Earl Shilton
BUILDING SOCIETY
YOUR MUTUAL FRIEND

# CAPITAL REQUIREMENTS DIRECTIVE

# PILLAR 3 DISCLOSURE DOCUMENT

# 31ST MARCH 2016

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# Earl Shilton Building Society ("the Society")

# Pillar 3 Disclosures as at 31st March 2016

## Introduction

1. The regulatory framework under which the Society operates with effect from 1st January 2014 is based on EU legislation known as CRD IV. The legislative capital adequacy framework is made up of the Capital Requirements Regulation (CRR), which is directly applicable to firms across the EU, and the Capital Requirements Directive (CRD), which must be implemented through national law. The Society seeks to ensure that it protects members savings by holding sufficient capital at all times.

2. The Prudential Regulation Authority (PRA) is the regulator of the Society and is responsible for implementing and monitoring the CRD in the UK. The Society has adopted the Standardised approach for Credit risk and the Basic Indicator Approach for Operational risk.

3. The CRD comprises 3 main elements, or 'Pillars', as follows:

- **Pillar 1**: Minimum capital requirements, using a risk based capital calculation focussing particularly on credit and operational risk, to determine the Capital Resources Requirement.

- **Pillar 2**: Internal capital adequacy assessment process (ICAAP) and supervisory review and evaluation process (SREP). The Board of the Society has undertaken an assessment of all of the key risks facing the Society and additionally has stress tested those risks to establish a level of additional capital to be held under Pillar 2. This has then been reviewed by the PRA, as part of their SREP arrangements.

- **Pillar 3**: Articles 431 to 455 of the CRR relate to capital disclosure requirements and through the Society's Internal Capital Adequacy Assessment Process (ICAAP) and these Pillar 3 disclosures, the Society aims to meet the requirements of these Articles.

4. The Society Board approves the ICAAP annually, using the level of individual capital guidance (ICG) and capital planning buffer advised by the PRA. The level of risk and capital adequacy is monitored by the Board on an ongoing basis.

5. The Society underwent a formal Supervisory Review and Evaluation Process (SREP) by the PRA in July 2015. The PRA issued Individual Capital Guidance (ICG) confirming the percentage of the Pillar 1 calculation to be held, together with a capital planning buffer. From 1st January 2016 the capital planning buffer has been replaced by the PRA buffer and the capital conservation buffer. A countercyclical buffer may also be required during periods of excessive credit growth in the wider market. The ICG issued by the PRA concluded that the level of Society capital held significantly exceeds the regulatory requirement.

6. The figures quoted in this disclosure have been drawn from the Society's Annual Report and Accounts as at 31st March 2016, unless otherwise stated. The Board's Disclosure Policy for its Pillar 3 report is based on its interpretation of the requirements of CRD IV. The Pillar 3 disclosures will be updated annually, following publication of the Annual Report and Accounts.

## Risk Management Objectives and Policies

7. The Board is responsible for determining a framework for risk management and control. It approves all policies and Committee terms of reference. The Executive Directors are responsible for

designing, operating and monitoring risk management and internal control processes. The Society uses a risk register to assess the likelihood and impact of its key risks. This is reviewed throughout the year by the Board and it forms a base for the identification of risks for incorporation into the ICAAP under Pillar 2.

8. The Assets and Liabilities Committee (ALCO), a Committee appointed by the Board and comprising both non-executive and executive directors, is responsible for monitoring risks on both sides of the balance sheet and meets monthly. This is explained more fully in section 20. The Board Audit, Risk and Compliance Committee, consisting solely of non-executives, considers the adequacy of internal controls, the Compliance function and the evaluation of risks. The system of internal control is designed to enable the Society to achieve its corporate objectives within a managed risk profile, not to eliminate risk.

9. The internal audit function provides independent and objective assurance that these processes are appropriate and effectively applied.

10. The principal business and financial risks to which the Society is exposed are credit, market, liquidity, regulatory, strategic and operational, these are detailed in sections 11 to 23 below.

11. Credit risk is the risk that losses may arise as a result of failure by a borrower or counterparty to meet its obligation to repay. The Board is responsible for reviewing the Lending Policy of the Society and monitoring the arrears profile. The ALCO monitors exposure to treasury counterparties as detailed in section 43 below. Concentration risk, which adds a further dimension to credit risk, arises as a result of the concentration of exposures within the same category, whether it is geographical location, product type, industry sector or counterparty type. These risks are managed through adherence to Board-approved lending and liquidity policies, which provide for a range of limits that are regularly monitored and reviewed in the light of changing economic conditions and Society objectives.

12. The Society is predominantly a residential mortgage lender, which means that it is exposed to the housing market in England and Wales by virtue of its statutory nature limits. Within the residential mortgage business, the Society's main concentration risk is geographical, as the largest part of its lending is in the East Midlands region, where the Society has its core area of operation.

13. Product type concentrations also exist as the Society operates primarily as a traditional residential mortgage lender. Any non-core lending is monitored regularly by the Board to ensure that lending policy limits are not exceeded. All concentrations are managed within limits which the Board believes are appropriate to current economic conditions and Society objectives.

14. The Board has ensured that the Society ICAAP makes provision for an additional amount of capital to be available to cover any downturn in house prices or increased mortgage losses, during periods of negative growth in the U.K.

15. Market risk incorporates the loss of income, mainly as a result of changes to interest rates. Exposure to this risk is primarily managed through natural hedges that exist in the Society balance sheet. Capital is allocated under Pillar 2 to cover the impact of a 2% parallel shift in interest rates over 3 years.

16. Liquidity risk concerns the Society's ability to meet its financial obligations, as they fall due as a result of imbalances in the cash flow of its activities. This risk is managed by maintaining a prudent level of liquid resources at all times in accordance with limits set out in Board policies for both Liquidity and Financial Risk Management.

17. Regulatory Risk considers the risk that the volume and complexity of regulatory issues may impact on the Society's ability to compete over time. Included here is Conduct risk, which looks at the way the Society conducts its business with its customers. The Board conducts a regular review of the fair treatment of customers and is satisfied that the Society's approach is both appropriate and robust. Further risk arises out of the Society's function as a deposit taker. The Society is required to contribute to the Financial Services Compensation Scheme if there are claims on the Scheme as a result of other deposit takers failing and is currently contributing each year.

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18. Strategic Risk is the risk that the Society is exposed to external factors. These are considered by the Board as part of the corporate plan process, ensuring that the Society makes an adequate amount of profit and maintains sufficient capital. The Society does not operate a defined benefit pension scheme, the assets being held separately from those of the Society in a group Personal Pension Plan provided by Legal and General Assurance Society Ltd.

19. Operational risk is associated with the Society's internal processes and systems and the potential for these not to function properly. It also covers human error and external events. The Society operates a robust control environment to mitigate operational losses and holds insurance cover where relevant. Operational risks are identified in the Society's Risk Register and a Contingency Plan is in place to ensure that any disruptions can be adequately managed.

20. In addition to the operational risk function, the Society has a formal structure for managing financial risk, which includes the establishment of risk limits, reporting lines, mandates and other control procedures. The ALCO is charged with responsibility for managing and controlling balance sheet exposures and the use of financial instruments for risk management purposes.

21. Full details regarding the financial risks and instruments used by the Society are given in the Annual Report and Accounts 2016, Note 25, Financial Instruments.

22. The Board recognises that there are residual risks inherent in any business, which may not be identified specifically. Adequate provision has been made for general residual risks in the ICAAP by applying a buffer to the individual capital guidance (ICG) requirement issued by the PRA.

23. Earl Shilton Building Society has capital ratios marginally over peer group society averages, as a result of which the Society is able to maintain overall capital at a level well in excess of the ICG, even after the addition of the internal buffer referred to above.

## Capital Resources and Leverage Ratio

24. Total Society capital resources at 31st March 2016, amount to £10.3m. This is made up predominantly of Tier 1 capital: general reserves (the accumulated profits of the Society), Tier 2 capital is made up of the collective provision for bad and doubtful debts.

25. Table 1 provides details of the components of Tier 1 capital, Tier 2 capital and total capital within the Society.

| TABLE 1 | |
|---|---|
| **Tier 1 Capital Resources** | **£m** |
| Accumulated profits held as general reserves | 9.93 |
| Deductions (intangible assets) | (0.03) |
| **Tier 2 Capital Resources** | |
| Collective impairment provision | 0.37 |
| **Total Capital Resources** | |
| Tier 1 and Tier 2 | 10.27 |

26. A non-risk-based leverage ratio is being introduced by changes to European rules which become mandatory from 1st January 2018. The Society's total on and off-balance sheet exposures at 31st March 2016 are £128.8m. Based on Tier 1 capital resources of £9.9m, the Society's Leverage Ratio under CRD IV is calculated at 7.7%. This has increased from 7.4% at 31st March 2015 due to the growth in the Society's reserves during the year and is not expected to change significantly throughout the period of the Corporate Plan.

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## Capital Adequacy Assessment

27. The Society maintains a three-year strategic planning framework, this is reviewed by the Society's Board annually to take account of current and changing economic conditions. The process culminates in the annual production of a three-year corporate plan with detailed budgets covering the following years' activities.

28. The corporate plan is produced by reference to the Society's ICAAP, both documents reflect the Board's risk appetite and integrate the capital position and forecasts into future strategy.

29. The Society's ICAAP also contains the capital plan for the next three years and the Board ensures that there are adequate capital resources to support the corporate goals contained within the plan.

30. 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.

31. 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.

32. Under the basic indicator approach for operational risk, the Society calculates its average net income over the previous three years and provides 15% of that average net income as the minimum capital requirement for operational risk.

33. Table 2 provides details of the calculation of capital resource requirements within the Society as at 31st March 2016, covering both liquidity and mortgage exposures.

| TABLE 2<br>Capital Resources Requirement | | | |
|---|---|---|---|
| **Credit Risk** | Exposure £m | Risk weighted assets value £m | Minimum capital required £m |
| **Treasury Assets** | | | |
| Central government (UK gilts / Treasury Bills) & Bank of England | 22.1 | - | - |
| Multilateral Development Banks | 1.0 | - | - |
| Credit Institutions | 8.6 | 2.6 | 0.2 |
| Cash | 0.1 | - | - |
| Total Treasury Assets | **31.8** | **2.6** | **0.2** |
| **Loans and Advances to Customers** | | | |
| Residential – performing loans | 93.5 | 33.8 | 2.7 |
| Residential – past due loans | - | - | - |
| Non-residential/business – performing loans | 2.6 | 2.6 | 0.2 |
| Non-residential/business – past due loans | - | - | - |
| Total Loans and Advances to Customers | **96.1** | **37.6** | **2.9** |
| **Fixed and Other Assets** | 0.9 | 0.9 | 0.1 |
| Total Credit Risk – Capital Resources Required | **128.8** | **41.7** | **3.2** |
| Operational Risk – Capital Resources Required | | | 0.4 |
| **Total Pillar 1 Capital Resources Required** | | | **3.6** |

## Credit Risk (Mortgages)

34. The Society regards as 'past due' any mortgage or loan account where more than three monthly repayments have not been made at the accounting date. Arrears of mortgage repayments are monitored closely and the Society has performed satisfactorily in comparison with national arrears and possession statistics.

35. Table 3 provides a Society analysis, for capital adequacy purposes, of loans and advances exposures at 31st March 2016:

| TABLE 3 | | | | | | |
|---|---|---|---|---|---|---|
| Society | Residential | | | Non-Residential | | |
| Loans and Advances Exposures | Performing £m | Past Due £m | Total £m | Performing £m | Past Due £m | Total £m |
| | | | | | | |
| **Total** | **93.5** | **-** | **93.5** | **2.6** | **-** | **2.6** |

36. A reconciliation of the above table to Note 12 of the Annual Report and Accounts 2016 'Loans and advances to customers' is provided in Table 4:

| TABLE 4 | |
|---|---|
| Reconciliation of Society Loans and Advances to Customers | Total £m |
| Society loans and advances to customers per note 12, Annual Report & Accounts | 91.1 |
| Add back: Collective and Specific impairment provisions | 0.4 |
| **Society accounting value of loans and advances to customers** | **91.5** |
| Total residential exposures for capital adequacy purposes | 88.9 |
| Total commitments for residential mortgage loans | 4.9 |
| Total non-residential exposures for capital adequacy purposes | 2.6 |
| **Society capital adequacy value of loans and advances to customers** | **96.4** |
| Adjustments to reflect different reporting requirements and timing differences | 4.9 |
| **Reconciled Value of Loans and Advances to Customers** | **91.5** |

37. A geographical analysis of Society exposures, shown in table 4, is given in Table 5, below:

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| TABLE 5 | | | | | | |
|---|---|---|---|---|---|---|
| Society | Residential | | | Non-Residential | | |
| Geographical Region | Performing £m | Past Due £m | Total £m | Performing £m | Past Due £m | Total £m |
| East Midlands | 28.0 | - | 28.0 | 1.6 | - | 1.6 |
| West Midlands | 6.8 | - | 6.8 | 0.1 | - | 0.1 |
| South Central | 5.6 | - | 5.6 | - | - | - |
| East Anglia | 8.1 | - | 8.1 | 0.6 | - | 0.6 |
| London | 6.8 | - | 6.8 | - | - | - |
| South East | 6.8 | - | 6.8 | 0.1 | - | 0.1 |
| North East | 7.0 | - | 7.0 | - | - | - |
| North West | 4.9 | - | 4.9 | 0.2 | - | 0.2 |
| South West | 12.8 | - | 12.8 | - | - | - |
| Wales | 2.1 | - | 2.1 | - | - | - |
| **Total** | **88.9** | **-** | **88.9** | **2.6** | **-** | **2.6** |

38. A residual maturity analysis of Loans and Advances to customers is provided at Note 12 of the Annual Report and Accounts 2016. It should be noted that this maturity analysis assumes that loans and advances run for their full, agreed term. In practice, mortgage loans seldom continue to the agreed maturity date and, therefore, the actual repayment profile is likely to be significantly different from that disclosed.

## Provisions

39. The Society's accounting policy in relation to the provision for loans and advances is stated in full in Note 1, Accounting Policies, to the Annual Report and Accounts 2016.

40. Full details of the movements on provisions for bad and doubtful mortgage debts are provided in Note 13 to the Annual Report and Accounts 2016.

41. For capital adequacy purposes, collective provisions are regarded as Tier 2 capital (Table 1 above).

42. No specific provisions have been utilised to adjust downwards the value of risk-weighted assets in the capital adequacy calculations.

## Credit Risk (Treasury)

43. The purpose of the Treasury Policy including both the Liquidity Policy and the Financial Risk Management Policy is to ensure that the Society operates within prudent limits in respect of counterparties in terms of both amount invested and counterparty rating. Investments in banks and building societies are held purely for liquidity purposes. The minimum policy ratings using the Fitch ratings agency are short term F1 and long term A-, although treasury deposits can also be made with unrated building societies at the discretion of the Board on a case by case basis. The Board have also considered the Society's exposure to its main clearing bank, National Westminster and the guarantee implicit in the UK Government's stake in RBS Group, which is rated by Fitch at short term F2 and long term BBB+. As a consequence, limits are placed on both the amount deposited and the original maturity of those deposits. In addition to the use of Fitch ratings, market intelligence is used to allow for the delay between a counterparty being in difficulty and this being reflected in a downgrading of its Fitch rating. Policy limits and counterparties are regularly reviewed by the Assets and Liabilities Committee, with formal policy approval being made at Board level. The Society receives counterparty grading amendments from its Treasury advisors and limits may be suspended following adverse downgrades.

The breakdown of liquid assets by maturity and rating at 31st March 2016 under the standardised approach is shown in Table 6 below:

| TABLE 6 | | | | |
|---|---|---|---|---|
| Group | Maturity Profile | | | |
| Credit Rating | Less than 3 months | 3 months to 1 year | Over 1 year to 3 years | Total |
| | £m | £m | £m | £m |
| Government securities | 5.0 | 3.0 | 1.0 | 9.0 |
| Bank of England | 13.1 | - | - | 13.1 |
| AAA to AA- | 2.0 | - | 1.0 | 3.0 |
| A+ to A- | 1.0 | 1.0 | - | 2.0 |
| BBB+ | 2.1 | - | - | 2.1 |
| Unrated Building Societies | 0.5 | 2.0 | - | 2.5 |
| Cash | 0.1 | - | - | 0.1 |
| **Total** | **23.8** | **6.0** | **2.0** | **31.8** |

## Interest Rate Risk

44. Interest rate risk is referred to under the heading of Market Risk, in section 15 of this document. The interest rate risk to which the Society is most exposed is basis risk. Basis risk arises where balance sheet components are subject to different interest rate markets. This includes exposure to fixed rate lending on treasury assets which is matched with balances on the other side of the balance sheet which are at variable rates.

45. Interest rate risk is managed by utilising natural hedges on the balance sheet and by the setting of exposure limits.

46. The interest rate risk on savings and mortgage products is reviewed on a regular basis and action taken as appropriate.

47. The Society balance sheet is stress tested against Board gap limits on a monthly basis for the effects of a 1%, 2% and 3% parallel shift in interest rates, after the appropriate adjustment of capital allocations. The Board has set a limit on the effect that a 2% parallel shift in interest rates can have on the Society's capital. Capital is provided within the ICAAP under Pillar 2.

48. 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 ICAAP.

49. Full analysis of interest rate risk exposures at 31st March 2016 is given in Note 25 of the Annual Report and Accounts 2016 'Financial Instruments – Market Risk'.

## Remuneration Policies and Practices

50. 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.

51. To minimise this risk, the Board sets the remuneration policy in line with its risk appetite and long term objectives and remuneration is set at a level that attracts and retains staff of the appropriate calibre. Consequently, the Society's policy on remuneration is to seek to ensure that its remuneration decisions are in line with effective risk management of the Society.

52. The Society also seeks to ensure that its remuneration decisions are in line with its business strategy and that it is consistent with the Society's current financial position and future prospects, and seeks to establish an appropriate balance between the fixed and variable elements of remuneration which may vary depending on the seniority and nature of an individual's employment.

53. 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 currently there are no incentive schemes in operation. A non-contractual bonus of up to 3% basic salary has been paid to all staff for a number of years.

54. 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 and staff engaged in control functions, two of whom, the Chief Executive and the Deputy Chief Executive & Finance Director are executive directors.

55. Other senior members of staff are deemed not to affect the risk profile of the Society in the way that these staff do, as they report directly to the Executive and are constrained by their operating mandates.

56. 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 and Accounts 2016.

57. 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 as follows:

- IS & Estates Manager
- Regulation & Compliance Manager
- Financial Controller
- Business Development & Marketing Manager
- Customer Services Manager
- Management Accountant & Resources Manager

Aggregate information on the remuneration for Code staff for the period 1st April 2015 to 31st March 2016 is given below:

| TABLE 7 | | | | |
|---|---|---|---|---|
| Society | Number | Fixed Remuneration | Variable Remuneration | Total Remuneration |
| | | £ | £ | £ |
| Non-executive Directors | 6 | 107,247 | - | 107,247 |
| Executive Directors | 2 | 197,586 | 4,950 | 202,536 |
| Other Remuneration Code staff | 6 | 250,006 | 6,417 | 256,423 |
| **Total** | **14** | **554,839** | **11,367** | **566,206** |

58. In all cases fixed remuneration includes pension contributions paid by the Society and the value of taxable benefits.

## Country-by-Country Reporting

59. The following additional Pillar 3 disclosures have been prepared in accordance with the Capital Requirements (Country-by-Country Reporting) Regulations 2013 which came into effect on 1 January 2014. These Regulations are set out in Article 89 of the Capital Requirements Directive 4 (CRD IV), which is binding on all EU member states.

60. The objective of the country-by-country reporting (CBCR) requirements is to provide greater transparency and expanded disclosure in financial statements for the benefit of investors. The CBCR disclosures inform the reader of the source of a firm's income and the location of its operations.

61. The Earl Shilton Building Society ("the Society") is a UK registered entity. Its activities are detailed in the Directors Report on pages 2 to 8 of the Annual Report and Accounts 2016.

62. The Society's total operating income for the year ended 31 March 2016 was £2,647,489.

63. The number of employees was 27.

## Conclusion

64. This disclosure document, prepared in accordance with regulatory requirements, is intended to provide background information on the Society's approach to risk management. It also provides asset information and capital calculations under Pillar 1. The disclosures are published within 4 months of the Group's financial year end and are updated annually.

65. In the event that a user of this disclosure document requires further explanation on the disclosures given, application should be made, in writing, to the Deputy Chief Executive & Finance Director at Earl Shilton Building Society, 22 The Hollow, Earl Shilton, Leicester LE9 7NB.