



Pillar 3 Disclosures 2021

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The information contained in this document has not, and is not required to be, audited by the Society's external auditors and does not form any part of the financial statements.

Introduction

1. The regulatory framework under which the Society operates is an EU legislative package known as "CRD IV". CRD IV is made up of the Capital Requirements Regulation (CRR), which is directly applicable to firms across the EU, and the Capital Requirements Directive (CRD), both of which have been implemented in the UK by the Prudential Regulation Authority (PRA). CRD IV is intended to implement the Basel III agreement in the EU. Following the UK's departure from the EU, the CRD IV legislation remains part of the "retained EU law" in the UK and thus continues to apply to the Society.
2. 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 aim to meet the requirements of these articles.
3. The Directors of Scottish Building Society aim to ensure the protection of our members' savings by having sufficient capital even during a significant economic downturn.
4. The calculation of the Society's capital requirements under CRD IV is made up of the following key components:
 - **Pillar 1:** Minimum capital requirements, using a risk-based capital calculation focussing particularly on credit and operational risk.
 - **Pillar 2a:** The Society has conducted an Internal Capital Adequacy Assessment Process (ICAAP) designed to assess all of the key risks facing the Society and to apply stress testing of those risks to establish a level of additional capital to be held under Pillar 2a. Pillar 1 and Pillar 2a capital requirements are added together to determine the Society's Total Capital Requirement (TCR).
 - **Capital Buffers:** These are additional amounts of capital to be kept aside to ensure that, in the event of stressed conditions, the Society remains well capitalised and meets, at the very least, its stressed capital requirements. The capital buffers include a 'Capital Conservation Buffer' (CCB), a 'Countercyclical Buffer' (CCyB) and a 'PRA Buffer'. The CCB and CCyB collectively are referred to as the CRD4 buffer.
5. The Board approved the Society's most recent ICAAP in September 2020 and the Board continues to monitor risk and capital adequacy on an ongoing basis.
6. The Society underwent a formal capital related Supervisory Review and Evaluation Process (SREP) by the PRA in February 2019 following which the PRA set Total Capital Requirements (TCR) for the Society of 8% of Risk Weighted Assets plus the CRD4 buffer. No PRA buffer was applied.
7. Actual capital held is significantly in excess of the TCR set by the PRA and the level of capital required as calculated in the Society's ICAAP.
8. Scottish Building Society has a dormant wholly owned subsidiary, SBS Mortgages Limited, which, together with the Society, forms the Group. Group accounts were not required on the basis of materiality of the subsidiary. The figures quoted in this disclosure have been drawn from the Society's Annual Report and Accounts as at 31 January 2021, unless otherwise stated.

Structure and Organisation of Risk Management Function

9. The Board is responsible for determining a framework for risk management and control. It approves all policies and committee terms of reference and is responsible for approval of the Society risk appetite and relevant risk management policies.
10. The Society operates a three lines of defence model and, under the direct oversight of the Board, the Society has the following key governance and risk management committees, membership of which is a mix of Directors and other senior management:

Board Committees

- Audit Committee
- Board Risk Committee
- Nomination & Remuneration Committee

Management Committees

- Operational Risk Committee
- Asset and Liability Committee (ALCO)
- Retail Credit Committee

11. The Society maintains a detailed risk register which is presented to the Board Risk Committee throughout the year. Individual risk registers are maintained in respect of the relevant risk categories, and are reviewed on a rolling basis by the appropriate committee. The reviews of the risk registers form a base for the identification of risks for incorporation into the ICAAP under Pillar 2.
12. The Audit Committee, which is a Board Committee consisting solely of Non-Executive Directors, meets at least four times each year and considers regulatory compliance matters and adequacy of internal controls. It also reviews audit reports, monitors the relationship with internal and external auditors and agrees the annual internal audit plan.
13. The Board Risk Committee, which is a Board Committee consisting solely of Non-Executive Directors, meets at least six times a year. The Committee's remit includes the responsibility for oversight of the Society's Risk Control Framework and Risk Management, consideration of the Board Risk Appetite Statement and supporting metrics and stress testing outputs, review of Board policies and key prudential documentation from a risk perspective.
14. The Nomination & Remuneration Committee is a Board Committee, consisting solely of Non-Executive Directors, which meets at least four times each year. The Committee reviews Board constitution, skills, performance, succession plans and Director elections and is responsible for remuneration policy for all Directors and for making recommendations to the Board regarding general remuneration and contractual arrangements.
15. The Operational Risk Committee is a Management Committee, chaired by the Chief Executive, which generally meets bi-monthly. The Committee is responsible for monitoring and reviewing the Operational Risks (including Conduct Risks) of the Society, making recommendations to the Board Risk Committee on Operational Risk Appetite, and drawing to the attention of the Board any concerns relating to Operational Risks. The remit of the Committee is reviewed at least annually by the Board Risk Committee.
16. The Asset and Liability Committee (ALCO) is a Management Committee, chaired by the Finance Director, which meets at least monthly to review and update financial risk management policies. ALCO also makes decisions within pre-agreed parameters on product pricing, margin, liquidity management, balance sheet funding and interest rate risk management. ALCO is overseen by the Board Risk Committee.

17. The Retail Credit Committee is a Management Committee, chaired by the Finance Director, which generally meets bi-monthly. The Committee is responsible for monitoring and reviewing the performance and risks of the mortgage book of the Society, making recommendations to the Board on policy matters and drawing to the attention of the Board Risk Committee to any concerns relating to the quality of the book, including loss provisioning. The remit of the Retail Credit Committee is reviewed at least annually by the Board.
18. 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 entirely.
19. The internal audit function provides independent and objective assurance that these processes are appropriate and effectively applied.

Risk Management Objectives and Policies

20. The principal business and financial risks to which the Society is exposed are credit, operational, conduct, liquidity, interest rate, governance and strategic, and climate change. These are covered in the following paragraphs.
21. **Credit Risk** relates to the risk that mortgage customers or treasury counterparties, to whom the Society has lent money, may default on their obligation to pay.
22. The Retail Credit Committee is responsible for reviewing the lending policies of the Society and for monitoring the arrears profile. The ALCO overviews exposure to treasury counterparties, overseen by the Board Risk Committee.
23. The retail credit risk appetite of the Society is articulated through a combination of the individual product criteria of its residential based lending products, and a suite of limits agreed by the Society's Board. Reporting against credit risk appetite is a key part of the information regularly provided to the Retail Credit Committee.
24. The treasury counterparty credit risk appetite of the Society is articulated through a suite of limits recommended by ALCO and agreed by the Society's Board. The Society will always put security of investment ahead of additional yield and the Society's requirements for minimum credit quality for counterparties, and other appropriate limits, are documented in our liquidity policy. Reporting positions against these limits is a key part of the monthly overview provided to ALCO.
25. 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.
26. Within the residential mortgage business, the Society's main concentration risk is geographical, as the majority of its lending is in Scotland, where the Society has its core area of operation.
27. Product type concentration also exists as the Society operates primarily as a traditional residential mortgage lender. All non-core lending is carefully controlled and 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.

28. 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 UK.
29. **Operational Risk** is the risk of a loss arising from inadequate or failed internal processes or systems, human error or external events, including cyber risk. The principal operational risks facing the Society are:
 - Fraud
 - Execution, Delivery and Process Management
 - Clients, Products and Business Practice
 - Business Disruption and Systems Failures
 - Damage to Physical Assets
 - Employment Practices and Workplace Safety
30. Operational risks and relevant controls are captured on the Operational Risk Register and are reviewed bi-monthly by the Operational Risk Committee.
31. **Conduct Risk** is the risk of the Society failing to treat its customers fairly, with resulting detriment to those customers. The Society has categorised its potential conduct risks into six separate categories, these being: Society Culture, Products, Sales & Advertising, Operational Processes, Engagement, and Regulatory Standards. The Society has a low appetite for losses arising from Conduct Risk.
32. Conduct risks and relevant controls are captured on the Society's Risk Register and are reviewed bi-monthly by the Operational Risk Committee.
33. **Liquidity Risk** relates to the Society's ability to meet its financial obligations as they fall due. The Society has a Board policy in place for Liquidity and Funding risk management to ensure it maintains sufficient funds in liquid form at all times.
34. 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. This formal structure is overseen by the Board Risk Committee.
35. The Society's Internal Liquidity Adequacy Assessment Process (ILAAP) provides an overview and assessment of the liquidity position of the Society and of the controls over liquidity management. The most recent ILAAP was approved by the Board in December 2020. The Society's liquidity requirements, current and projected position and controls continue to be monitored on an ongoing basis by ALCO, Board Risk Committee and the Board.
36. **Interest Rate Risk** is the risk of the Society's financial position deteriorating as interest rates move over time and the failure to preserve interest rate margins arising from an increase in the cost of funds or a decrease in the earning capacity of assets.
37. The main activities undertaken by the Society that give rise to interest rate risk are as follows:
 - Management of the investment of capital and other non-interest bearing liabilities;
 - Issue of fixed rate savings products;
 - Fixed rate wholesale funding;
 - Fixed rate mortgage and other lending; and,
 - Fixed rate investments.
38. Interest rate risk is managed by utilising natural hedges on the balance sheet and by effecting interest rate swaps with external counterparties.

39. The interest rate risk on savings and mortgage products is reviewed on a regular basis and hedging action taken as appropriate.
40. The Society balance sheet is tested on a monthly basis against Board gap limits and for the effects of a 2% parallel shift in interest rates.
41. 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's overall risk appetite.
42. Full analysis of interest rate risk exposures as at 31 January 2021 is given in Note 27 of the Report & Accounts 2021.
43. **Governance Risk** is the risk that the Society may not be governed effectively at Society and business unit level and/or the strategy selected at Society level may be ineffective or inappropriate.

Strategic Risk is the risk of loss or reduced earnings due to inappropriate senior management or Board actions caused by unprepared or misjudged strategic decisions, and/or implementation of those decisions.

Governance and Strategic risks are articulated in a set of Board Policy statements, and are monitored against a set of qualitative statements and quantitative measures, which are regularly reviewed by the Board.

44. **Climate Change Risk** is the risk to the Society arising from climate change which is recognised in terms of both Physical and Transition risks. Physical risks include increased risk of flooding, subsidence and coastal erosion arising from extreme weather events or longer term shifts in climate, impacting on the value of, and longer term ability to insure, mortgaged properties. Transition risks arise from factors such as policy and regulation, and changing customer preferences resulting from the adjustment to a lower carbon economy. The Society is increasingly aware of these risks in respect of both credit risk management and strategy, and will continue to develop its risk management approach.
45. The Board recognises that there are residual risks inherent in any business, which may not be identified specifically. Accordingly the Board has resolved that the Society should maintain an excess of capital over the regulatory requirement.

Capital Resources & Leverage Ratio

46. The capital resources of the Society at 31 January 2021 total £35.7million.
47. This consists predominantly of core Tier 1 capital of £35.4million, which is the Society's Reserves (accumulated profits) less the value of Intangible Assets (computer software).
48. There is also upper Tier 2 capital of £0.3million, which consists of the Society's collective impairment allowance as at 31 January 2021.
49. The Society has no need for remunerated capital and therefore has no subordinated debt or permanent interest bearing shares. There are no deductions required in respect of any of the Society's capital resources.
50. The Society's total assets as at 31 January 2021 are £525.7million.
51. Leverage Ratio – Factoring in off-Balance Sheet lending commitments of £23.9million, reported assets of £525.7million and Tier 1 capital resources of £35.4million, the Society's Leverage Ratio is calculated as being 6.4% as at 31st January 2021 (31 January 2020: 7.8%).

Capital Adequacy Assessment

52. The Society maintains a rolling five-year strategic planning framework which is reviewed by the Society's Board on an annual basis. The five-year financial plan enables a forecast of the Society's capital and its regulatory capital resources requirement to be made, and this is a key element of the Society's ICAAP. The Corporate Plan is produced with reference to the ICAAP, and both reflect the Board's risk appetite in relation to the Society's operations, thus integrating the capital adequacy position and forecasts into business strategy.
53. The ICAAP contains calculations of the capital resources requirement as at the date of preparation (September 2020), with forecasts for the following five years, using the standardised approach for credit risk and the basic indicator approach for operational risk.
54. 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, as required under Pillar 1.
55. With respect to 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.
56. The ICAAP also includes assessments of the capital adequacy position under stressed scenarios in order to ensure that this will be satisfactory in such circumstances.
57. Table 1 (see next page) provides details of the calculation of the capital resources requirements of the Society as at 31 January 2021 under Pillar 1.

Capital Adequacy Assessment (continued)

Table 1
Pillar 1 Society Capital Resources Requirements as at 31 January 2021

Credit Risk Category	Asset (£m)	Risk weighted asset value (£m)	Minimum Capital Required (£m)
Treasury Assets			
Central government (UK gilts & Treasury Bills)	100.1	-	-
Multilateral Development Banks	7.0	-	-
Credit institutions	6.6	1.6	0.1
Cash	0.1	-	-
Total Treasury Assets	113.8	1.6	0.1
Loans and advances to customers			
Residential: Performing loans	394.9	141.3	11.3
Past due loans*	3.3	3.3	0.3
Non-residential/business: Performing loans	10.1	10.1	0.8
Past due loans*	0.9	0.9	0.1
Total loans and advances to customers	409.2	155.6	12.5
Fixed and other assets	2.7	2.7	0.2
Total credit risk exposures and capital resources required	525.7	159.9	12.8
Mortgage Pipeline	23.9	5.2	0.4
Credit Value Adjustment (on OTC Derivatives)		0.2	0.0
Operational risk capital requirement		13.0	1.0
Society total capital resources required (Pillar 1)		178.3	14.2

(* 'Past due' refers to loans >90 days in arrears)

The total asset value of £525.7million shown above reconciles to the total assets figure in the Society's Statement of Financial Position in the Report & Accounts for the year ended 31 January 2021.

As at 31 January 2021, the Society's total capital requirement (TCR) was 8% of RWAs plus a CRD4 buffer of 2.5% of RWAs, equating to £18.7million.

Credit Risk – further information

- 58. This section provides further information concerning the Society’s credit risk exposures in respect of mortgage lending.
- 59. The Society regards as 'past due' any mortgage account where more than three monthly payments have not been made at the accounting date. Arrears of mortgage repayments are monitored closely and the Society has performed well in comparison with national arrears and possession statistics.
- 60. Table 2 below provides an analysis, for capital adequacy purposes, of loans and advances exposures at 31 January 2021:

Table 2

Society Loans & Advances Exposures as at 31 January 2021

	Performing (£m)	Past Due (>90 days) (£m)	Total (£m)
Residential	394.9	3.3	398.2
Non-residential/business	10.1	0.9	11.0

- 61. Table 3 below provides an analysis of loans and advances by geographical area at 31 January 2021:

Table 3

Society Loans & Advances by geographical area as at 31 January 2021

Area	Residential (£m)		Non-Residential/business (£m)		Total (£m)
	Performing	Past Due	Performing	Past Due	
Edinburgh & Lothians	88.9	0.3	2.9	-	92.1
Highlands	43.5	0.1	4.0	0.3	47.9
Aberdeen	50.6	0.3	0.8	-	51.7
Glasgow	61.9	0.9	-	-	62.8
West	50.7	0.3	0.1	0.6	51.7
Tayside & Fife	28.0	0.4	0.3	-	28.7
Central	25.3	0.6	0.7	-	26.6
Borders	22.6	0.2	0.5	-	23.3
Islands	22.4	0.2	0.8	-	23.4
Outside Scotland	1.0	-	-	-	1.0
Grand Total	394.9	3.3	10.1	0.9	409.2

- 62. A residual maturity analysis of Loans and Advances to customers is provided at Note 27 of the Report & Accounts 2021. It should however 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 in the Accounts.
- 63. The Society’s approach to provisioning and the details of provisions held is provided in Notes 1 and 12 of the Report & Accounts 2021.
- 64. Wholesale counterparty credit risk has been risk weighted in accordance with the regulatory requirements and is driven by counterparty credit rating and maturity.

Wholesale counterparty credit limits are approved by the Board and are within the stated risk appetite of the Society.

Liquidity Risk – further information

65. This section provides further information concerning the Society's liquidity risk position.
66. Liquidity risk is managed by maintaining a prudent level of liquid resources at all times in accordance with limits as set out in the Society's Liquidity & Funding Policy.
67. Liquidity stress testing is carried out on a regular basis (at least quarterly) to confirm that the Society could withstand a number of liquidity stress scenarios.
68. The key regulatory metric to monitor short term liquidity risk is the Liquidity Coverage Ratio (LCR), which measures the potential net cash outflow under a prescribed set of assumptions as a proportion of the Society's 'High Quality Liquid Assets' (HQLA). The regulatory requirement is that the LCR will exceed 100%.
69. The Society's average LCR for the financial year to 31 January 2021 (based on 12 month-end LCR calculations) was 181%.
70. The year-end LCR figure was 264% as a result of the Society holding more of its liquid asset investments as HQLA during the financial year.

Asset Encumbrance

71. The Society has pledged part of its loan book as collateral with the Bank of England in order to participate in the Term Funding Scheme with additional incentives for SMEs (TFSME). Participation in this scheme provides the Society with a source of funding that diversifies the funding portfolio and reduces the overall funding cost, allowing the Society to optimise mortgage rates for its members. Although the loans remain fully owned and operated by the Society, they are reported as encumbered.
72. Other encumbered assets consist of cash collateral posted for the interest rate swap portfolio that supports the management of interest rate risk.
73. Of the Society's £525.7million total assets, £96.3m of mortgages were pledged as collateral under the TFSME, and £0.9m of cash was provided as collateral against interest rate swap exposures.

Remuneration

74. The Directors' Remuneration Report contained within the Report & Accounts 2021 provides details of remuneration policy and quantitative figures relating to Directors.
75. The CRR rules (Article 450) require additional disclosure regarding remuneration to be included in this document.

Policy for staff remuneration

76. Basic salaries are reviewed annually by reference to jobs carrying similar responsibilities in comparable organisations and in the light of market conditions generally.
77. Discretionary bonuses are payable to all staff based on Society and individual performance.

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78. Where individual staff remuneration includes a performance-related bonus, this is based on a 'balanced scorecard' to ensure that no single factor can unduly influence the amount payable.
79. Any Executive Director bonuses paid are cash bonuses and are approved in advance by the Nomination & Remuneration Committee. Any staff bonuses paid are also cash bonuses which are advised to the Nomination & Remuneration Committee.
80. All eligible staff receive a defined level of pension contribution, made into a personal pension policy.

Aggregate quantitative information

81. The Society operates as one integrated business area and the aggregate information for staff numbers and costs for the period ended 31 January 2021 is stated in Note 6 of the Report & Accounts 2021.
82. CRR rules (Article 450) also require disclosure of aggregate information for those individuals defined as having a material impact on the risk profile of the institution (i.e. Senior Management and other key staff members).
83. Based on this definition, the following individuals fall into this category as at 31 January 2021:

• Chief Executive Officer	•
• Finance Director	•
• Society Secretary	• Head of IT
• Head of Finance	• Chief Risk Officer
• Commercial Manager	• Financial Risk Manager
• Head of Lending	• Credit Risk Manager
• Head of Operations	• Operational Risk Manager

84. The aggregate remuneration for these twelve individuals for the period ended 31 January 2021 was as follows:

Salary	£978,871
Bonus	£61,362
Pension Contributions	£77,438
Total Remuneration	£1,117,671

Conclusion

85. This disclosure document, prepared in accordance with the requirements of CRR Articles 431-455, 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 and Pillar 2a.
86. The disclosures are published within 4 months of the Society's financial year end and are updated annually.
87. 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 Finance Director at Scottish Building Society, SBS House, 193 Dalry Road, Edinburgh EH11 2EF.