



Pillar 3 Disclosures

for the year ended 31 December 2012

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1. Overview

Background

The Capital Requirements Directive (CRD) commonly referred to as Basel 2, introduced the need for banks and building societies operating under this new legislative framework to publish certain information relating to their risk management and capital adequacy. The disclosure of this information is known as Pillar 3 and is designed to complement the two other pillars of the CRD, namely the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). This document sets out the disclosures prepared for Ecology Building Society and the information provided here is in accordance with the rules set out in the FSA handbook BIPRU Chapter 11.

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, identifying, 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. The Committee 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.

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. RACE 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. The Board reviews the list of approved counterparties on a regular basis. 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

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. 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 FSA to cover events that are unforeseen.

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 £109.731m at 31 December 2012. This figure is net of general and specific provisions.

The Society's capital resources at this date were £6.797m, comprised of:

Tier	Type	Amount
Tier 1	General Reserves	£5.973m
Tier 2	Subordinated debt	£1.146m
Tier 2	General Provisions	£0.031m

The Society's subordinated liabilities are unsecured and rank behind the claims of the Society's depositors, creditors and investing members.

4. Capital Adequacy

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 which has a three year time horizon, and 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.

Risk Weighted Exposure Amounts and Operational Risk Capital			
Standardised Exposure Classes	Assets £000	Risk Weighted Assets £000	Pillar 1 Capital £000
Residential Mortgage Assets	67,358	23,731	1,899
Commercial Mortgage Assets	11,499	11,499	920
Liquid Assets	30,744	5,821	466
Fixed and Other Assets	1,648	1,648	132
	111,249	42,699	3,417

Operational Risk Capital Requirement	2,074	2,074	311
Pillar 1 Statutory Minimum Capital	113,323	44,773	3,728
Off balance sheet items included in Mortgage Assets (offers and retentions)	1,518	565	45

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 use of rating information, 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.

The Society makes reference to Fitch IBCA ratings to determine the minimum rating required for each counterparty. Each counterparty is subject to continuing approval from the Board of Directors.

Maturity of Treasury Investments				
Fitch Ratings Service	<3 months £000	3 months to 1 year £000	>1 year £000	Total £000
AAA to AA-			1,000	1,000
A+ to A-	9,639	4,000		13,639
Unrated	5,500	1,500	50	8,050
British Government	4,995	3,994		7,989
Total	20,134	9,494	1,050	30,678

6. Credit Risk and mitigation

The average loan to value on the core residential mortgage portfolio is low at 38.05% against indexed valuations, with a haircut (a further reduction across the portfolio of between 1.5 and 5% depending on the nature of sub book). This acts as an effective mitigant against credit risk. At 31 December 2012, 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	56,975	0
Development	626	0
BTL	6,635	0
FSOL	13,221	0
Unsecured	78	0
Total	77,535	0

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 2012 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 Society's objective in setting remuneration policies is to ensure that they 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.

Remuneration of executive directors and other senior management positions is determined by the Remuneration Committee, which consists of three non-executive directors and is chaired by Mark Jones.

In setting remuneration, the Committee takes account of fees, salaries and other benefits provided to directors and to other senior management of comparable institutions. 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.

Variable remuneration is paid to all employees including executive directors after a qualifying period of 12 months. Previously, this was in accordance with a Profit Related Pay Scheme which ceased to exist on 1 January 2012. The scheme was replaced by a Performance Related Pay scheme, with goals for senior management set by the Board. The first distribution under the new scheme will be made in March 2013.

Remuneration Code Staff

Code staff are defined by the FSA 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”.

The Board has determined that Non-Executive directors, the Chief Executive and Finance Director (executive directors) and members of senior management are designated as being subject to the FSA Remuneration Code.

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 2012.

Aggregate information on the remuneration of the six ~~six~~ five non-executive directors and two executive directors for the year ending 31 December 2012 is given below:

Directors	Number	Fixed remuneration £000	Variable remuneration £000	Total remuneration £000	variable as a % of fixed remuneration
Non-Executive	5	56	-	56	-
Executive	2	148	6	148	4.08

Other Senior Management and those involved in control functions

The Society operates a two-level senior management structure with a Triumvirate of Chief Executive, Finance Director and Chief Operating Officer comprising Tier 1, with all other senior managers at Tier 2. The Remuneration Committee is the final arbiter of the Tier 1 salaries, and is consulted regarding Tier 2 salaries on the basis of proposals made by the Chief Executive. The following senior manager posts in Tier 2 were subject to the Code rules in 2012:

- Business Development Manager
- Compliance Manager
- Technology Manager

Aggregate information on the remuneration of the Senior Managers, (including PRP payments where applicable) for the year ending 31 December 2012 is given below:

Number of other code staff	Fixed remuneration £000	Variable remuneration £000	Total remuneration £000	Variable as a % of fixed remuneration
4	184	3	184	1.79

Fixed Remuneration for 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.