Pillar 3 Disclosures

for the year ended 31 December 2013

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1. Overview

Introduction

The Basel 2 framework as implemented in Europe as the Capital Requirements Directive (CRD), also referred to as Basel 2, sets out how much capital building societies must hold in order to provide security for members, depositors and shareholders. In the UK the Prudential Regulation Authority (PRA) is responsible for the implementation of the CRD, which consists of three main elements referred to as “Pillars”:

- Pillar 1 – this sets out the minimum capital requirements, using a risk based capital calculation focusing mainly on credit and operational risk. The Ecology uses the standardised approach to calculate Credit Risk which is expressed as 8% of the risk weighted exposure amounts for each exposure class. Capital required to cover operational risk is assessed under the Basic Indicator Approach and calculated by reference to the net income of the Society averaged over the previous 3 years

- Pillar 2 – this is an internal assessment of additional capital required to cover risks faced by the Society that are not covered by the minimum regulatory capital resource requirement set out under Pillar 1, including stress testing the outcomes to identify the level of additional capital that should be held. This process is known as the Internal Capital Adequacy Assessment Process (ICAAP). The PRA reviewed the Society’s ICAAP in April 2013 with an updated level of individual capital guidance (ICG) and capital add-on advised by the PRA in August 2013

- Pillar 3 – this requires building societies and banks to disclose key information on the Society’s own funds, risk exposures and risk management processes

This document sets out the Board’s policy on the disclosure requirements of Pillar 3, as set out in BIPRU 11, that were in force on 31 December 2013. In addition to the disclosures required by legislation in place on that date this document also includes disclosure of the Society’s CRD IV transitional capital position based upon new legislation.

Frequency

This report will be made on an annual basis. The disclosures will be as at the Accounting Reference Date (ARD) of 31 December, and will be published within four months of the ARD. The Society will aim, however, to make the disclosures shortly after the publication of the Annual Report and Accounts.

Media and Location

The report will be published on the Society’s corporate website www.ecology.co.uk .

2. Risk Management Policy and Objectives

Oversight

The Chief Risk Officer (CRO) oversees the management and development of a comprehensive process for assessing, indentifying, monitoring and reducing pertinent business risks that could interfere with the Society’s objectives and goals. The CRO reports to the Risk, Audit, Compliance and Ethics Committee (RACE). On behalf of the Board, RACE considers and approves the Society’s risk management framework, its risk appetite and its risk management policies for all risk categories. RACE also monitors key risk management information, adherence to the Society’s ethical standards and reviews the Society’s overall capital adequacy. The Chair of RACE reports quarterly to the Board on the Committee’s deliberations. During 2013 RACE met four times.

Credit Risk

As a provider of residential mortgages, credit risk is the most significant risk facing the Society. Credit risk is the risk of loss arising from a customer or counterparty failing to meet their financial obligations to the Society as and when they fall due. The Board sets the risk appetite for both lending (residential and commercial) and treasury activities.

The lending policy of the Society is reviewed by the Board and sets out policy limits and underwriting procedures. The Society first of all determines if the borrowing request meets the Society's environmental lending criteria. Where these are met, for ordinary residential lending, the loan is assessed against the following: affordability, residency, residential history, credit history, employment history, nature of income and loan to value. In addition, confirmation of borrower identity and an assessment of the value of any security are undertaken prior to granting the loan. When considering applications, the primary focus is placed on the willingness and ability to repay.

The maximum mortgage loan available is based on the lower of the current value or purchase price of the property. No lending is undertaken based solely upon security provided by the value of the underlying assets and all mortgages are secured by way of a first legal charge against the property.

For commercial loans, third-party guarantees, supporting collateral and security, robust legal documentation, and financial covenants are also taken into account.

Counterparty and country limits for treasury activity are set out in the Financial Risks policy which is reviewed by the Board. The Society first of all seeks to identify potential counterparties with the most defensible records on a range of ethical criteria. This element itself is a strong indicator of counterparty quality and is reviewed at least annually, via internal analysis. Note is taken of external credit ratings as produced by Fitch IBCA, which provide triggers for disengagement.

Operational Risk

Operational risk is the risk of a loss arising from failed or inadequate internal processes or systems, human error or other external factors.

The Society has adopted the basic indicator approach (BIA) to operational risk which is expressed as a percentage of the average of the latest three years of the sum of net interest income and net non-interest income. There is no intention to move to a more advanced approach in the short to medium term.

The Society does not engage in any complex forms of funding or use off-balance sheet instruments and the Board is therefore content that no risk to the Society arises from these sources.

The Society manages its operational risks through internal controls, and various risk mitigation techniques, such as insurance and business continuity planning. The Society maintains a register of operational risks faced by the Society which are scored to reveal any potential implications for the level of capital held. The impact of these risks is re-evaluated on at least an annual basis and whenever a loss event occurs.

Liquidity and Funding Risk

Liquidity risk is the risk that the Society does not have sufficient financial resources available to meet its obligations as they fall due, or that the Society is unable to meet regulatory prudential liquidity ratios. It is Society policy to ensure that sufficient liquid assets are at all times available to meet the Society's obligations, after taking into account withdrawals of customer deposits, draw-down of customer facilities and growth in the balance sheet. The management of the Society's liquidity is the responsibility of the Treasury function, which monitors liquidity limits on a daily basis.

The Society's liquidity objectives are:

- to meet all liabilities and cash-flow requirements as they arise and ensure sufficient funds for day-to-day needs
- to protect itself against the inherent maturity and interest-rate mismatch arising from the principal activity of lending long-term and financing this by means of predominantly short-term liabilities
- to cover expected imbalances in cash flows (e.g. where outflows in respect of tax payments, mortgage lending and capital expenditure, exceed inflows from mortgage redemptions and repayments and other receipts for a particular period)
- to cover the normal range of fluctuations in funding flows, which will arise but which are unpredictable to the timing and amount (e.g. release of retentions, closure of retail accounts)
- to maintain confidence that the Society will be able to meet its obligations to investors when called upon to do so and to honour its commitments for mortgage lending
- earn a reasonable return balanced with risk, market rates and the Society's own ethical stance.

The Society has exposures to banks and building societies in its portfolio, which are held purely for liquidity purposes. The risk posed by counterparties is controlled by restricting the amount of lending to institutions with a credit rating below A-. ALCO reviews the list of approved counterparties on a regular basis and recommends changes for approval to the Board. The Society has not experienced any losses in its treasury portfolio for some 20 years.

The Society has no exposure to wholesale funding and has had no such exposure for at least 15 years.

The Society performs liquidity stress testing based on a range of adverse scenarios, and has a liquidity contingency funding plan which is maintained in order to ensure that the Society has access to sufficient resources to meet obligations as they fall due if these scenarios occur. Stressed liquidity profiles are reported to every ALCO meeting.

Market Risk

Market risk is the risk of any impact on the Society's financial condition due to adverse market movements caused by market variables such as interest rates. As the Society does not operate a Trading Book, the only element relevant to the Society is interest rate risk in the banking book, which mainly arises from mismatches between the re-pricing dates of the assets and liabilities on the Society's balance sheet. The Society does not provide fixed-rate mortgages or savings products at the present time, so the level of risk is minimal and is tracked through standard gap analysis techniques.

Concentration Risk

Exposure to Concentration Risk is monitored on a daily basis. As a Society that lends on a national basis, including Northern Ireland, the Society is not subject to an undue level of Geographic concentration risk.

The activities of the Society are of course highly concentrated in residential lending and funded primarily by retail investments. However, the Society argues firstly that this model has long-term resilience and secondly, the Society's deliberate focus on energy efficiency and environmental impacts of residential property ensures a high level of quality in the lending book and a higher degree of resilience than the mainstream market which will increase as energy prices rise.

The Society's lending model which requires energy efficiency improvements ensures that there is no dependence on either remortgage business or introduced business. Internal limits and the nature of the product range ensure that there is no undue exposure to any property type or class of borrower, including more specialist books such as self-build and buy-to-let.

The Society takes particular note of concentration risk arising from large exposures which are a function of the relatively small size of the Society. This is controlled by close attention to the credit assessment process.

Business Risk

Business risk arises from macroeconomic factors that may impact on the ability of the Society to carry out its business plan. Business Risk is managed through regular review and development of the Corporate Plan, management oversight and an embedded corporate governance process. The Society conducts stress and scenario analysis as part of its corporate planning process to identify potential mitigating actions that can be employed in the event of a downturn.

Pension Obligation Risk

The Society has never operated a defined benefit scheme, and therefore does not have any exposure to pension obligation risk.

Residual Risk

The Society 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 PRA to cover events that are unforeseen.

Conduct Risk

Conduct Risk is the risk of the Society's conduct resulting in poor outcomes for consumers, consumers being either members or potential members. The Board fully embraces the Financial Conduct Authority (FCA)'s Principle 6, namely to ensure that the Society pays due regard to the interests of its members and treats them fairly at all times. These principles are firmly embedded within the Society's culture and maintained through staff and Director induction, training and performance management.

Conduct Risk is monitored by the RACE committee and the Board, as part of the Society's Ethics framework. This framework goes beyond a risk mitigation perspective by also seeking to maximise opportunities to improve outcomes for the Society's full range of stakeholders. The Ethics (Conduct Risk) Policy is reviewed annually. The Ethics Manager reports on conduct to every RACE committee.

3. Capital Resources

The capital resources of the Society are calculated in accordance with the Capital Requirements Directive. The assets of the Society, as shown in the Balance Sheet, were £124.801m at 31 December 2013. This figure is net of general and specific provisions.

The table below summarises the composition of the Society's regulatory capital for the Society as at 31 December 2013, together with prior year comparatives.

Capital resources	As at 31/12/2013 £000	As at 31/12/2012 £000
Common Equity Tier 1 - general reserves	6,375	5,973

Tier 2 - sub-ordinated debt	1,047	1,146
- general provisions	25	31
Total capital resources	**7,447**	**7,150**

Common Equity Tier 1 capital

These are the general reserves of the Society and represent the accumulated after tax profits of the Society.

Tier 2 capital

The Society holds two issues of subordinated liabilities which qualify as Tier 2 capital. The debt is unsecured and ranks behind the claims of the Society's depositors, creditors and investing members. Under Basel II debt in its final five years to maturity is subject to an annual amortization percentage of 20%. Under transitional arrangements Basel III requires all debt held by the Society to be amortized on a daily basis between 10 and 20% dependent on the maturity date of the debt.

General provisions of the Society represent part of the Society's free capital and are therefore included as Tier 2 capital.

4. Risk Weighted Exposure Amounts and Operational Risk Capital

The Society's planning process seeks to ensure that the Society will have enough capital to meet the base regulatory requirements under the CRD, to support the business's expected growth potential, concomitant with its risk appetite and its assessments of current and future material risks. This assessment is informed by the regular stress and scenario testing that is performed both on the Society's capital and liquidity position. These conclusions are set out in the Corporate Plan in conjunction with the ICAAP which also takes into account the Society's Individual Capital Guidance.

The Society allocates capital as set out in the table below to the assets of the Society on a risk weighted basis in line with the 'Standardised Approach' to Credit Risk as specified by the Capital Requirements Directive. Additionally, the Society uses the 'Basic Indicator Approach' to evaluate the additional capital required to cover the Operational Risk associated with the Society's activities.

	Exposure £000	Risk Weighted Exposure £000	Pillar 1 capital £000
Liquidity			
Gilt edged securities	14,507	0	0
Credit Institutions	25,434	6,488	519
Total Liquidity	**39,941**	**6,488**	**519**
Loans and advances to customers			
Residential performing loans	74,408	26,746	2,140
Non-residential performing loans	10,350	10,350	828
Past due items	78	75	6
Total Loans and advances to customers	**84,836**	**37,171**	**2,974**
Other Exposures			
Fixed and other assets	1,609	1,609	129
Total Credit Risk	**126,386**	**45,268**	**3,622**
Operational Risk	**2,153**	**2,153**	**323**

Total Pillar 1 capital requirement			**3,945**
Total Capital available			**7,447**
Excess of capital over minimum capital requirement under Pillar 1			**3,502**

On 16 June 2013, the European Union Council formally adopted a package of two legislative instruments collectively referred to as CRD IV that amend and replace existing capital requirement directives.

The Capital Requirements Regulation contains Pillar 1 and Pillar 3 requirements and is directly applicable as EU law. The accompanying Capital Requirements Directive contains Pillar 2 measures that embody a degree of national discretion by Regulators. The objective of the reform package is to improve the financial services sector's ability to absorb shocks arising from financial and/or economic stress, so reducing the potentially destabilising impact on the financial sector into the real economy. CRD IV legislation was implemented on 1 January 2014.

The key elements of CRD IV are as follows:

- New limits and capital buffers
- Higher thresholds for all forms of capital with an increased focus on Common Equity Tier (CET) 1. (The Society's CET1 ratio at 31 December 2013 was 14.08%)
- Introduction of the Leverage Ratio. The Basel Committee is using a period to 2017 to test a minimum Tier 1 leverage ratio of 3.00%. At 31 December 2013 the Society's Tier 1 leverage ratio under CRD IV is 4.81.

The actual impact of CRD IV on the Society's capital ratio is also dependent on the related European Banking Authority (EBA) technical standards and the PRA's approach to implementation in those areas for which it is responsible.

5. Counterparty Credit Risk

The Society's counterparty treasury credit risk management policy is designed to ensure that the Society can obtain the best possible return whilst operating within prudent limits in respect of counterparties.

In selecting counterparties and the limits to be applied to them, the Society makes reference to Credit Ratings supplied by ECAIs, balance sheet data, and a general assessment of the counterparty in terms of background information which includes an overall ethical assessment which is updated annually or more frequently as required. This assessment includes among other matters:

- examination of the counterparties' environmental, sustainable development, biodiversity and waste management policies
- consideration of the degree of reporting on climate change
- compliance with the health and safety, environmental and labour legislation of the jurisdictions the counterparty is active in
- significant sectoral and regional exposures.

Counterparties are reviewed by ALCO and are subject to continuing approval by the Board.

Maturity of Treasury Investments

Fitch Ratings Service	<3 months £000	3 months to 1 year £000	>1 year £000	Total £000
AAA to AA-	3,500		1,000	4,500
A+ to A-	6,150	2,500		8,650
BBB+ to BBB-	4,091			4,091
BB+ to BB-	1,582			1,582
Unrated	3,000	3,550		6,550
British Government	7,995	5,491	1,000	14,486
Total	**26,318**	**11,541**	**2,000**	**39,859**

6. Credit Risk and mitigation

Indexed valuations are applied to the mortgage portfolio on a quarterly basis. As a prudent measure these valuations are reduced between 1.5 % and 5% depending on the nature of the loan (i.e. residential, development, secured on land or Buy to Let). At the end of December 2013, after applying these reductions the residential mortgage portfolio is low at 36.96%. At 31 December 2013, the Society had no properties in repossession.

The following table shows the extent of Past Due cases in the loan book separated into prime residential, development, buy-to-let and Fully Secured on Land (FSOL). The FSOL book contains a number of cases which are primarily residential in nature but have a significant amount of land attached, which may have some limited commercial exploitation.

Past Due amounts relate to the overall mortgage balances not the amount in arrears.

Past due - loans > 3 months in arrears	Balances £000	Past Due £000
Residential	66,958	44
Development	431	0
Buy to Let	5,974	0
FSOL	10,094	34
Unsecured	41	0
Total	**83,498**	**78**

Specific provisions are made regarding properties taken into possession, and potentially on mortgages which are three months or more in arrears. In these cases, 5% is added to the

mortgage balance, and between 20 and 30% is deducted from the latest physical valuation obtained, and a provision made for any apparent loss in realisable value. At the end of December 2013 there were no cases three months or more in arrears that were considered to be impaired.

A general provision is made to cover potential losses which might arise due to unknown factors based on general economic conditions and the Society's previous experience of impairment.

7. Remuneration Code Disclosures

The Remuneration Code is set out in the Regulator's Handbook SYSC19a and this requires information to be disclosed concerning the Society's remuneration policy and practices for those staff whose professional activities have a material impact on the Society's risk profile.

To minimise this risk the Board ensures that its remuneration policies are in line with its business strategy, risk appetite and long term objectives, and that remuneration is set at a level that retains and attracts staff of the appropriate calibre.

The Society's Remuneration Committee will ensure that its remuneration policy is consistent with the risk appetite of the Society. It will promote sound and effective risk management and will not encourage any excessive risk taking. This will be done by ensuring that no members of staff receive rewards for the achievement of quantitative targets for the amount of business written.

The remuneration of non-executive, executive directors and other members of senior management is determined by the Remuneration Committee, which consists of non-executive directors, details of whom are in the Annual Report and Accounts.

In setting remuneration, the Committee takes account of fees, salaries and other benefits provided to directors and to other senior management of comparable institutions that are similar in size and complexity. Non-executive directors are paid fees only.

The Society has a long established policy that no basic salary will exceed a maximum of five times the lowest full grade available.

All employees including executive directors are included in the Performance Related Pay Scheme after a qualifying period of 12 months. This is an annual scheme that provides non-pensionable rewards directly linked to the achievement of key performance objectives aimed at personal and professional development. The overall objective is to improve Society performance whilst maintaining the financial strength of the Society for the long term benefit of its members.

Remuneration Code Staff

Code staff are defined by the FCA as "staff that have a material impact on the firms risk profile; this includes staff that perform significant influence functions, Senior Managers and risk takers".

Information concerning the mandate of the Remuneration Committee and the decision-making process it uses in determining the remuneration policy for executive, and non-executive, directors is contained in the Society's Annual Report and Accounts 2013.

The Board has identified that the personnel whose professional activities have a material impact on the Society's risk profile are the directors and members of the Executive team. Two members of the Executive team, the Chief Executive and the Finance Director are executive directors. The above personnel are considered by the Society to be Remuneration Code staff under SYSC 19A of the PRA Handbook.

Directors	Number	Fixed remuneration £000	Variable remuneration £000	Total remuneration £000

Non-Executive Directors	[1]9	65	-	65
Executive Directors	2	151	6	157
Senior Managers	5	226	8	234

Fixed Remuneration for the executive directors and Senior Managers includes pension contributions paid by the Society and the value of any taxable benefits.

8. Conclusion

These disclosures do not constitute a financial statement and are intended to provide background information on capital requirements and in that context, the Society's approach to risk management.

Any questions or comments regarding these disclosures should be addressed to Paul Ellis (Chief Executive) or Pam Waring (Finance Director) at the Society.

[1] Includes two non-executive directors who retired in April 2013