SCOTTISH BUILDING SOCIETY

Pillar 3 Disclosures 2023

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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 as set out in the 'PRA Rulebook (CRR) Instrument 2021' as implemented in the UK by the Prudential Regulation Authority (PRA). These rules replaced the previous Capital Requirements Regulation (CRR) with effect from 1 January 2022.

2. Articles 431 to 455 of the PRA Rulebook relate to disclosure requirements with Article 433b confirming the reduced disclosures required for "small and non-complex institutions" (defined in Article 4 as balance sheets less than £13 billion). The following 'Pillar 3' disclosures aim to meet the requirements of these articles, recognising the Society's position as a small and non-complex institution.

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 the Capital Requirements Directive (CRD) 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) and a 'Countercyclical Buffer' (CCyB) which, collectively, are referred to as the CRD buffer.

5. The Board approved the Society's most recent ICAAP in October 2021 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 (C-SREP) by the PRA in October 2022 following which the PRA re-confirmed Total Capital Requirements (TCR) for the Society of 8% of Risk Weighted Assets plus the CRD buffer.

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 2023, unless otherwise stated.

Risk Management Objectives and Policies

9. 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.

10. **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.

11. 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.

12. 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.

13. 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.

14. 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.

15. 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.

16. Product type concentration also exists as the Society operates primarily as a traditional residential mortgage lender. All specialist 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.

17. The Board has ensured that the Society's 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.

18. **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

19. Operational risks and relevant controls are captured on the Society's Risk Register and are reviewed bi-monthly by the Operational Risk Committee.

20. **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 the following categories: Product design and governance, sales practice (incl advice and post sales administration), vulnerable customers, complaints management, marketing and member communications, and pricing. The Society has a low appetite for losses arising from Conduct Risk.

21. Conduct risks and relevant controls are captured on the Society's Risk Register and are reviewed by the Operational Risk Committee.

22. **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.

23. 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.

24. 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 March 2023. 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.

25. **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.

26. 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.

27. Interest rate risk is managed by utilising natural hedges on the balance sheet and by effecting interest rate swaps with external counterparties.

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

29. 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.

30. 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.

31. Full analysis of interest rate risk exposures as at 31 January 2023 is given in Note 27 of the Annual Report & Accounts 2023.

32. **Strategic Risk and Business 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.

    Strategic and Business 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.

33. **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.

34. 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.

35. The Board believes that the Society's Risk Management Framework is robust and is fit for purpose in the context of the Society's relatively straightforward business model. By virtue of being constructed upon foundations of strong governance, it enables the Board a clear line of sight to where the Society may be exposed through the regular reporting of all risk categories, and the identification of any new areas of concern.

Capital Resources & Leverage Ratio

36. The capital resources of the Society at 31 January 2023 total £40.1million.

37. This consists predominantly of core Tier 1 capital of £39.9million, which is the Society's Reserves (accumulated profits) less the value of Intangible Assets (computer software).

38. There is also upper Tier 2 capital of £0.3million, which consists of the Society's collective impairment allowance as at 31 January 2023.

39. 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.

40. The Society's total assets as at 31 January 2023 are £644.6million, of which £119.6m represents deposits held with the Bank of England.

41. Leverage Ratio – Factoring in off-Balance Sheet lending commitments of £31.5million, £525.0m of reported assets net of Bank of England deposits,

and Tier 1 capital resources of £39.9million, the Society's Leverage Ratio is calculated as being 7.2% as at 31st January 2023 (31 January 2022: 7.4%).

Capital Adequacy Assessment

42. 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.
43. The ICAAP contains calculations of the capital resources requirement as at the date of preparation (June 2021), with forecasts for the following five years, using the standardised approach for credit risk and the basic indicator approach for operational risk.
44. 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.
45. 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.
46. 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.
47. Table 1 (see next page) provides details of the calculation of the capital resources requirements of the Society as at 31 January 2023 under Pillar 1.

Capital Adequacy Assessment (continued)

Table 1
Pillar 1 Society Capital Resources Requirements as at 31 January 2023

Credit Risk Category		Asset (£m)	Risk weighted asset value (£m)	Minimum Capital Required (£m)
Treasury Assets				
Central government (UK gilts & Treasury Bills)		119.6	-	-
Multilateral Development Banks		7.0	-	-
Credit institutions		7.9	1.6	0.1
Cash		0.1	-	-
Total Treasury Assets		134.6	1.6	0.1
Loans and advances to customers				
Residential:	Performing loans	494.7	176.4	14.1
	Past due loans*	3.6	3.6	0.3
Non-residential/business:	Performing loans	6.6	6.6	0.5
	Past due loans*	0.7	0.7	0.1
Fair value adjustment for hedged risk		(10.2)	(10.2)	(0.8)
Collective Impairment		(0.3)	(0.3)	-
Effective Interest Rate adjustments		1.0	1.0	0.1
Total loans and advances to customers		496.1	177.8	14.3
Derivative financial instruments		10.9	10.8	0.9
Fixed and other assets		3.0	3.0	0.2
Total credit risk exposures and capital resources required		**644.6**	**193.2**	**15.5**
Mortgage Pipeline		31.5	6.6	0.5
Exposure to Derivatives >3 months and Credit Value Adjustment (on OTC Derivatives)			1.4	0.1
Operational risk capital requirement			18.6	1.5
Society total capital resources required (Pillar 1)			**219.8**	**17.6**

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

The total asset value of £644.6million shown above reconciles to the total assets figure in the Society's Statement of Financial Position in the Annual Report & Accounts for the year ended 31 January 2023.

As at 31 January 2023, the Society's total capital requirement (TCR) was 8% of RWAs plus a CRD buffer of 3.5% of RWAs, equating to £25.3million.

Liquidity & Funding

48. 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%.

49. The Society's average LCR for the financial year to 31 January 2023 (based on quarterly the end-of-month positions over the preceding 12 months) was 241%, as outlined in the table below:

	Apr-22	Jul-22	Oct-22	Jan-23
High Quality Liquid Assets (£m)	132.4	126.2	122.4	125.5
Outflows (£m)	50.6	58.5	63.1	70.7
Inflows (£m)	5.8	3.2	9.9	11.2
Net outflows (£m)	44.9	55.3	53.3	59.5
Liquidity Coverage Ratio	**295%**	**228%**	**230%**	**211%**
		Average LCR		**241%**

50. In relation to funding, the key regulatory metric is the Net Stable Funding Ratio (NSFR) which measures the Society's 'Available Stable Funding' against its 'Required Stable Funding'. The regulatory requirement is that the NSFR will exceed 100%.

51. The Society's average NSFR for the financial year to 31 January 2023 (based on quarterly the end-of-month positions over the preceding 12 months) was 155%, as outlined in the table below:

	Apr-22	Jul-22	Oct-22	Jan-23
Available amount of stable funding (£m)	547.7	544.2	541.3	552.5
Required amount of stable funding (£m)	349.5	351.5	349.1	360.0
Net Stable Funding Ratio	**157%**	**155%**	**155%**	**153%**
		Average NSFR		**155%**

Remuneration

52. The Directors' Remuneration Report contained within the Annual Report & Accounts 2023 provides details of remuneration policy and quantitative figures relating to Directors.

53. The CRR rules (Article 450) require additional disclosure regarding remuneration to be included in this document.

Policy for staff remuneration

54. Basic salaries are reviewed annually by reference to jobs carrying similar responsibilities in comparable organisations and in the light of market conditions generally.

55. Discretionary bonuses are payable to all staff based on Society and individual performance.

56. 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.

57. Any Executive Director bonuses paid are cash bonuses and are approved in advance by the Remuneration Committee. Any staff bonuses paid are also cash bonuses which are advised to the Remuneration Committee.

58. All eligible staff receive a defined level of pension contribution, made into a personal pension policy.

Aggregate quantitative information

59. The Society operates as one integrated business area and the aggregate information for staff numbers and costs for the period ended 31 January 2023 is stated in Note 6 of the Annual Report & Accounts 2023.

60. 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).

61. Based on this definition, the following individuals fall into this category as at 31 January 2023:

• Chief Executive Officer	• Head of Membership
• Finance Director	• Chief Risk Officer
• Society Secretary	• Head of IT & Digital Transformation
• Head of Mortgage Operations and First Line Risk	• Compliance Manager
• Head of Finance	• Head of HR
• Head of Lending	• Financial Crime Risk Manager
• Commercial Manager	• Financial Risk Manager
• Head of Relationship Centres & Mortgage Advice	

62. The aggregate remuneration for these fifteen individuals for the period ended 31 January 2023 was as follows:

Salary	£1,271,064
Bonus	£135,688
Pension Contributions	£99,491
Total Remuneration	£1,506,243

Conclusion

63. This disclosure document, prepared in accordance with the requirements of the PRA Rulebook 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.
64. The disclosures are published within 4 months of the Society'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 Finance Director at Scottish Building Society, SBS House, 193 Dalry Road, Edinburgh EH11 2EF.

Attestation

66. The Finance Director confirms to the best of his knowledge that the disclosures provided according to the Disclosure Part of the PRA Rulebook (CRR) instrument 2021 have been prepared in accordance with the internal control processes agreed upon at the management body level.
67. Approved by the Scottish Building Society Board and signed on its behalf by:

Neil Easson
Finance Director
17 May 2023