Ecology
Building Society

Pillar 3 Disclosures

for the year ended 31 December 2015

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1. Overview

1.1.1 Introduction

The regulatory framework under which the Society operates is the European Union Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR), which came into force on 1 January 2014. The CRD and CRR, commonly known as CRD IV, provide for consistent capital adequacy standards for banks and building societies and an associated supervisory framework across the European Union and are enforced in the UK by the Prudential Regulation Authority (PRA). The legislation sets out the rules that determine the amount of capital each institution must hold in order to provide security for members and depositors 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 applicable 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 by management and the Board of additional capital resources required to cover the specific risks faced by the Society that are not covered by the minimum regulatory capital resource requirement set out under Pillar 1. This process is known as the Internal Capital Adequacy Assessment Process (ICAAP) and it includes stress testing the risks identified to establish a level of additional capital that should be held.
- Pillar 3 – this requires disclosure of the key information on the Society’s own funds, risk exposures and risk management processes.

This document contains the requirements for Pillar 3 (disclosure) and the information provided here is in accordance with the rules and guidance contained in CRD IV.

The Society underwent a formal Supervisory Review and Evaluation Process (SREP) by the PRA in **April 2015** with an updated level of individual capital guidance (ICG) and capital add-on advised by the PRA in December 2015.

The figures quoted in this disclosure have been drawn from the Society’s Annual Report and Accounts as at 31 December 2015, unless otherwise stated.

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 Ecology Building Society, 7 Belton Road, Silsden, West Yorkshire, BD20 0EE.

1.1.2 Media and Location

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

2. Risk Management Policy and Objectives

2.1.1 Background

The Board has an approved Statement of Risk Appetite which is detailed in the Society's ICAAP document.

Through its normal business operations the Society is exposed to a number of risks, the most significant of which are credit, liquidity and funding, concentration, interest rate, conduct, regulatory and legal and residual risk. The Society has a formal structure for managing these risks including established risk limits, reporting lines, mandates and other control procedures.

2.1.2 Oversight

The Society's Board of Directors, which comprises two Executive Directors and seven Non-Executive Directors, has ultimate responsibility for developing an appropriate risk and control framework, but has delegated powers to the Risk, Audit, Compliance and Ethics Committee (RACE) to advise the Board on the current risk exposures and future risks strategy.

The Board's 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 Financial Risks Policy. It monitors and controls structural risks in the balance sheet, including liquidity, treasury, and funding levels and also recommends policy development. It monitors implementation of Policy to ensure that the Board's defined risks are adhered to.

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 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 2015 RACE met four times.

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

2.1.3 Credit risk

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 to individuals 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.

2.1.4 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.

2.1.5 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
- to 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 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.

2.1.6 Interest rate risk

Interest rate risk is the risk that arises from mismatches between the re-pricing dates of the assets and liabilities on the Society's balance sheet. The Society is exposed to interest rate risk through its Treasury deposits and its guaranteed floor rate on savings accounts. However, 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.

2.1.7 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 re-mortgage 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.

2.1.8 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.

2.1.9 Regulatory and legal risk

The volumes and complexity of regulatory issues may reduce the Society's capital and ability to compete and grow, or result in fines, public censure or restitution costs because of failure to understand, interpret, implement and comply with EU and UK regulatory requirements. The Society has an internal compliance function to monitor compliance with existing legislation, the implementation of controls and the impact of new requirements. This is overseen by the RACE Committee.

2.1.10 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.

2.1.11 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.

3. Capital Resources

The capital resources of the Society are calculated in accordance with the CRR. The assets of the Society, as shown in the Balance Sheet, were £145,929m at 31 December 2015. This figure is net of collective and individual provisions.

The table below summarises the composition of the Society's regulatory capital for the Society as at 31 December 2015, together with prior year comparatives. The comparative figures for 2014 have been re-stated in accordance with FRS102 accounting standards.

Capital resources	As at 31/12/2015 £000	As at 31/12/2014 £000
Common Equity Tier 1 - general reserves	7,733	6,851
Tier 2 - sub-ordinated debt	548	723
- collective impairment allowance	104	60
Total capital resources	8,385	7,634

Common Equity Tier 1 capital

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

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 the transitional arrangements in Basel III all debt held by the Society is to be amortized on a daily basis at an annual rate of 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.

Profit and Capital

Current profit levels are sufficient to underpin the Society's growth based on existing capital requirements. Because of the strong potential to grow further the Society's intention to take on supplementary capital in the future remains. Whilst the Society is continuing to plan to issue a new capital instrument it awaits the outcome of ongoing regulatory deliberations on adequate capital levels before determining the extent of its capital raising ambitions.

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 CRR, 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 CRR. 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. The table below details the Society's Pillar 1 capital requirement as at 31 December 2015.

	Exposure £000	Risk Weighted Exposure £000	Pillar 1 capital £000
Liquidity			
Central Government	19,283	0	0
Credit Institutions	10,459	2,073	166
Total Liquidity	**29,742**	**2,073**	**166**
Loans and advances to customers[1]			
Residential performing loans	130,880	40,776	3,262
Non-residential performing loans	7,199	5,674	454
Past due items	0	0	0
Total Loans and advances to customers	**138,079**	**46,450**	**3,716**
Other Exposures			
Fixed and other assets	2,677	2,729	218
Total Other Exposures	**2,677**	**2,729**	**218**
Total Credit Risk Exposures	**170,498**	**51,253**	**4,100**
Operational Risk Capital Requirement			408
Total Pillar 1 Capital Requirement			**4,508**
Tier 1 Capital			**7,733**
Excess over Pillar 1 minimum			3,224

[1] Includes commitments

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.

Policy Limits and counterparties are reviewed by ALCO and are subject to formal approval by the Board. The Society receives counterparty grading updates from its treasury advisors and limits may be suspended following adverse downgrades.

The table below shows the breakdown of liquid assets by maturity and rating as at 31 December 2015 under the standardised approach.

Credit Ratings	<3 months £000	3 months to 1 year £000	>1 year £000	Total £000
AAA to AA-	3,500			3,500
A+ to A-	2,000			2,000
BBB+ to BBB-	2,173	500		2,673
BB+ to BB-	769			769
Unrated	500	1,000		1,500
Central Government	15,781	3,491		19,272
Total	**24,723**	**4,991**		**29,714**

6. Mortgage Credit Risk and mitigation

Mortgages are the Society's principle asset class. Throughout the year and at each year end, assessment is made of all advances where the account is in arrears. Where expected future cash flows from borrowers are lower than the current balance outstanding the account is considered impaired.

Allowance for impairment is reviewed annually, or when there is a material change in circumstances that could lead to increased losses in the mortgage book, such as a change in national or local economic conditions, deterioration in house prices or the trend in arrears.

In determining provisioning requirements, individual assessments are made of all advances and loans on properties that are in arrears, in possession, in forbearance and where the balance is in excess of 5% capital. An individual provision is made against those advances and loans that are considered to be impaired and a loss is likely to occur should the property be taken into possession, with account taken of any discount which may be needed against the value of the property to agree a sale.

At the end of December 2015 there were no cases that were three months or more in arrears that were considered to be impaired and there were no properties in repossession. At that date there were no accounts that were recorded as being past due (90 days or more in arrears).

In addition a collective 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.

Full details on the movements in collective and individual provisions are provided in note 12 in the Annual Report and Accounts 2015. Further detail about the credit quality and the Loan to value of the mortgage book is in Note 24.

A residual maturity analysis of loans and advances to customers is provided in Note 11 of the Annual Report and Accounts, disclosed on the basis that all loans are held for their agreed maturity.

Indexed valuations are applied to the mortgage portfolio on a quarterly basis. At the end of December 2015, the average LTV of the residential mortgage portfolio remains low at 38.63%.

7. CRD IV Disclosures

CRD IV introduced a leverage ratio which measures the levels of tier 1 capital against both on and off balance sheet exposures. This controls the overall level of growth that the institution can contemplate as a backstop to CRD IV capital ratios based on risk weightings. The leverage 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 Basel Committee is using a period to 2017 to test a minimum Tier 1 leverage ratio of 3.00%. At 31 December the Society's Tier 1 Leverage Ratio is 5.13%.

CRD IV 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 location of its operations. This information can be found in Note 29 of the Annual Report and Accounts.

8. Remuneration Code Disclosures

The Remuneration Code as set out in the Regulator's Handbook SYSC19D 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 three 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 6 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.

8.1.1 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 2015.

The Board has identified that the personnel whose professional activities have a material impact on the Society's risk profile are the 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 19D of the PRA Handbook.

	Number	Fixed remuneration £000	Variable remuneration £000	Total remuneration £000
Executive	3	230	8	239
Senior Managers	5	152	5	171

Fixed Remuneration for the executive directors and Senior Managers includes pension contributions paid by the Society and the value of any taxable benefits. Two senior managers did not qualify for variable remuneration in 2015.