



Capital Requirements Directive

Pillar 3 Disclosures

For the year ended 31 August 2016



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Introduction

1. The European Union Capital Requirements Directive ('CRD') and Capital Requirements Regulations ('CRR') came into force on 1 January 2014. The CRD and CRR (known collectively as 'CRDIV') seek to ensure that, according to consistent standards, all banks and building societies hold adequate capital to protect their depositors and shareholders.
2. The Society seeks to ensure that it protects its members by holding sufficient capital at all times.
3. 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 CRDIV in the UK.
4. The CRD comprises 3 main elements, or 'Pillars', namely:
 - Pillar 1: Minimum capital requirement for credit market and operational risk, assessed according to a formulaic risk based calculation.
 - Pillar 2: Assessment of additional capital requirements following review under the Internal Capital Adequacy Assessment Process ('ICAAP') and the PRA's Supervisory Review and Evaluation Process ('SREP').
 - Pillar 3: Disclosures of the risks faced by a society in its normal course of business, together with a description of the capital held to support the business.
5. The Society has adopted the Standardised Approach for Credit risk and the Basic Indicator Approach for Operational risk.
6. The Society's Board has undertaken an assessment of all of the key risks facing the Society and has assessed the amount of additional capital under Pillar 2 that it considers necessary to cover these risks. This assessment takes into account the capital requirement under stressed scenarios to ensure the Society is well placed to maintain sufficient capital even during a severe downturn in the markets in which it operates.
7. This disclosure document, prepared as at 31 August 2016 covers the entire business across the three legal entities in the group (Hanley Economic Building Society ('the Hanley') [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 2016, unless otherwise stated.
8. The Board approved the Society's ICAAP, together with the Pillar 3 Disclosure Document, at their meeting dated 31 January 2017.

Risk Management Policies and Objectives

9. The Hanley is a mutual organisation with no equity shareholders. Its mission statement is “to be the chosen provider of mortgages and savings in our heartland built on trusted values and exceptional customer service”.
10. As a part of its day to day operations the Society will raise funds in the wholesale markets and invest funds in other institutions to manage its overall liquidity position.
11. 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.
12. The Board has overall responsibility for the identification, assessment, management and mitigation of the risks to which the Society is exposed. To that end it has put in place a formal risk management framework including Board risk appetite statements, individual key risk policies and defined risk reporting structure.

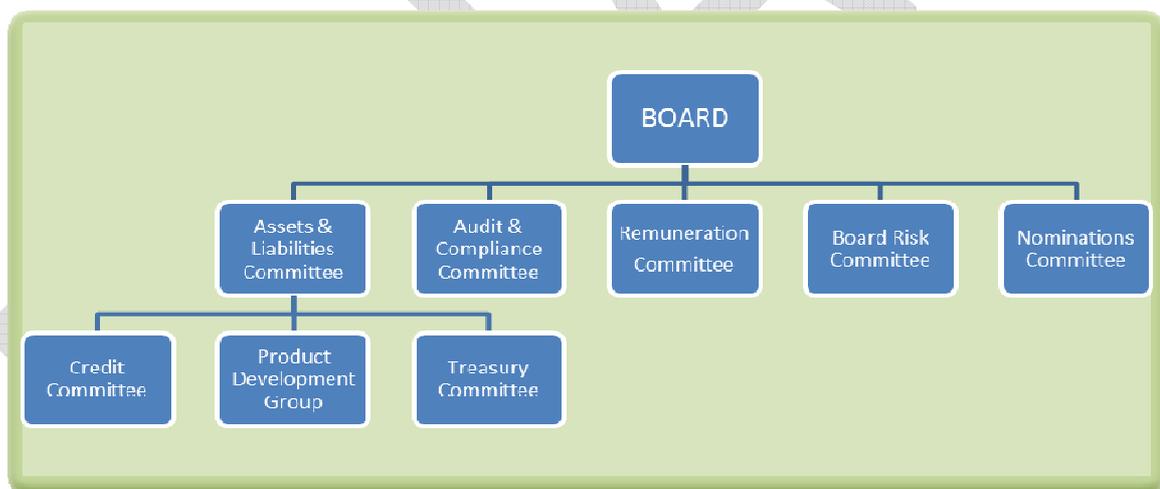


Figure 1: Board and Sub-Committees

13. 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 at each Board meeting.
14. The 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.

15. 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.
16. The Society operates a three lines of defence model with the operational areas being the first line, Compliance and Senior Management being the second line and the internal audit function (outsourced to RSM UK) being the third line.
17. 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.
18. The principal business and financial risks to which the Society is exposed are Credit, Liquidity, Interest Rate, Conduct, Operational, Regulatory & Legal and Business risk. Additional risks considered to be of importance include concentration risk and insurance 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 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) 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.

g) 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.

h) 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 the West Midlands (29.76%), London & South East (23.11%) and North West (19.10%). 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.

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

19. Total Society capital at 31 August 2016 was £24.1m, comprising Tier 1 capital (general reserves) and Tier 2 capital (collective impairment provisions for bad and doubtful debts).
20. The Society has no need for remunerated capital and therefore has no subordinated debt or permanent interest bearing shares.
21. Table 1 provides details of the components of Tier 1 capital, Tier 2 capital and total capital of the Society as at 31 August 2016.

Capital Resources	£'k
<u>Tier 1 Capital</u>	
Gross(Accumulated General Reserves)	25,032
Deductions: Deferred Taxation	(1,107)
Net Tier 1 Capital	23,925
<u>Tier 2 Capital</u>	
Collective impairment provision for bad and doubtful debts	150
Deductions	-
Net Tier 2 Capital	150
<u>Total Capital</u>	
Gross	24,075
Deductions	-
Net Total Capital	24,075

Table 1: Capital Resources 31 August 2016

22. 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.
23. 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.
24. 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.
25. 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.
26. 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.

27. Table 2 details the Society's Pillar 1 capital requirement as at 31 August 2016 by asset class.

EXPOSURE CLASS	Asset £'k	Risk Weighted Asset £'k	Capital £'k
On Balance Sheet:			
Treasury Assets			
Central government	37,583	0	0
Regional & local government	0	0	0
Credit institutions	44,688	14,500	1,160
Total Treasury Assets	82,271	14,500	1,160
Loans & Advances to Customers			
Residential – performing loans	276,970	109,686	8,775
Residential – past due items	14,464	10,947	876
Non residential – performing loans	4,167	4,167	334
Non residential – past due items	4,956	1,029	82
Total Loans & Advances to Customers	300,557	125,829	10,067
Other Assets			
Fixed & other assets	4,685	3,578	286
Total Other assets	4,685	3,578	286
Total On Balance Sheet	387,513	143,907	11,513
Off-Balance Sheet			
Interest rate derivatives	174	85	7
Mortgage Pipeline Commitments	16,096	2,204	176
Total Off Balance Sheet	16,270	2,289	183
Credit Risk – Capital Requirement	403,783	146,196	11,696
Operational Risk – Capital Requirement			762
Total Pillar 1 Capital Requirement			12,458
Tier 1 Capital			23,925
Excess over Pillar 1 Minimum			11,467

Table 2: Capital Resource Requirements 31 August 2016

28. 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.

Credit Risk – Mortgages

29. The Society regards any mortgage where 3 or more monthly repayments have not been made at the accounting date as 'past due'.
30. Table 3 provides an analysis, for capital adequacy purposes, of loans and advances exposures as at 31 August 2016.

Region	Residential		Non - Residential		Total £'k
	Performing £'k	Past Due £'k	Performing £'k	Past Due £'k	
East Anglia	9,186	0	0	0	9,186
East Midlands	17,305	210	25	0	17,540
London & South East	65,746	573	3,144	0	69,463
North	6,672	0	0	0	6,672
North West	40,829	11,867	58	4,670	57,424
South West	21,882	0	117	0	21,999
Wales	10,944	0	0	0	10,944
West Midlands	87,010	1,330	823	286	89,449
Yorkshire & Humberside	17,397	483	0	0	17,880
Total	276,971	14,463	4,167	4,956	300,557

Table 3: Mortgage Loans Exposure 31 August 2016

31. Table 4 provides a reconciliation of the above table to 'Loans and advances to customers' in the Annual Report & Accounts 2016.

	£'k
Loans and advances to customers per Annual Report & Accounts	291,211
Add back: General and specific loss provisions	9,346
Society accounting value of loans and advances to customers	300,557
Total residential exposures for capital adequacy purposes (as per Table 3)	291,434
Total non-residential exposures for capital adequacy purposes (as per Table 3)	9,123
Society capital adequacy value of loans and advances to customers	300,557
Adjustments to reflect different reporting requirements and timing differences	-
Reconciled value of loans and advances to customers	300,557

Table 4: Reconciliation of Loans and Advances to Customers 31 August 2016

32. The residual maturity analysis for loans and advances to customers is provided in Note 10 of the Society's Report & Accounts 2016 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 Society's impairment provisioning methodology in Note 1 together with the movement on provisions for bad and doubtful debts in Note 6.
33. 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 £19.87m. In a number of cases it is the Society's strategy to either appoint an LPA Receiver or take possession of these individual properties with a view to generating a rental income stream to cover interest. As at 31 August 2016 the Society had a total of £13.24m under such an arrangement.

Credit Risk – Treasury

34. 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.
35. 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.
36. 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.
37. Table 5 shows the breakdown of liquid assets by maturity and rating at 31 August 2016 under the standardised approach.

Ratings	Maturity of Treasury Investments			
	< 3 Months	3 Months to 1 Year	>1 Year	Total
	£'k	£'k	£'k	£'k
AAA to AA-	37,754	0	0	37,754
A+ to A-	15,607	18,546	0	34,153
BBB+ to BBB-	9,355	0	0	9,355
Unrated Building Societies	1,009	0	0	1,009
Total	63,725	18,546	0	82,271

Table 5: Investment Maturity Analysis 31 August 2016

Interest Rate Risk

38. 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.
39. Interest rate risk is managed by utilising internal hedges on the Society's balance sheet and by utilising interest rate swaps with external counterparties.
40. 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.
41. 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.

CRDIV Disclosures

42. From 1 January 2014 the PRA has adopted the Capital Requirements Directive ('CRDIV') or otherwise known as Basel II. This directive will have future impacts on the capital requirements for banks and building societies and the Society has adopted the new principles when assessing capital adequacy.
43. A requirement under CRDIV is the introduction of the leverage ratio which measures levels of Tier 1 capital against both on and off balance sheet exposures. CRDIV requires a minimum ratio of 3% and as at 31 August 2016 the Society had a leverage ratio of 6.30%.
44. The capital ratio is the level of total capital resources as a percentage of total risk weighted assets. The ratio must be a minimum of 8% and as at 31 August 2016 the Society had a ratio of 15.47%.
45. CRDIV also introduced a requirement for country by country reporting. The objective of this is to provide increased transparency regarding the source of the Financial Institution's income and the locations of its operations.
46. The Hanley Economic Building Society and its Subsidiaries are all UK registered entities, the activities of which are disclosed in Note 16 of the Annual Report & Accounts 2016.
47. The Hanley's total operating income for the year ended 31 August 2016 was £5,092k and profit before taxation was £1,058k. All arose from UK activities.
48. Corporation tax of £279k was paid in the year and was all within the UK tax jurisdiction.

- 49. No public subsidies were received in the year.
- 50. The number of full-time equivalent employees was 56.

Remuneration Policies and Practices

- 51. 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.
- 52. 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.
- 53. 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.
- 54. 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 2016.
- 55. The total remuneration of the two Executive Directors in respect of the year ended 31 August 2016 was £353k. The Society does not operate any form of bonus or incentive scheme for Executive Directors.
- 56. 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 Human Resources Manager and the Head of Operations.
- 57. The total remuneration of these members of the Executive team was £187k. No variable bonus was paid during the year ended 31 August 2016.

Conclusion

58. 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.
59. In the event that a user of this disclosure document requires further explanation on the disclosures given they should write to the Deputy Chief Executive & Finance Director at Hanley Economic Building Society, Granville House, Festival Park, Hanley, Stoke-on-Trent. ST1 5TB.

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