



## **CAPITAL REQUIREMENTS DIRECTIVE** **– PILLAR 3 STATEMENT**

### **Introduction**

In accordance with the provisions of the Capital Requirements Directive (CRD), generally referred to as Basel 2, Century Building Society is required to provide detailed information of its capital structure and capital adequacy thereby providing members, and prospective members, with key information relating to the Society's capital, risk exposures and the risk assessment process.

The information provided in this document is in accordance with the rules laid out in the Financial Services Authority (FSA) handbook and all figures are correct as of 31<sup>st</sup> December 2009.

### **The Society's Activities/Risk Appetite**

The Society's activities remain substantially of a traditional nature; with over 96% of total mortgages being fully secured on residential property, and financed by funding of over 98% in the form of shares held by individuals.

On 26<sup>th</sup> March 2009 the Society's Board of Directors agreed the under-noted risk appetite:

The Society's affairs will be managed in such a manner so as to ensure that, at no time, including a one in twenty five year stress test, will the Society's reserves fall below the total capital required under the CRD plus a buffer of £200,000.

### **The Assessment of Capital Adequacy**

The Capital Requirements Directive seeks to ensure that the financial resources held by the Society are commensurate with the risks associated with our business profile and the controlled environment within the Society.

There are three "pillars" :

1. Pillar 1 – this sets out the minimum capital requirement the Society will be required to meet for credit, market and operational risk.

2. Pillar 2 – the Society and the Financial Services Authority (FSA), our regulator, will require to take a view on whether the Society requires additional capital against risks not fully covered in Pillar I. The Society maintains a process for assessing overall capital adequacy in relation to the risk profile and a strategy for maintaining the appropriate capital levels. The FSA will review these assessments and strategies and other information received and may take appropriate action if they are not satisfied with the results of these processes.
3. Pillar 3 – Pillar 3 complements the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2) by encouraging market discipline by way of disclosure requirements which will allow market participants to assess key pieces of information on the Society's capital, risk exposures and risk assessment processes.

## **Approaches Adopted**

### **Pillar 1**

In the assessment of the Pillar I capital requirement, a firm may adopt one of two approaches for the assessment of credit risk :

1. The Standardised Approach (TSA) – as its name applies this approach requires a firm to follow a prescribed format and calculation process.
2. The Internal Ratings Based Approach (IRB) – whereby a firm has been approved by the regulator to assess its own capital adequacy by way of its own sophisticated modelling systems.

### **Century Building Society has adopted The Standardised Approach to the assessment of credit risk under Pillar 1.**

There are three options available to a firm in the assessment of its operational risk under Pillar 1 :

1. The Basic Indicator Approach (BIA) – where the capital requirement will be based on a fixed percentage currently 15% of gross income.
2. The Standardised Approach (TSA) – where the capital charge is still based on gross income but where the firm's activities are divided along business lines each with their own percentage charge.
3. The Advance Measurement Approach (AMA) – which allow firms to determine their operational risk capital requirement according to an internal model providing it meets certain requirements.

### **Century Building Society has adopted the Basic Indicator Approach to the assessment of operational risk under Pillar 1.**

**Century Building Society has no exposure to Financial Market Risk.**

**Century Building Society's total Pillar 1 Capital Requirement is £883,000**

## **Pillar 2**

The Board and management of the Society have identified the additional under-noted risks which are not fully covered under Pillar 1 and which may have an additional capital requirement:

Credit Risk / Capital Planning – Reference is made to the Stress Tests (below) in which it will be noted that an additional capital requirement of £2,000 is required under Pillar 2 for Credit Risk, and £1,000,000 for Capital Planning Buffer.

Operational Risk –

1. Compliance with legislation and regulation – as a small building society, operating on a narrow profit margin, we do not have the benefit of a dedicated compliance department. We recognise that as regulations and legislation becomes ever more complex it may pose a greater challenge to management.

The Board of Directors therefore consider it likely that in the foreseeable future, the Society may require to consult external advisors on specific legal / regulatory issues. Clearly this will have a cost burden and we therefore consider it appropriate to provide additional capital of £100,000 under Pillar 2 in recognition of this potential cost.

2. Segregation of duties – the Board of Directors recognise the specific difficulties for a small Society in regard to effective segregation of duties. In order to provide for what might be deemed “ideal segregation”, additional staff would need to be employed, with the attendant cost thereof but being not fully utilised for the benefit of the Society and indeed the individual employed. Although not having the most ideal segregation of duties, the Directors are confident of other compensating controls in place including a thorough system of internal audit.

Despite the fact that the Society has sustained no loss which can be attributed to a weakness in segregation of duties within at least the last ten years, the Directors nevertheless consider it prudent to provide for additional capital in the sum of £50,000 under Pillar 2 in recognition of the potential, albeit small, risk identified.

3. Long term absences – the Society's relatively small number of staff could give rise to a potential problem in a period of long term absences and, although the Society has experienced no such problems within the last ten years at least, we do however recognise the potential risk involved. The Board of Directors therefore consider it appropriate to provide additional capital of £50,000 under Pillar 2 in recognition of this.
4. Exposure to legal/financial crime – irrespective of how robust or comprehensive a financial institution's internal control may be, no such systems can fully offset potential exposure to legal/financial crime. All financial institutions have to depend on professional advice from lawyers, accountants, surveyors etc but there have been instances of corruption amongst such professionals resulting in financial losses to

institutions. In view of the above, the Board of Directors consider it prudent to provide additional capital in the sum of £100,000, under Pillar 2, in recognition of this potential risk.

5. Complaints/referrals to Financial Ombudsman Service – the Society has a very good record in regard to complaints, having had no referrals to the ombudsman that has resulted in a financial penalty. The Board of Directors acknowledge the potential of making mistakes and consider it prudent to provide additional capital in the sum of £30,000 under Pillar 2 in recognition of the potential, albeit small, risk involved.

Century Building Society's total Operational Risk Capital Requirement is £330,000

Concentration Risk –

1. The Board of Directors consider it appropriate to provide additional capital of £90,000 for geographical concentration risk.
2. The Board of Directors consider it appropriate to provide additional capital of £31,000 in respect of sectoral, non-internationally active and granularity concentration risks.

**Century Building Society's total Pillar 2 Capital Requirement is £653,000**

### **Stress Tests**

The Society has undertaken a range of stress tests to determine whether it could survive a severe economic downturn. The tests were carried out on a worst scenario basis having regard to our experiences over the last 25 years as required by the FSA for Pillar 1 IRB models, and other severe business shocks.

The key stress tests undertaken were:

#### 1 Credit Risk / Capital Planning

The relatively small size of the Society's mortgage portfolio has made possible the review of each and every mortgage file by the Chief Executive. The Chief Executive's experience in the Scottish property market has enabled him to make a conservative assessment of the valuation of each property as at 30<sup>th</sup> June 2007 and these 'base' valuations have been index linked to 31<sup>st</sup> December 2009. The Chief Executive also considered the employment security of each borrower in this period of recession and deemed all accounts, regardless of payment record to date, as potential arrears cases.

Within the last 25 years the greatest drop in Scottish property values was approximately 8.5% in the year to 31<sup>st</sup> December 2008 and this followed a long period of sustained growth. 2009 saw a modest average increase of 1% in Scottish property values and this growth pattern is expected to continue throughout 2010. In assessing the Society's Capital Planning Buffer (refer to Annex 1), the Board of Directors has assumed a worse case scenario of a 30% drop in property values and assessed how this would affect the equity margins on our mortgage accounts during 2010.

The Capital Planning figure is calculated by using the stressed scenario to project capital resources and capital requirements through an economic or business cycle. The scenarios will also include management action taken to increase capital. The Capital Planning Buffer is the difference between the maximum capital surplus over ICG and the minimum capital surplus over this period.

The Society has stress tested the effect of an immediate 30% reduction in property values. This will have two main effects on capital requirements:

- 1 Additional losses will be made on the sale of properties currently in possession.
- 2 The risk weightings used to calculate the Pillar 1 requirement will change as they are dependant on property values.

Management action taken will involve re-valuation of the property currently held in the balance sheet at net book value.

Result: The 30% reduction was applied to all property values. Additional losses of £212,000 were identified for those properties in possession. Pillar 1 risk weightings were also amended, thereby changing the ICG requirement of Pillar 1 plus Pillar 2. Management action involving the revaluation of the Society's property was also included. The results are shown in Annex 1, and the Board of Directors therefore consider that the sum of £1,000,000 is required for the Capital Planning Buffer. In addition, having regard to the recent FSA Risk Assessment of the Society (ICG), the Board of Directors consider it appropriate to provide additional capital of £2,000 for credit risk.

## 2 Liquidity Risk

The Society monitors liquidity on a daily basis in order to ensure that any significant outflow would not pose a problem. Having a significant proportion of funding on a fixed term basis assists in planning for liquidity and the close control of maturing tranches. We therefore have an adequate warning of a potential liquidity crisis. A comprehensive contingency plan is in place.

In the light of the above, the Board of Directors is confident in the effectiveness of the Society's procedures and policies and see no requirement for additional capital under Pillar 2 at this stage.

## 3 Interest Rate Risk

The Society's exposure to interest rate risk is stress tested by way of a 2% movement in the yield curve. A Gap Analysis of the interest rate maturity profile and the balance sheet is carried out each month and this is reported to, and monitored by, the Board of Directors. The Board of Directors has set the maximum limit for the 2% Sensitivity of £200,000 and this sum is therefore the additional capital required under Pillar 2.

## **Analysis of Current and Forecast Capital**

	Actual 31 Dec 09 £000	Forecast 31 Dec 10 £000	Forecast 31 Dec 11 £000
Tier 1 Capital (see below)	2,671	2,678	2,801
Tier 2 Capital (see below)	16	14	12
Total Capital Available	<u>2,687</u>	<u>2,692</u>	<u>2,813</u>
Pillar 1 Capital Required	883	855	881
Pillar 2 Capital Required	653	633	652
Capital Planning Buffer	<u>947</u>	<u>1,000</u>	<u>1,000</u>
Total Capital Required under the Regulations	<u>2,483</u>	<u>2,488</u>	<u>2,533</u>
Surplus Capital Available	<u>204</u>	<u>204</u>	<u>280</u>

Tier 1 capital is capital that can be used to absorb losses; is permanent; ranks for repayment upon winding up after all other debts and liabilities; and has no fixed costs attached to it. In the case of the Society, this is the General Reserve.

Tier 2 capital includes capital that does not meet the requirements of permanency and absences of fixed costs that apply to tier 1 capital. This includes general and collective provisions. In the case of the Society, this is the Contingency Reserve.

**As of 18<sup>th</sup> March 2010, the Directors are not aware of any issues which could have a material effect on the above current or forecasted capital analysis. Should any such matters arise then this document will be amended accordingly.**