
- Have oversight of the Executive Underwriting Committee.
- Provide guidance and instruction on any policy change required as a result of a change in the risk profile of the Society's mortgage book.
- Receive and approve a report on the credit quality, risk profile and performance of the Society's mortgage book.

Frequency; meets 4 times a year and otherwise as required

Nomination Committee

Composition: The Committee is made up of three members, two of whom must be non-executive directors.

Main functions:

- regularly review the structure, size and composition (including the skills, knowledge and experience) required of the board, compared to its current position and make recommendations to the board with regard to any changes.
- Give full consideration to succession planning for members of the board and the chief executive, taking into account the challenges and opportunities facing the Society, and what skills and expertise are therefore needed on the Board in the future.
- Evaluate the balance of skills, knowledge and experience on the board, and, in the light of this evaluation prepare a description of the role and capabilities required for a particular appointment.
- Keep under review the leadership needs of the Society, both executive and non-executive, with a view to ensuring the continued ability of the Society to compete effectively in the market place;

Frequency; meets annually, or when required

Remuneration Committee

Composition: The Committee is made up of four non-executive directors.

Main functions:

- To determine and agree the broad policy for the remuneration of the Society's Chief Executive, Board Chair, Executive Directors, Non-executive Directors and non-board members as appropriate.
- In determining such policy, ensure that the Society attracts and retains executives of sufficient calibre for its continued well-being and that members of the executive are motivated and fairly rewarded for their individual contributions to the Society's overall performance.

Frequency; meets annually or when required

4. Capital resources

The Capital Resources of the Group are calculated in accordance with the FSA Handbook, Prudential Standards, General Prudential sourcebook (GENPRU 2 Annex 2). The scope of these resources as at 31st December 2008 (the last audited accounts) relate to the Society and Subsidiaries.

There are no current or foreseen material, practical or legal impediment to the prompt transfer of capital resource between the Cambridge Building Society and its subsidiaries.

The Group assets as at 31st December 2008 are £919.5m, which include Society assets of £923.6m.

The Group Capital Resources as at 31st December 2008 comprise:

		£m
Tier 1	General Reserves	53.85
Tier 2	General loss provision	0.58
Total		54.43

The Group has no other form of capital, nor has any deductions from Tier 1 or any other tier of capital.

5. Compliance with FSA Handbook Prudential sourcebook & Pillar 2

Adequacy of capital

A key component of the Cambridge Building Society Corporate Plan is to maintain our capital strength above the board agreed requirement. In order to do this the Society needs to generate and retain profits that will add to the general reserves, the main source of capital.

The Corporate Plan process, in addition to establishing objectives and strategies, and also determines a risk appetite framework and policies to manage risk.

Capital Adequacy Assessment Process

Complementing the Corporate Plan, the Society undertakes an Internal Capital Adequacy Assessment Process (ICAAP), which focuses on ensuring that capital resource of the Society is sufficient given the Corporate Plan objectives, both in normal and stressed conditions.

This process involves reviewing all risks relating to assets and operations and making an assessment of capital required to mitigate any material financial impact of those risks. Included in this process is a detailed assessment of the results of the Society stress models based on a number of economic scenarios. The key risk areas are detailed in section 2.

The Society translates its overall risk appetite for credit risk into a range of lending and liquidity limits controlling the exposures taken. These exposures are carefully monitored by the board or board committee on a regular basis. Other risks are monitored regularly.

The board assesses relevant financial information on each of these areas against a clearly defined risk appetite and approves the capital requirements arising from this detailed review. It also takes into account any areas where they feel the models and internal assessments do not adequately capture the full risk exposure by holding extra capital where appropriate.

Risk weighted exposure Amounts & Operational Risk Capital

The assets of the Group are analysed by risk category which assigns risk weights according to the "Standardised Approach" under the FSA Handbook BIPRU 3. 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 Group averaged over the previous 3 years, described in the FSA Handbook BIPRU 6.

As at 31 st December 2008	Assets £m	Risk Weighted Assets £m	Capital £m
Liquid Assets			
Sovereign & cash	1.8	Nil	Nil
Local authorities	Nil	Nil	Nil
Financial institutions	231.0	48.8	3.90
Loans & Advances to Customers¹			
Residential	643.8	227.1	18.17
Commercial	30.3	30.3	2.42
Past due items	5.8	5.0	0.40
Fixed and other assets	8.3	8.3	0.67
Total Credit Risk Exposures	921.0	319.5	25.56
Operational Risk Capital Requirements			2.24

In addition the Group holds capital of £0.16m against mortgage assets offered not completed and off balance sheet financial instruments.

Counterparty Credit Risk

The purpose of the Society's counterparty treasury credit risk management policy is to ensure that the credit risk appetite, which is that the Society has no appetite for credit losses in Treasury, is met. Appropriate internal systems and controls have been implemented to ensure that credit losses are prevented, including segregation of duties and reporting.

The methodology for establishing counterparty limits involves consideration of the background rating information. The minimum rating required under Fitch is F1+, with F1 allowed for UK banks and for a maximum exposure of 3 months. Investments in Local Authorities, which are not rated, and unrated Building Societies are also permitted, the later with monetary limits linked to asset size.

Counterparty exposures are inclusive of an allowance for hedging instruments based on 10% of the nominal amount.

Counterparty limit policy is reviewed, as a minimum, each year by the Assets & Liability Committee and any changes recommended to the Board for approval. Limits may be suspended by the Treasury function pending removal in the event of adverse market intelligence. No dealing can be undertaken with counterparties which do not have a pre-approved limit. Where appropriate, exposure to counterparties is monitored on a consolidated basis.

¹ Excludes mortgage loss provision

Residual maturity breakdown by Exposure ClassAs at 31st December 2008

£m	Up to 3 months	3 months to 1 year	1 year to 5 years	Over 5 years	Total
Liquid Assets					
Sovereign & cash	1.7	0.1	-	-	1.8
Local authorities	-	-	-	-	-
Financial institutions	161.1	48.1	21.8	-	231.0
Loans & Advances to Customers					
Residential	8.1	23.9	107.5	504.3	643.8
Commercial	0.5	3.6	4.1	22.1	30.3
Past due items	-	-	0.1	5.7	5.8

The maturity of exposures is shown on a contractual basis. In addition it does not take into account any installments receivable over the life of the exposure.

Exposure and "Past Due" by Exposure Class and Geographic Region

The tables below detail loan exposure and "past due" by Exposure Class and geographic region. Past due amounts shown below relate to the overall mortgage balances, not the amount in arrears.

The main exposure class is core residential, however the Society has a material exposure to Buy to let and in additional land fully secured on land (Commercial) is show separately.

All loans relate to the Society as at 31st December 2008.

	Core Residential £m		
	Past Due	Performing	Total
East Anglia	3.3	470.8	474.1
London & South East	1.0	78.0	79.0
South West & Wales	0.1	4.6	4.7
Midlands	-	6.9	6.9
North	-	4.1	4.1
TOTAL	4.4	564.4	568.8

	Buy to let £m		
	Past Due	Performing	Total
East Anglia	1.3	69.1	70.4
London & South East	0.1	9.2	9.3
South West & Wales	-	0.3	0.3
Midlands	-	0.5	0.5
North	-	0.3	0.3
TOTAL	1.4	79.4	80.8

	Commercial £m		
	Past Due	Performing	Total
East Anglia	-	28.5	28.5
Other	-	1.8	1.8
TOTAL	-	30.3	30.3

Provisions

Specific and general provisions for losses are based on an appraisal on mortgage assets.

Specific provisions are assessed on individual properties in possession and loans which are in arrears. Specific provision for impaired loans take into account any discount which may be needed against the value of the property to agree a sale within three months, the amount recoverable from any insurance policies and anticipated realisation costs. The basis of provisioning also recognises that not all accounts in arrears will result in possession and thereby a factor based on current experience to reflect this probability when calculating the provision for arrears.

The general provision is based on an appraisal of losses that may exist on assets not covered by specific provisions.

The amount charged in the annual income and expenditure account represent losses written off in the accounting year together with the net change in provisions. Interest in respect of all loans is credited to the income and expenditure account as it becomes receivable. Irrecoverable Interest on repossessed properties is written off against interest receivable.

Details relating to the above can be found in the 2008 Annual Report and Accounts.

6. Conclusion

A key component of the Cambridge Building Society Corporate Plan is to maintain our capital strength above the Board agreed requirement. In order to do this the Society needs to generate and retain profits that will add to the general reserves, the main source of capital.

The disclosure of the document is intended to meet the requirements of the FSA Handbook BIPRU Chapter 11 by providing background information on:-

- the Society's approach to risk management, its policies and objectives,
- the governance of the Board and Board Committee structure
- capital resources, and
- compliance with the FSA Handbook source book & pillar 2.