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PILLAR 3 DISCLOSURE DOCUMENT

31 August 2011



Pillar 3 Disclosure Document Index

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Introduction

1. The legislative framework, the 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, was introduced by the European Union from the beginning of 2007.
2. The Financial Services Authority ('FSA') is the regulator of Hanley Economic Building Society and its subsidiaries ('the Society') and is responsible for implementing the CRD in the UK. The Society adopted the new legislation on 1st January 2008, in line with the timetable agreed with the FSA. The Standardised Approach was used for Credit risk and the Basic Indicator Approach for Operational risk.
3. The CRD comprises 3 main elements, or 'Pillars', namely:
 - Pillar 1: Minimum capital requirement, using a risk based capital calculation focussing particularly on credit and operational risk, to determine the Society's Capital Resources Requirement ('CRR').
 - Pillar 2: Internal Capital Adequacy Assessment Process ('ICAAP') and Supervisory Review and Evaluation Process ('SREP'). The Society's Board has undertaken an assessment of all of the key risks facing the Society and additionally has stress tested those risks to establish a level of additional capital to be held under Pillar 2. The methodology adopted was reviewed by the FSA as a part of their SREP / ARROW visit held in November 2008.
 - Pillar 3: This policy document deals with the requirements under Pillar 3 (disclosure) and the information provided is in accordance with the Rules laid down in the FSA handbook, BIPRU, section 11.
4. The Board approved the Society's ICAAP at their meeting dated 29 November 2011.
5. This disclosure document, prepared as at 31 August 2011 covers the entire business across the three legal entities in the group (Hanley Economic Building Society [FSA number 206024], Hanley Mortgages Services Ltd [FSA Number 301487] and Hanley Financial Services Ltd [FSA number 211538]. The figures quoted in this disclosure have been drawn from the Society's Annual Report and Accounts as at 31 August 2011, unless otherwise stated.
6. The Society's aim is to ensure it protects members' savings by having sufficient capital even during a significant economic downturn.

Risk Management Policies and Objectives

7. The Society's prudent nature ensures that it maintains a low exposure to risk, thereby maintaining public confidence and allowing for the achievement of its corporate objectives.
8. The Board is responsible for determining a framework for risk management and control. It approves all policies and Committee terms of reference. The Executive Directors are responsible for designing, operating and monitoring risk management and internal control processes. The Society uses a risk register to assess the likelihood and impact of its key risks. This is reviewed at least annually by the Board and it forms a base for the identification of risks for inclusion in the ICAAP under Pillar 2.
9. The Board Assets and Liabilities Committee ('ALCO'), comprising both Non-Executive and Executive Directors, is responsible for monitoring risks on both sides of the balance sheet. Specifically ALCO is responsible for reviewing the Society's lending policy and monitoring the

exposures and arrears performance in accordance with this. This includes exposures to individual counterparties and sector concentration. Furthermore ALCO is responsible for recommending limits on treasury counterparties, country exposures and types of financial instruments for approval by the Board.

10. The Audit, Risk and Compliance Committee ('ARCC'), consists solely of Non-Executive Directors. It considers the adequacy of internal controls, the compliance function and the evaluation and on-going management of risk. The system of internal control is designed to enable the Society to achieve its corporate objectives within a managed risk profile.
11. The internal audit function provides independent and objective assurance that these processes are appropriate and effectively applied.
12. The Board has approved a Statement of Risk Appetite which is detailed in the Society's ICAAP document.
13. The Society is primarily a producer and retailer of financial products, mainly in the form of mortgages and savings. These products give rise to a financial asset or liability and are termed financial instruments.
14. Through its normal operations the Society is exposed to a number of risks the most significant of which are credit, liquidity, regulatory, market, interest rate, strategic, operational, concentration and residual risk. The Society has a formal structure for managing these risks including established risk limits, reporting lines, mandates and other control procedures.
 - Credit Risk

Credit risk is the risk of a customer or counterparty not meeting their obligations as they fall due. Credit risk arises primarily from loans to retail and commercial mortgage customers and from liquid assets held by the Society.

Key policy statements covering credit risk are included in the Board approved Lending Policy, Liquidity Policy, Structural Risk Policy and Wholesale Funding Policy. Each policy is reviewed at least annually by the Board.
 - Liquidity Risk

Liquidity risk is the risk that the Society is not able to meet its financial obligations as they fall due. The Society's Liquidity Policy sets internal limits to maintain full public confidence in the solvency of the Society and to meet its financial obligations. This is achieved through maintaining a prudent level of liquid assets, through wholesale funding facilities and through management of the growth of the business.
 - Regulatory Risk

Regulatory risk is the risk that the volume and complexity of regulatory issues may impact on the Society's ability to compete over time.
 - Market Risk

Market risk incorporates the loss of income, mainly as a result of changes to interest rates. Exposure to this risk is managed on a continuous basis, within limits set by the Board, using interest rate swap and cap products. All transactions in such instruments are undertaken to manage the risks arising from underlying business activities. No transactions of a speculative nature are undertaken.
 - Strategic Risk

Strategic 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.

By its nature, strategic risk is dependent upon external macroeconomic factors, in particular, economic downturn, loss of business to competitors, pricing pressures and changes in costs. These factors are considered as part of the Society's corporate planning process.

- Operational Risk

Operational risk is the risk of loss arising from failed or inadequate systems, human error or other external factors. All business areas have responsibility for putting in place appropriate controls and these are monitored by senior management and the Audit and Compliance Committee.

- Concentration Risk

Concentration risk arises as a result of the concentration of exposures within the same category, whether it is geographical location, product type, industry sector or counterparty type. These risks are managed through adherence to Board-approved lending and liquidity policies, which provide for a range of limits that are regularly monitored and reviewed in the light of changing economic conditions.

- Claims on the Financial Services Compensation Scheme (FSCS)

Along with other deposit takers the Society is liable to any claims on the FSCS as a result of the failure of other deposit takers.

- Loss of Key Personnel

Many of a building society's activities require specialist skills which, by their nature, can be considered to be scarce. To mitigate this risk the Society has in place a comprehensive succession plan for both Non-executive directors and senior staff. In addition a capital provision has been made under Pillar 2 as part of the ICAAP to cover the cost of buying-in specialist skills should the need arise.

- Insurance Risk

This is the risk that there may be gaps in the scope of the Society's insurances, that there is insufficient cover in place, or that the covenant of the insurer is defective. Processes are in place which provide the Board with the assurance that the Society's insurance arrangements are robust.

- Conduct Risk

This risk concerns the way in which the Society conducts its business with its customers. This includes, for example, the way that it deals with borrowers in arrears, complaints handling and behaving in a way that treats all customers fairly. Included in the Society's approach to conduct risk is a regular review by the Board of the fair treatment of customers. The Board is satisfied that the Society's approach to conduct risk is both appropriate and robust.

- Residual Risk

The Board recognises that there are residual risks inherent in any business, which may not be identified specifically. Adequate provision has been made for general residual risks in the ICAAP by applying a buffer to the Individual Capital Guidance ('ICG') requirement issued by the FSA.

Capital Adequacy Assessment & Capital Resources

15. Total Society capital at 31 August 2011, amount to £28.4m, comprising Tier 1 capital (general reserves) and Tier 2 capital (general provisions for bad and doubtful debts).
16. The Society has no need for remunerated capital and therefore has no subordinated debt or permanent interest bearing shares.
17. Table 1 provides details of the components of Tier 1 capital, Tier 2 capital and total capital of the Society as at 31 August 2011.

<u>Capital Resources</u>	<u>£'m</u>
<u>Tier 1 Capital</u>	
Gross(Accumulated General Reserves)	28.2
Deductions	-
Net Tier 1 Capital	<u>28.2</u>
<u>Tier 2 Capital</u>	
Gross (general provisions for bad and doubtful debts)	0.2
Deductions	-
Net Tier 2 Capital	<u>0.2</u>
<u>Total Capital</u>	
Gross	28.4
Deductions	-
Net Total Capital	<u>28.4</u>

Table 1: Capital Resources 31 August 2011

18. The Society operates a three year strategic plan which is set on an annual basis following the Board's dedicated strategy meeting. The plan is subject to ongoing review by the Board, considering the current and changing economic conditions and the impact and opportunities available to The Society.
19. The Corporate Plan is driven by reference to the Society's ICAAP and in particular the Board's risk appetite for different business activities and risks.
20. The ICAAP contains the capital plan for the Society for the next three years and the Board ensures that there are adequate capital resources to support the corporate goals contained within the plan.
21. In order to produce a detailed capital plan, the Society's ICAAP contains calculations of the capital resources requirement (effectively, the minimum capital required) each year using the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk.
22. Under the Standardised Approach for credit risk, the Society applies a risk weighted asset value to each of its exposure classes and provides 8% of that risk weighted asset value as the minimum capital requirement for credit risk.
23. Under the Basic Indicator Approach for operational risk, the Society calculates its average net income over the previous three years and provides 15% of that average net income as the

minimum capital requirement for operational risk.

24. Table 2 provides details of the calculation of capital resource requirements within the Society as at 31 August 2011 covering both liquidity and mortgage exposures.

	<u>Asset</u>	<u>Risk Weighted</u> <u>Asset</u>	<u>Capital</u>
	<u>£'m</u>	<u>£'m</u>	<u>£'m</u>
Non Cash Liquidity Exposures			
Central Government	15.8	0	0
Regional & Local Government	0	0	0
Credit Institutions	79.3	19.9	1.6
Total non cash Liquidity exposures	95.1	19.9	1.6
Loans & Advances to Customers			
Residential – performing loans	203.3	72.2	5.8
Residential – past due items	14.7	17.4	1.4
Non Residential – performing loans	9.9	9.9	0.8
Non Residential – past due items	8.5	11.5	0.9
Total Loans & advances to Customers	236.4	111.0	8.9
Other Exposures			
Fixed & Other Assets	4.3	3.9	0.3
Total Other Exposures	4.3	3.9	0.3
Credit Risk – Capital Resources required	335.8	134.8	10.8
Operational Risk – Capital Resources required			0.7
Group total capital resources required			11.5

Table 2: Capital Resource Requirements 31 August 2011

Credit Risk - Mortgages

25. The Society regards any mortgage where 3 or more monthly repayments have not been made at the accounting date as 'past due'. Arrears of mortgage repayments are monitored closely and the Society has performed satisfactorily in comparison with national arrears and possession statistics.

26. Table 3 provides an analysis, for capital adequacy purposes, of loans and advances exposures as at 31 August 2011.

Region	<u>Residential</u>		<u>Non - Residential</u>		<u>Total</u>
	<u>Performing</u>	<u>Past Due</u>	<u>Performing</u>	<u>Past Due</u>	
	<u>£m</u>	<u>£m</u>	<u>£m</u>	<u>£m</u>	
East Anglia	4.9	0	0	0	4.9
East Midlands	10.0	0.5	0.1	0	10.6
London & South East	63.9	1.2	5.8	0	70.9
North	2.4	0	0	0	2.4
North West	24.6	10.8	1.4	8.3	45.1
South West	11.9	0.2	0.2	0	12.3
Wales	4.7	0	0	0	4.7
West Midlands	72.2	1.9	2.4	0.2	76.7
Yorkshire & Humberside	8.7	0.1	0	0	8.8
Total	203.3	14.7	9.9	8.5	236.4

Table 3: Mortgage Loans Exposure 31 August 2011

27. Table 4 provides a reconciliation of the above table to 'Loans and advances to customers' in the Annual Report and Accounts 2011.

	<u>£m</u>
Loans and advances to customers per Annual report and Accounts	233.7
Add back: General and specific loss provisions	2.7
Society accounting value of loans and advances to customers	236.4
Total residential exposures for capital adequacy purposes (as per Table 4)	218.0
Total non-residential exposures for capital adequacy purposes (as per Table 4)	18.4
Society capital adequacy value of loans and advances to customers	236.4
Adjustments to reflect different reporting requirements and timing differences	-
Reconciled value of loans and advances to customers	236.4

Table 4: Reconciliation of Loans and Advances to Customers 31 August 2011

28. The residual maturity analysis for loans and advances to customers is provided in Note 10 of the Society's Report & Accounts 2011 and is on the basis that loans and advances run for their full contractual term, and in addition, does not take into account any instalments receivable over the life of the exposure, the Annual Report & Accounts also provide full details of the provisioning methodology in Note 1 together with the movement on provisions for bad and doubtful debts in Note 6.

Credit Risk - Treasury

29. The Society's Liquidity Policy statement is used to manage the credit risk arising from its treasury counterparties. The Policy ensure that the Society operates to obtain the best possible return, within prudent limits in respect of counterparties in terms of both the amount invested and counterparty rating.

30. Investments in banks and building societies are purely for liquidity purposes. The minimum policy ratings, as measured against the Fitch ratings agency are short term F1 and long term AA-. Treasury deposits are also made with unrated building societies.
31. Policy limits and counterparties are regularly reviewed by ALCO, with formal approval being made at Board level. The Society receives counterparty grading updates from its treasury advisors and limits may be suspended following adverse downgrades.
32. Table 5 shows the breakdown of liquid assets by maturity and rating at 31 August 2011 under the standardised approach.

<u>Ratings</u>	<u>Maturity of Treasury Investments</u>			
	<u>< 3 Months</u>	<u>3 Months to 1 Year</u>	<u>>1 Year</u>	<u>Total</u>
	<u>£'m</u>	<u>£'m</u>	<u>£'m</u>	<u>£'m</u>
AAA to AA-	18.8	38.3	18.5	75.6
A+ to A-	6.0	2.0	1.0	9.0
BBB+ and below	0	8.5	2.0	10.5
Unrated Building Societies	0	0	0	0
Total	24.8	48.8	21.5	95.1

Table 5: Investment Maturity Analysis 31 August 2011

Interest Rate Risk

33. The main activities undertaken by the Society that give rise to interest rate risk are as follows:-
- Management of the investment of capital and other non-interest bearing liabilities;
 - Issue of fixed rate savings products
 - Fixed rate wholesale funding
 - Fixed rate mortgage lending
 - Fixed rate treasury instruments.
34. Interest rate risk is managed by utilising natural internal hedges on the Society's balance sheet and by the utilising interest rate swaps with external counterparties.
35. Interest rate risk, as measured by a 3% parallel shift in interest rates, is reviewed on a regular basis and hedging action taken as appropriate.
36. Interest rate risk limits are an expression of the Board's risk appetite and are reviewed annually as an integral part of updating The Society's ICAAP.

Remuneration Policies and Practices

37. A risk arises if the Society's remuneration policies and practices could result in staff being rewarded for decisions inconsistent with the Board's risk appetite. It is therefore the Society's policy on remuneration to seek to ensure that its remuneration decisions are in line with effective risk management.
38. The Society seeks to ensure that its remuneration decisions are in line with its business strategy and long term objectives, and consistent with the Society's current financial condition and future prospects. It also seeks to establish an appropriate balance between the fixed and variable elements of remuneration, although this balance will vary depending on the seniority and nature of an individual's employment. Performance measurements used to calculate variable remuneration are therefore adjusted to take into account current or potential risks to the business and are consistent with the need to retain a strong capital base. Variable remuneration is not paid unless it is sustainable within the Society's situation as a whole. Guaranteed incentive payments do not form part of any remuneration package and all incentive schemes are non-contractual.
39. The Board has identified that those staff whose professional activities have a material impact on the Society's risk profile are the members of the Executive team, two of whom, the Chief Executive and Finance Director who are executive directors.
40. Information concerning the mandate of the Remuneration Committee and the decision-making process it uses in determining the remuneration policy for the executive directors, and information on the link between pay and performance, is contained in the Directors' Remuneration Report in the Society's Annual Report and Accounts 2011.
41. The total remuneration of the two Executive Directors in respect of the year ended 31 August 2011 was £285k. The Executive Directors waived their entitlement to any variable bonus earned during the year.
42. The Remuneration Committee is also responsible for determining the terms and conditions of other members of the Executive team after consultation with the Chief Executive. These are Group Secretary, Human Resources Manager and the Head of Risk.
43. The total remuneration of these members of the Executive team was 144k. No variable bonus was paid during the year ended 31 August 2011.

Conclusion

44. This disclosure document has been prepared in accordance with the requirements of BIPRU 11 as interpreted by the Society based on its size and complexity. It is updated annually within three months of the Society's financial year end.
45. In the event that a user of this disclosure document requires further explanation on the disclosures given they should write to the Group Secretary at Hanley Economic Building Society, Granville House, Festival Park, Hanley, Stoke on Trent. ST1 5TB.