THE HANLEY ECONOMIC Building Society

www.thehanley.co.uk

# PILLAR 3 DISCLOSURE DOCUMENT

**31 August 2014**

midlands excellence special award winner

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## INDEX

## Introduction

1. The legislative framework, the Capital Requirements Directive ('CRD'), came into force on 1 January 2014 and governs how much capital all banks and building societies must hold to protect their members, depositors and shareholders. The Society seeks to ensure that it protects its members by holding sufficient capital at all times.

2. The Prudential Regulation Authority ('PRA') is the prudential regulator of Hanley Economic Building Society and its subsidiaries ('the Society') and is responsible for implementing the CRD in the UK. The Society has adopted the Standardised Approach 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 focusing 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 results of the Board's assessment are subject to review by the PRA under the SREP arrangements.

    - Pillar 3: Disclosures of key information on risk exposures and risk management processes by the Society as required by BIPRU Chapter 11.

4. The Board approved the Society's ICAAP at their meeting dated 12 January 2015.

5. This disclosure document, prepared as at 31 August 2014 covers the entire business across the three legal entities in the group (Hanley Economic Building Society [FCA number 206024], Hanley Mortgages Services Ltd [FCA Number 301487] and Hanley Financial Services Ltd [FCA number 211538]). The figures quoted in this disclosure have been drawn from the Society's Annual Report & Accounts as at 31 August 2014, 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, and 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's Risk Register records the key risks to which it is exposed and includes an assessment of their likelihood and impact. This is formally reviewed annually by the Board and it forms the base for the identification of risks for inclusion in the ICAAP under Pillar 2. In addition all significant risks are considered regularly at Board meetings throughout the year.

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 and Compliance Committee ('A&CC'), consists solely of Non-Executive Directors, and considers all matters of an audit nature, including internal controls, compliance, scope and content of internal and external audit work, financial reporting and other relevant regulatory requirements. Representatives are from the Society Executive, Internal Audit and Compliance function, together with External audit, who also attend Committee meetings by invitation. In addition, both Internal and External Auditors are specifically empowered to meet with the Chairman and other members of the Committee in private sessions.

11. The internal audit function provides independent and objective assurance that these processes are both appropriate and effective.

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.

**a) Credit Risk**

Credit risk is the risk of a customer or counterparty not meeting their obligations as they fall due. This risk is most likely to arise in the potential inability of a customer to make repayments on their mortgage, and of treasury counterparties to repay loan commitments.

The risk of treasury counterparty default is managed through Board approved Liquidity, Funding and Structural Risk policies. Counterparty credit quality and exposure limits are monitored by the Assets & Liabilities Committee who make recommendations to the Board on changes in any of its related policies.

Mortgage credit risk is managed through the Society's underwriting process which seeks to ensure that customers can afford to repay their debt. All mortgage applications are rigorously assessed with reference to the Society's Lending policy, changes to policy are approved by the Board and the approval of mortgage applications is mandated. All applications are supported by an independent valuation sourced from the Society's authorised panel of valuers. In the unfortunate event of customers experiencing financial difficulties, the Society is highly proactive in providing support.

In respect of residential development loans, the Society additionally has potential exposure in the value of new build properties and development land. This is mitigated by taking a longer term approach to the management of its loans to this sector, which enables the Society to take advantage of any positive cyclical movements in underlying property values.

**b) 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 is to maintain sufficient liquid resources to cover cashflow imbalances and fluctuations in funding, to maintain full public confidence in the solvency of the Society and to meet its financial obligations.

The Society manages this risk through continuous forecasting of cashflow requirements and assessment of retail and wholesale funding risk. The required amount, quality and type of liquid assets required to ensure obligations can be met at all times is maintained in accordance with the Liquidity policy. Regular stress tests are performed to ensure the Society can meet its obligations in both normal and stressed circumstances. The Society's management of liquidity risk is overseen by the Assets & Liabilities Committee.

**c) Interest Rate Risk**

Interest rate risk represents the Society's exposure to movements in interest rates and 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.

**d) Conduct Risk**

The risk is that the Society does not treat its customers fairly and delivers inappropriate consumer outcomes. The Board acknowledges the requirement to fully embrace the Financial Conduct Authority's Principle 6, namely to ensure that the Society pays due regard to the interests of its customers and to treat them fairly at all times. These principles are firmly embedded within the Society's culture and working practices.

### e) Operational Risk

Operational risk is the risk of loss through failed or inadequate systems, human error or other external factors. The Society mitigates this risk through having a robust and effective internal control framework in which risks are monitored and controlled on a regular and timely basis by senior management and the Audit and Compliance Committee.

The Society has adopted the Basic Indicator Approach ('BIA') for operational risk which is expressed as a simple percentage (15%) of the average of the latest three years of the sum of net interest income and net non-interest income.

### f) Concentration Risk

The Society is a regional building society whose principal business objective is the provision of secured lending on residential property funded by retail savings. Accordingly its activities are highly concentrated in residential lending, bringing with it exposure to the UK housing market. Although the Society lends throughout England and Wales, it does have particular regional concentrations, specifically West Midlands (29.59%), London & South East (25.13%) and North West (19.33%). Geographic concentration is monitored when undertaking stress testing, where the results of house price movements are modelled using regional indices.

Product concentration arises through a focus on residential lending. The Society's products are 97% residential based. The risk is monitored through adherence to the Lending Policy and limits.

### g) Regulatory and Legal Risk

Regulatory and legal risk is the risk of fines, public censure, limitation on business, or restitution costs arising from failing to understand, interpret, implement and comply with UK and EU regulatory requirements. The Society has an independent compliance function which monitors compliance with existing legislation, controls implemented to ensure compliance and the impact of new requirements. The compliance function reports to the Audit and Compliance Committee.

### h) Business Risk

Business risk means any risk to the Society arising from changes in the business or economic conditions, including the risk that the Society may not be able to carry out its business plan or implement its required strategy. Business risk is managed through regular review and development of the business plan, management oversight and an embedded corporate governance framework.

### i) Insurance Risk

This is the risk that there may be gaps in the risks covered by 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 provides the Board with the assurance that the Society's insurance arrangements are robust.

## Capital Adequacy Assessment, Capital Resources & Leverage

15. Total Society capital at 31 August 2014 was £29.5m, 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 or their successor, Core Capital Deferred Shares 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 2014.

| Capital Resources | £'k |
|---|---|
| **Tier 1 Capital** | |
| Gross( Accumulated General Reserves) | 29,459 |
| Deductions | - |
| Net Tier 1 Capital | 29,459 |
| **Tier 2 Capital** | |
| Gross (general provisions for bad and doubtful debts) | 150 |
| Deductions | - |
| Net Tier 2 Capital | 150 |
| **Total Capital** | |
| Gross | 29,609 |
| Deductions | - |
| Net Total Capital | 29,609 |

***Table 1: Capital Resources 31 August 2014***

18. The Society operates a three year Corporate Plan which is contemporised annually as a part of 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. Table 2 details the Society's Pillar 1 capital requirement as at 31 August 2014 by asset class.

| CREDIT RISK | Asset | Risk Weighted Asset | Capital |
|---|---|---|---|
| | £'k | £'k | £'k |
| **Non Cash Liquidity Exposures** | | | |
| Central government | 28,485 | 0 | 0 |
| Regional & local government | 0 | 0 | 0 |
| Credit institutions | 51,227 | 17,378 | 1,390 |
| **Total Non Cash Liquidity exposures** | 79,712 | 17,378 | 1,390 |
| | | | |
| **Loans & Advances to Customers** | | | |
| Residential – performing loans | 254,960 | 92,412 | 7,393 |
| Residential – past due items | 14,856 | 18,158 | 1,453 |
| Non residential – performing loans | 4,727 | 4,728 | 377 |
| Non residential – past due items | 5,868 | 8,256 | 661 |
| **Total Loans & Advances to Customers** | 280,411 | 123,554 | 9,884 |
| | | | |
| **Other On-Balance Sheet Exposures** | | | |
| Fixed & other assets | 3,806 | 3,806 | 304 |
| **Total Other On-Balance Sheet Exposures** | 3,806 | 3,806 | 304 |
| | | | |
| **Off-Balance Sheet Exposures** | | | |
| Interest rate contracts | 427 | 180 | 15 |
| Other | 14,087 | 1,007 | 80 |
| **Total Other On-Balance Sheet Exposures** | 14,514 | 1,187 | 95 |
| | | | |
| Credit Risk – Capital Requirement | 378,443 | 145,925 | 11,673 |
| Operational Risk – Capital Requirement | | | 663 |
| Total Pillar 1 Capital Requirement | | | 12,336 |
| Tier 1 Capital | | | 29,459 |
| Excess over Pillar 1 Minimum | | | 17,123 |

***Table 2: Capital Resource Requirements 31 August 2014***

24. Basel III introduces a non-risk based leverage ratio to supplement the risk based capital requirements. This ratio shows Tier 1 capital as a proportion of on and off balance sheet assets. The ratio does not distinguish between credit quality of loans and acts as a primary constraint to excessive lending in proportion to the capital base. The minimum ratio must be 3% but the leverage ratio will not become binding until 1 January 2018.

25. The Society's calculated leverage ratio as at 31 August 2014 was 7.84%.

## Credit Risk – Mortgages

26. 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.

27. Table 3 provides an analysis, for capital adequacy purposes, of loans and advances exposures as at 31 August 2014.

| Region | Residential | | Non - Residential | | Total |
|---|---|---|---|---|---|
| | Performing | Past Due | Performing | Past Due | |
| | £'k | £'k | £'k | £'k | £'k |
| East Anglia | 8,341 | 0 | 0 | 0 | 8,341 |
| East Midlands | 16,047 | 0 | 49 | 590 | 16,686 |
| London & South East | 66,069 | 1,033 | 3,364 | 0 | 70,466 |
| North | 6,162 | 117 | 0 | 0 | 6,279 |
| North West | 37,260 | 11,889 | 64 | 4,986 | 54,199 |
| South West | 18,123 | 0 | 144 | 0 | 18,267 |
| Wales | 7,838 | 0 | 0 | 0 | 7,838 |
| West Midlands | 79,950 | 1,635 | 1,091 | 292 | 82,968 |
| Yorkshire & Humberside | 15,170 | 182 | 15 | 0 | 15,367 |
| Total | 254,960 | 14,856 | 4,727 | 5,868 | 280,411 |

***Table 3: Mortgage Loans Exposure 31 August 2014***

28. Table 4 provides a reconciliation of the above table to 'Loans and advances to customers' in the Annual Report & Accounts 2014.

| | **£'k** |
|---|---|
| Loans and advances to customers per Annual Report & Accounts | 277,923 |
| Add back: General and specific loss provisions | 2,488 |
| **Society accounting value of loans and advances to customers** | 280,411 |
| Total residential exposures for capital adequacy purposes (as per Table 3) | 269,816 |
| Total non-residential exposures for capital adequacy purposes (as per Table 3) | 10,595 |
| **Society capital adequacy value of loans and advances to customers** | 280,411 |
| Adjustments to reflect different reporting requirements and timing differences | - |
| **Reconciled value of loans and advances to customers** | 280,411 |

***Table 4: Reconciliation of Loans and Advances to Customers 31 August 2014***

29. The residual maturity analysis for loans and advances to customers is provided in Note 10 of the Society's Report & Accounts 2014 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 provides full details of the provisioning methodology in Note 1 together with the movement on provisions for bad and doubtful debts in Note 6.

30. Residential and non-residential mortgages are classed as 'past due' if the loan is in possession or subject to a Law of Property Act Receivership, has outstanding arrears of more than 3 months or has interest suspended. The total balance outstanding on cases classified as past due is £20.74m. In a number of cases it is the Society's strategy to appoint an LPA Receiver and let individual properties with a view to generating a rental income stream to cover interest. As at 31 August 2014 the Society had a total of £13.36m under such an arrangement.

## Credit Risk – Treasury

31. The Society's Liquidity Policy statement is used to manage the credit risk arising from its treasury counterparties. The Policy ensures 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.

32. 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-. The Board has agreed to include selective UK clearing banks with a long term rating of A- within the Society's eligible counterparties. Treasury deposits are also made with unrated building societies and other mutuals.

33. Policy limits and counterparties are reviewed regularly by ALCO, with formal approval made at Board level. The Society receives counterparty grading updates from its treasury advisors and limits may be suspended following adverse downgrades.

34. Table 5 shows the breakdown of liquid assets by maturity and rating at 31 August 2014 under the standardised approach.

| Ratings | Maturity of Treasury Investments | | | |
|---|---|---|---|---|
| | < 3 Months £'k | 3 Months to 1 Year £'k | >1 Year £'k | Total £'m |
| AAA to AA- | 10,465 | 17,475 | 8,558 | 36,498 |
| A+ to A- | 17,441 | 21,760 | 0 | 39,201 |
| Unrated Building Societies | 0 | 4,013 | 0 | 4,013 |
| Total | 27,906 | 43,248 | 8,558 | 79,712 |

***Table 5: Investment Maturity Analysis 31 August 2014***

## Interest Rate Risk

35. 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.

36. Interest rate risk is managed by utilising internal hedges on the Society's balance sheet and by utilising interest rate swaps with external counterparties.

37. Interest rate risk, as measured by a 2% parallel shift in interest rates, is reviewed on a regular basis and hedging action taken as appropriate.

38. 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.

## Country By Country Reporting

39. The Capital Requirements (Country-by-Country Reporting) Regulations 2013 came into effect on 1 January 2014 and place certain reporting obligations on financial institutions that are within the scope of the EU Capital Requirements Directive IV (CRD IV).

40. The objective of the country-by-country reporting requirements is to provide increased transparency regarding the source of the Financial Institution's income and the locations of its operations.

41. The Hanley Economic Building Society and its Subsidiaries are all UK registered entities, the activities of which are disclosed on page 10 of the Annual Report & Accounts 2014.

42. The Hanley's total operating income and the number of full time equivalent employees during the year to 31 August 2014 were:

| Hanley Economic Building Society | 31 August 2014 |
|---|---|
| Total operating income £'k | 5,177 |
| Number of full time equivalent employees | 56 |

## Remuneration Policies and Practices

43. 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.

44. 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.

45. 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 Deputy Chief Executive & Finance Director are Executive Directors.

46. 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 & Accounts 2014.

47. The total remuneration of the two Executive Directors in respect of the year ended 31 August 2014 was £326k.

48. 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 the Group Secretary, Human Resources Manager and the Head of Operations.

49. The total remuneration of these members of the Executive team was £178k. No variable bonus was paid during the year ended 31 August 2014.

## Conclusion

50. 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, and is updated on an annual basis following the publication of the Annual Report & Accounts.

51. 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.