



Basel II Pillar 3
Disclosures
for the year ended 31 December 2010

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1. Overview

The Capital Requirements Directive (Basel II) introduced on 1 January 2007 sets out the rules regarding capital adequacy for banks and building societies, including the disclosure requirements (Pillar 3).

The rules within Basel II are categorised under three “pillars”:

Pillar 1 sets out the minimum regulatory capital resources requirement which predominantly comprises credit risk and operational risk.

Pillar 2 covers Management’s assessment of the additional capital resources required to cover the specific risks faced by the institution that are not covered by the minimum regulatory capital resources requirement set out under Pillar 1.

Pillar 3 requires building societies and banks operating under the Basel II framework to disclose qualitative and quantitative information regarding their risk assessment process and capital resources, and hence their capital adequacy.

In addition to the assessment of capital requirements under Pillar 1 and 2 above, the Company’s overall capital requirement is also reviewed and agreed by the FSA under the Supervisory Review and Evaluation Process (SREP). Under this process the FSA set the Individual Capital Guidance (ICG) for the Company, which is the minimum amount of capital that the Company should hold.

This document has been prepared to meet the Pillar 3 disclosure requirements of Basel II. This document is based upon the Company’s Annual Report and Accounts for the year ended 31 December 2010, unless otherwise stated. These disclosures are issued on an annual basis as soon as practicable after the publication of the Company’s Annual Report and Accounts.

These disclosures are published on the Company’s website (www.methodistchapel.co.uk). There is no requirement for the disclosures to be audited; however, some of the information within the disclosures also appears in the Company’s Annual Report and Accounts.

2. Risk Management Policies and Objectives

The Board has an established risk management framework for the Company that is proportionate to both the size of the Company and the risks to which it is exposed. This framework enables the Board to identify, monitor, control and report on the key risks faced by the Company.

The Company operates within its Board approved policies which cover all aspects of its operations. The consideration and management of risk is included in each of the Company's policies. Risk management is seen as a regular, ongoing process, inter-woven within the strategic and daily operational management of the Company.

The Company's Audit Committee of non executive Directors approves the risk based annual Audit Plan, and the Company's Internal Auditor reports monthly to the Audit Committee with copies of each report being sent to all Board members for information.

The Senior Officers are responsible for the day to day operation of the business in line with the overall Risk Appetite Statement and the resulting policies, limits and controls. They are also responsible for reporting performance against the internal limits to the Board for discussion as appropriate at each meeting, and more frequently if appropriate. The Board regularly reviews and challenges policies, documents and limits and takes action as necessary.

The Internal Auditor independently provides objective assurance as to the adequacy and effectiveness of internal controls across the business. A risk based programme of work is undertaken which is designed to provide appropriate coverage of the key business risks and processes. The Audit Committee approves the annual Internal Audit Plan and receives monthly reports on the results of audit work, with copies of each report being sent to all Board members for information.

3. Capital Resources and Business Strategy

Capital is held to provide a cushion to absorb losses that may occur during the economic cycle. In assessing the adequacy of its capital, the Company considers its risk appetite, the material risks to which the Company is exposed and the appropriate management strategies for each of the Company's material risks.

The Company's main source of capital is from retained surpluses added to the reserves that have accumulated since the Company's formation in 1890. The Company does not give priority to enhancing the level of dividend paid to its shareholders

It is essential that the Company maintains sufficient capital to support its ongoing activities and this requirement is an integral part of the Company's corporate planning process. The Company's 4-Year Plan projects forward and takes into account the need to maintain resources to support the Plan's objectives.

In addition to the corporate planning process the Company is required to undertake an Internal Capital Adequacy Assessment Process (ICAAP) which is a formal process that calculates the Company's capital requirement in normal and stressed conditions.

The ICAAP involves reviewing all of the Company's business activities and calculating the capital required to support them.

The Company undertakes regular stress testing and reverse stress testing with the results of this testing influencing business decisions on an ongoing basis.

The Company has in place limits in relation to both loans and the investment of surplus funds which control the level of exposures which the Company may have in those areas of business.

4. Capital Adequacy

Under the 'Standardised Approach', as specified by the Capital Requirements Directive, the level of capital required against a given level of exposure to credit risk is calculated as:-

Credit risk capital requirement = Exposure value x Risk weighting x 8%

The risk weighting for each exposure is determined by reference to external credit ratings or regulatory guidance. In addition, an evaluation of the capital required to cover Operational Risk is calculated under the 'Basic Indicator Approach' and determined by reference to the annual gross income of the Company averaged over the previous 3 years.

The resulting capital requirements as at 31 December 2010 are set out overleaf.

	Exposure £'000	Risk Weighted Exposure £'000	Capital Required (8% Thereof) £'000
Credit Institutions	12,509	2,502	200
UK Treasury Stocks	2,672	-	-
Multilateral Development Banks	1,247	-	-
Sterling Corporate Bonds	2,328	1,400	112
Collective investment undertakings	1,592	1,179	94
Equity investments	4,379	4,379	350
			-
Loans and advances to customers	(drawn)	3,510	211
	(50% of undrawn)	1,397	112
Fixed and other assets	93	93	8
Total credit risk exposure	29,727	13,583	1,087
Operational risk capital requirement			14
Total Pillar 1 Capital Requirement			1,101

(The Company has no exposures to commodities, foreign currencies or trading-book business)

However due to the Company's small size relative to most other banks, its minimum capital requirement is calculated as the Euro 5 million regulatory base capital requirement for banks, as this is in excess of the sum of the credit, market and operational risk requirements under Pillar 1, shown above. As at 31 December 2010, this regulatory base capital requirement equated to £4.283 million.

The total capital resources of the Company were £6.997 million as at 31 December 2010. This was all Tier 1 Capital as defined in the Capital Requirements Directive, and consists of £1,197 of issued share capital and £6,995,772 reserves of the Company, representing the accumulated surpluses after tax.

Therefore the Company achieved headroom of £2.714 million (63%) over the regulatory base capital requirement.

5. Principal Risks

The principal risks faced by the Company are:

5.1 Business Risk

Business risk arises from changes to the Company's business, specifically the risk of not being able to carry out the Company's business plan and desired strategy. In assessing business risk, consideration is given to internal and external factors.

Risk Appetite

The business risk appetite is set by reference to the approved budget and four year plan sanctioned by the Board.

Mitigation

As part of the annual budgeting and planning process, the Company develops a set of management actions to prevent or mitigate the impact on earnings in the event that business risks materialise. Additionally, business risk monitoring, through regular reports and oversight, results in corrective actions to plans and reductions in exposures where necessary.

Revenue and capital investment considerations require additional in depth assessment followed by Board approval. Formal risk assessment is conducted as part of the financial approval process.

5.2 Liquidity Risk

The risk that the Company does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost, or that the Company does not have sufficiently stable and diverse sources of funding, or that the funding structure is inefficient.

Risk Appetite

The Company ensures that it maintains a minimum liquidity position sufficient to meet a demand for payment of all retail deposits repayable within 8 days, even under stressed scenarios. The risk appetite is considered as a 'low risk appetite' based on liquidity levels and risk profiles within the UK banking sector and this is reflected in the measures that the Company has in place to monitor liquidity. The Company has undertaken stress tests in this regard.

Mitigation

The Company mitigates the risk of a liquidity position arising which is outside of its appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term strategic funding.

The Company aims to maintain a minimum liquidity position that is well in excess of regulatory requirements, even under stressed scenarios, being reflective of the organisation's low risk appetite.

Full details of the 'traffic lights', measures and mitigants are included within the Company's ILSA document.

5.3 Market & Interest Rate Risk

The risk from adverse movements in external markets, e.g. interest rate movements, equity movements or currency movements which could potentially reduce income and/or increase expenses.

Risk Appetite

The Company has recently increased the proportion of gilts within the portfolio and already holds over 100% of the FSA required amount as its liquidity buffer. The Board has decided to limit the amount invested in UK equities to one third of the total market value of the funds in its investment portfolio, and its observance will be carefully monitored through the daily reports via the internet.

Only UK equities which relate to companies within the FTSE 350 are purchased, thereby ensuring that a high quality is maintained and that the liquidity of such investments is not a problem. Corporate bonds are highly rated sterling investments in quoted companies. The Company has no direct exposure to foreign exchange risk as it does not trade in these markets or in currencies other than Sterling.

The Company does not offer any fixed rate deposit or loan products other than car loans (limited to £250,000 in total) and therefore can respond appropriately to movements in market interest rates. Also, the recently introduced Payment Services Regulations require the Company to give 2 months advance notice of any reduction in interest rates payable to customers.

Mitigation

The Company has restricted its investments to highly rated, easily realisable fixed interest and equity stocks. The Company does not expect to generate significant losses upon the sale of these investments.

The unrealised gain on the Company's investments (currently £1.5 million) is monitored closely and trigger points are in place in order to respond quickly to adverse movements.

Summary of exposures to equities

As at 31 December 2010, the Company's exposure to equities (comprising largely investments in FTSE 350 companies and equity-related investment funds) is summarised below:

	£'000
Market value	5,418
Book cost	<u>4,379</u>
Unrealised gain	<u>1,039</u>

Gains of over £0.4 million were realised on the sale of equity investments during the year ended 31 December 2010.

The equity investments are generally held for the long term within the Company's ethical investing policy. The Company is not a dealing Company and the main purpose of the equity investments is to generate income to help the Company to achieve its purpose.

Neither the unrealised gains of £1.0 million nor the unrealised gain of approximately £0.5m on fixed interest investments are included in the calculation of the Company's capital resources under the Company's accounting policies.

5.4 Operational Risk

The risk of reductions in earnings through financial or reputational loss, from inadequate or failed internal processes and systems, operational inefficiencies, or from people-related or external events.

Risk Appetite

The Company will not engage in activities that in the opinion of the Board would fall outside its purpose. The Company has no intention of amending its main focus of activity in the foreseeable future. The Company's Audit Committee of non executive Directors approves annually the risk based annual Audit Plan, and the Company's Internal Auditor reports monthly to the Audit Committee with copies of each report being sent to all Board members for information.

The Company's Senior Officers produce detailed operational reports for the Board on a regular basis and the Company's Procedures Manual is maintained for all of the Company's main processes. A strict control environment operates with the segregation of duties being observed and audited. This segregation of duties is considered appropriate for the size of the Company.

Mitigation

The Company undertakes the following:

- identification of the key operational risks within the business;
- evaluation of the effectiveness of the existing control framework covering each of the key risks to which the business is exposed;

- evaluation of both the financial risk and non-financial risk (e.g. reputational damage);
- for each material risk identified an estimate of exposure to probability and event likelihood is undertaken; and
- appropriate action to mitigate or minimise the risk.

This process is embedded into the Company's daily procedures.

5.5 Regulatory Risk

Regulatory risk arises due to the ever increasing regulatory environment in which the Company operates and the increasing volume and pace of change from within the UK and European financial regulators. This can impact a company, both operationally in terms of cost of compliance, with uncertainty about legal and regulatory expectations, and strategically through pressure on key earnings streams.

Risk Appetite

The Company looks to ensure that it adopts all regulatory, legal and other compliance requirements in a proportionate way that satisfies the requirements of the regimes in a business enhancing fashion.

Mitigation

The Company has in place systems and controls to ensure that it complies with its regulatory reporting requirements as well as a framework to ensure that new and amended regulation is embedded in to the systems and processes of the organisation.

5.6 Counterparty Credit Risk

The risk of a reduction in earnings and/or value, as a result of the failure of the party with whom the Company has contracted to meet its obligations (both on and off balance sheet) as they fall due (i.e. loan repayments, investments or bank deposits).

Risk Appetite

Credit Risk (wholesale markets):

The Company will not engage in wholesale deposit lending other than with UK interbank counterparties with strong long term credit ratings, or allow placements exceeding the Company's large exposures capital base (subject to the FSA pre-notification rules). The amount of deposits placed with any one bank is limited to 50% of the total.

In addition, the Company invests in UK government gilts and major company corporate bonds via its investment manager, Sarasin and Partners. Sarasin and Partners operates within parameters and limits agreed by the Board. The corporate bonds are all sterling based and considered by the Investment Manager to be low risk and well diversified.

Mitigation

After careful checks have been made, the counterparties with whom the Company places deposits are approved in advance by the Board.

Credit Risk (retail markets):

The Company lends to Christian churches and organisations within the UK only and the total balance on loan at any time is restricted to a self-imposed guideline of 50% of the total depositors' balances or 150% of share capital plus reserves, whichever is the lower. Individual loan approvals cannot be greater than 10% of the FSA approved capital. Loans above £50,000 are generally secured by way of a legal charge and loans under £50,000 by way of a declaration from the Managing Trustees of the church. Bridging loans for manse purchase are secured by way of a solicitor's undertaking to repay the proceeds of the house sale to the Company.

Car loans to individuals (Methodist ministers and deacons) are limited to a total balance advanced of £250,000 and a maximum loan of £10,000 per individual.

Mitigation

Financial risk assessments are undertaken on all term property loans (including review of accounts covering three years) and loans are approved in accordance with defined limits with due consideration given to the collateral. All property loans require the approval of at least one Director plus the Chief Executive or Company Accountant. Where the application for a property loan comes from a body outside the Methodist Church the approval of the full Board is required.

Provisions

The Company has a Provisioning Policy which is reviewed by the Board at least annually. The experience of the Company over the whole of its life is that it has never had a bad debt in relation to its property loans. Historically, no provisions in relation to property loans to trustees have been assessed as necessary. However, the Board has agreed in principle to include such provisions in the future if appropriate.

Following the introduction of unsecured car loans to Methodist ministers and deacons a provision for bad debts is being made. This is 2.5% of the outstanding capital balance on car loans at the year end. The actual amount of the provision will therefore vary each year.

The need to raise a specific provision when a borrower requests a rescheduling of repayments will be considered at the time by the Chief Executive.

The Company's policy is to hold investments in British Government securities, Corporate Bonds and publicly quoted stocks and shares and investment funds. Since the market value of the investments held is in excess of the book value, no provision for losses on investments is considered necessary at present. In addition, the Company's investments are not held for trading, and so fluctuations in value do not have an immediate impact on profitability.

At 31 December 2010, the total provisions were £8,895. This comprised of a general provision of £4,692 in respect of car loans (2.5%) and a further specific provision of £4,202 in respect of one car loan. The total provision increased by £4,807 in the year. No provisions were released.

The property loans (excluding bridging loans) are repayable semi-annually on 30 June and 31 December. All payments due on 31 December 2010 have been received and no property loans are currently in default of agreed payment terms.

Geographical Breakdown of loans advanced

A breakdown of loan balances as at 31 December 2010 analysed by Methodist District is shown below:

	Property Loans £	Car Loans £	Total £
London	421,027	37,077	458,104
Beds, Essex & Herts	412,058	13,490	425,548
Nottingham & Derby	406,188	9,333	415,521
Plymouth & Exeter	396,063	3,750	399,813
Liverpool	234,677	7,170	241,847
Manchester & Stockport	201,060	9,145	210,205
East Anglia	207,750	-	207,750
Lincoln & Grimsby	190,000	5,413	195,413
Southampton	173,941	7,500	181,441
North Lancashire	152,823	-	152,823
Cornwall	125,250	9,452	134,702
Darlington	117,447	8,578	126,025
Northampton	113,375	-	113,375
Other England	166,789	66,611	233,400
Wales	-	8,878	8,878
Scotland	-	5,504	5,504
	<u>3,318,448</u>	<u>191,901</u>	<u>3,510,349</u>

Credit Quality

The table overleaf sets out the credit quality of corporate bonds and investments in collective investment undertakings (on a see-through basis) as at 31 December 2010.

The Company has adopted the standardised approach to credit risk and follows the standard mapping of credit quality steps to ratings provided by Standard & Poor's.

Whilst the Company uses credit risk mitigation techniques where suitable, these are not used in the calculation of the Pillar 1 capital requirements. Hence the exposure values and exposure values after credit risk mitigation are the same:

Credit quality step	Corporate Bonds			Collective Investment Undertakings		
	Risk Weight	Exposure	Exposure after credit risk mitigation	Risk Weight	Exposure	Exposure after credit risk mitigation
1	20%	159	159	20%	305	305
2	50%	1,602	1,602	50%	392	392
3	100%	567	567	100%	614	614
4	100%	-	-	100%	155	155
5	150%	-	-	150%	20	20
6	150%	-	-	150%	106	106
		2,328	2,328		1,592	1,592

All investments in Treasury stocks relate to the UK government and are credit quality step 1.

All exposures to financial institutions have a residual maturity of 3 months or less and the exposure by credit quality step is as shown below:

Credit quality step	Deposits with UK Financial Institutions with effective maturity of 3 months or less		
	Risk Weight	Exposure	Exposure after credit risk mitigation
1	20%	7,880	7,880
2	20%	4,460	4,460
3	20%	-	-
4	50%	-	-
5	50%	-	-
6	150%	-	-
		12,340	12,340

5.7 Capital Risk

Capital risk is defined as the risk that the Company has insufficient capital to provide a resource large enough to absorb losses or that the capital structure is insufficient to meet regulatory requirements.

Risk Appetite

The Company's target is to maintain its capital resources at a level which is increasingly above the Euro 5 million plus £1.4 million (subject to review) to cover potential stresses as identified in the Company's ICAAP.

Mitigation

The Company has developed an early warning 'traffic lights' system to enable the occurrence of the risks to its capital base to be quickly identified and corrective action taken where necessary.

The Company adopts a prudent and responsible approach to the management of capital and has prepared a detailed Internal Capital Adequacy Assessment Process (ICAAP) which was approved by the Board and in response to which the FSA felt able to issue an Individual Capital Guidance (ICG) to the Company.

The Board of the Company accepts that there is inherent risk in running a banking business; however, it is the Company's policy to minimise the unavoidable risks and further mitigate them wherever the costs of doing so are proportionate to the potential impact.

5.8 Residual Risk

The Company holds capital both to cover events that can be anticipated with a reasonable degree of certainty and to deal with market stresses. In addition, capital is held in excess of the minimum required by the FSA to cover events that are unforeseen.

6. Conclusion

This disclosure document is intended to provide background information on the Company's approach to risk management as related to maintaining and preserving the capital position of the Company.

In the event that a user of this document has comments or requires further information they are requested to contact the Company using the details shown overleaf or by e-mailing mcaa@methodistchapel.co.uk.

7. Notices

This Disclosure is based on the Company's latest ICAAP review (using figures as at 31 December 2010) and is subject to periodic review and update.

The information contained in this disclosure has not been audited by the Company's external auditors.

Methodist Chapel Aid Ltd is registered in England and Wales and its registration number is 30546.

The Company is authorised and regulated by the Financial Services Authority (reference number 204508).

The registered office address of the Company is: 1 Telford Terrace, Albemarle Road, York, YO24 1DQ. Tel: 01904 622150.