Annual Report and Accounts | **2014**


*At the heart of our communities*

PRINCIPALITY
BUILDING SOCIETY

# 2014 AT A GLANCE

## 6TH LARGEST BUILDING SOCIETY IN THE UK

With assets of £7.3bn Principality is the 6th largest building society in the UK and the largest in Wales.

## £53.5M PROFIT BEFORE TAX ON CONTINUING OPERATIONS

Excluding the sale of Peter Alan, Principality made profits before tax of £53.5m in 2014. This will be used to supplement the Society's capital requirements from regulators both in the UK and Europe and to invest in the business for the future.

## NET RETAIL MORTGAGE GROWTH OF 6.2%

The Society's net retail mortgage growth has increased by 6.2%, which will help Principality to meet its five year growth strategy which launched in 2012.

## SOCIETY GROSS MORTGAGE LENDING OF £1.0BN

Principality helped thousands of first-time buyers and home movers find a new home in 2014, resulting gross mortgage lending of £1bn for the Society.

## MOST RECOMMENDED SAVINGS PROVIDER IN WALES*

The Society was delighted to be named as Wales' most recommended savings provider for the second year running by its customers.

* Source: GfK NOP Financial Research Survey (FRS), 12 months ending December 2014, NPS measure of 2,357 Welsh savings account customers. Competitor list includes the following: Barclays, Halifax, HSBC, Lloyds Bank, NatWest, Nationwide, NS&I, Santander, TSB

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# **Chairman's** statement
## for the year ended 31 December 2014

In my first year as Chairman I am pleased to report that Principality has had a successful year with a particularly strong set of financial results. We work hard to ensure that the Society remains a trusted brand and continues to support social and community life in Wales. I am proud to be at the helm of the Society and to work with my colleagues on the Board, our executive management team and all our staff in delivering the right products and services to our Members and customers.

### Strategy and performance

Principality has had another successful year. Our on-going commitment to providing a safe home for savers and attractive mortgage products for borrowers has helped produce another set of strong financial results. Our assets grew by 2.9% to £7.3bn and we expanded our presence in the high street with the opening of another agency in Chepstow. We remain the largest building society in Wales and the 6th largest building society in the UK.

The on-going low interest rate environment looks set to persist for the foreseeable future which we know is a challenge for all savers. We are paying competitive rates and have been consistently above the market average. As well as our financial performance, we are also supporting our communities in more ways than ever before. The Member, Colleague and Community section later in the document gives further detail about the excellent work that we have been doing this year in the communities in which we live and work.

### Risk management

The regulatory environment for financial services is transforming rapidly but I firmly believe that Principality is in an excellent position to navigate these changes and continue to deliver value to our Members that sit at the heart of the business.

Managing the risks that face financial services organisations is critical to the continued success of the Society and in 2014 we have invested in strengthening our risk management capability further. During 2014, we also undertook a review of our Corporate Governance arrangements to ensure that we continue to adopt good practice in this area and to ensure that we are helping deliver a safe home for our Members' savings. The Financial Conduct Authority supervises how we conduct our business to ensure that we achieve fair outcomes for our customers, and during the year we have undertaken a number of activities to ensure that this is the case. We have strengthened our compliance and conduct risk management capabilities, developed a suite of Customer Treatment Standards, and commenced a programme of outcome testing which will enable us to assess the extent to which we are meeting our conduct objectives. From a prudential risk management perspective, during 2014, we have enhanced our risk governance structures to ensure that the Board continues to have clear oversight of key risks facing the business and to make sure they are handled in the correct way.

In 2015, effective management of the risks that face our business will, as always, be key. We have strong risk management capability and culture in Principality to ensure that this remains high on our agenda.

### Board of directors and key appointments

Along with a strong management team and a skilled, committed workforce, the strength of an organisation's Board is also critical to its success. The Board is responsible for setting the strategy, overseeing the Group's performance and ensuring it operates within agreed risk parameters. In 2014 the Principality Board was strengthened further and remains wholly committed to protecting Members' interests now and in the future.

There have been a number of changes to the Board in the last 12 months, not least the departure of Dyfrig John, the Society's former Chairman.

**Principality staff help to transform the gardens at Bryn Celynog Comprehensive School, Beddau**


**Principality staff learning British Sign Language to improve the way we communicate with customers**

Dyfrig has many distinguished years' experience in financial services both in the UK and abroad and I would like to thank him for the strong contribution and leadership that he demonstrated during the recent tumultuous economic times. In addition, we said goodbye to Langley Davies, non-executive director, and Guy Thomas (formerly Group Finance Director, and latterly the Group's Chief Operating Officer and the Chief Executive of our subsidiary, Nemo Personal Finance Limited) who stepped down from the Board. Langley spent nine years as a non-executive director in the Group and Guy retired after serving 11 years on the Board. Again, I extend my thanks to them for the very significant contribution that each of them has made to the success of the Society over many years.

I am pleased to say that we have made some key appointments to maintain the strength of your Board and the executive management team.

Derek Howell joined the Board in April and will stand for election for the first time in 2015. Derek, a qualified accountant and former partner at PwC, has extensive experience in the sector.

In addition to this, the executive management team has been bolstered by the appointment of Alan Jarman to the role of Group Chief Operating Officer and Chief Executive Officer of Nemo Personal Finance Limited. Alan has many years' experience in the retail banking sector, most recently at HSBC, where he held a number of very senior roles both in the UK and abroad.

## Members, community and heritage

At Principality, our Members are truly at the heart of everything that we do. Our network of branches and agencies consolidates our position as a leading brand on the high street across Wales and the borders, allowing us to meet our Members' needs face-to-face as well as in our contact centre and online. Listening to, and acting on, feedback from Members allows us to ensure that we remain able to deliver the products and services that our Members want and need. During 2014, as well as our Annual General Meeting, we held three Member Forum events and three Member Talkback events, which allow our Members to meet with our directors and key people in our business. Listening to our Members allows us to put plans in place to ensure that we will continue to meet demands in a world of rapidly advancing technology. This, and developing products that meet our Members' needs, are areas that we will continue to invest in for the future.

Our staff work extremely hard to ensure that our business is making a difference in local communities and to the economy of Wales, and I am delighted that during 2014 their efforts were recognised with the Society winning five prestigious awards and being highly commended or runner up in a further four awards. While 2014 has seen many other large financial institutions start to focus on the community, at Principality we pride ourselves on having been active in our communities for many years. We continued to build on those strong community roots in 2014 through initiatives such as community days at schools, national parks and food banks as well as support for local sports teams and choirs, to name but a few.

In 2014 we also celebrated the 10th anniversary of support for the Principality Premiership as well as our continued support for other events and groups around Wales and the borders. We also won the Long-term Support award at the Arts and Business Cymru Awards in recognition of our 35 year sponsorship of the National Eisteddfod, a key event in the Welsh national calendar.

Our Charity of the Year in 2014 was MS Society Cymru and through a wide range of activities I am delighted to say that our staff have raised more than £86,000. I would like to thank all of our staff and Members who have participated in and supported these events which have raised such a fantastic amount to help support people with Multiple Sclerosis throughout Wales.

## 2015 Outlook

In election year in the UK, with continuing uncertainty in the global economic outlook and falling oil prices, 2015 will no doubt create more economic challenges. I believe however, that Principality will be well placed to address these challenges thanks to our strong capital and liquidity management. We are mindful of the impact that a rise in the Bank of England Bank Rate will have on our savers and borrowers and will continue to do what we can to ensure that we remain competitive and provide the high standards of service that we have always done. In the Group Chief Executive's Review and within the remainder of the report we will elaborate further on the Society's strategy.

As Chairman, my priority is to ensure that our Members' interests remain at the forefront of our minds and decision making. We hope to continue to grow the Society, so that we can help more people to enjoy the benefits of mutuality, to enhance our products and services and in doing so continue to make a significant contribution to the people and economy of Wales in 2015 and in the future.

Laurence Philip Adams

L P Adams

Chairman
10 February 2015

# Group Chief Executive's review
## for the year ended 31 December 2014

It has been another successful 12 months for Principality Group with steady growth, firmly positioning ourselves to meet the targets laid out in our five year growth strategy that was announced in 2012.

In 2014, we have built on our core principles of providing a safe home for our customers' savings and helping people to buy their homes, whilst continuing to deliver strong customer service. This has resulted in the Society being named the most recommended savings provider in Wales* for the second year running.

This year we have also grown our assets to £7.3bn (2013: £7.1bn) and our net retail mortgage balances to £4.8bn (2013: £4.5bn), whilst boosting our high street presence by opening our 71st outlet.

We have continued to develop the business to ensure that it is in a strong position to grow sustainably, whilst ensuring that our business model is steady and looking after our Members' needs.

In 2014, Principality was also given a major vote of confidence by credit rating agency Moody's Investors Service, by being upgraded and awarded a positive outlook. This signifies the agency's opinion on the credit quality of the Society, and demonstrates its confidence that the Society remains safe and secure for our owners, our Members.

We have also recorded a record profit before tax on continuing operations for the year in 2014 of £53.5m (2013: £28.2m), which will help us to keep the business secure as demand for capital increases from regulators both in the UK and Europe. As a mutual building society we have to balance the needs of our savers and borrowers as well as deliver profit for the business. Increased profit is currently the only way that the Society is able to create more capital to invest in the long-term and provide essential protection for the Society and our Members in the future. The profit before tax from continuing operations for the year includes a one off credit of £10.1m in relation to our pension scheme, further details of which are set out in the Strategic Report. Additionally, the Group generated a profit of £10.5m in relation to the sale of Peter Alan which is discussed in more detail on page 5.

The last 12 months has been a story of strong growth for the Society, keeping our strategy firmly on track and always keeping the Member at the heart of the business to ensure long-term benefits for them and the communities in which we live and work.

### KEY PERFORMANCE HIGHLIGHTS

- Most recommended savings provider in Wales*
- Grown assets to £7.3bn (2013: £7.1bn)
- Net retail mortgage balances £4.8bn (2013: £4.5bn)
- Net interest margin 1.87% (2013: 1.68%)
- Opened our 71st outlet in Wales and the borders
- Upgraded and awarded a positive outlook by Moody's Investors Service
- Grown profits before tax on continuing operations to £53.5m (2013: £28.2m)

Principality staff manning the counter at the Eisteddfod in Llanelli

Principality staff joined by Neath & Port Talbot college students to clean Aberavon beach

### Helping people into homes

The last 12 months has also seen the biggest change in the mortgage market since 2004, with the introduction of the Mortgage Market Review. The changes require customers to demonstrate in much more detail than before their ability to afford the mortgage, and face-to-face and telephone sales must now be on an advised basis. As a responsible lender we have, for some time, been acting in accordance with a number of the changes, but there is no doubt that the changes resulted in increased complexity for our business. The pace of change is certainly here to stay and regulation looks set to impact our business for many years to come so we must not be complacent. But, the Society successfully implemented the recent changes to ensure our mortgage business continues to prosper.

This year we have helped more than 2,300 first-time buyers get onto the property ladder. We realise that people's circumstances are constantly changing and that to ensure their financial security from time to time they will need to change products and look at other options. This is something that we are committed to helping with and we will continue to look at our product offering to ensure we can meet our customers' ever-changing demands.

Whilst savers remain the Society's primary source of funding we have to ensure we have a diversified funding model to support the growth in our mortgage book. In 2014 we successfully completed our second issuance of Residential Mortgage Backed Securities (RMBS) to institutional investors, attracting £475 million of long-term funding that will supplement our savings book in helping to meet our growth plans.

Our support of a range of sustainable and affordable housing initiatives within Wales has also continued in 2014. We have worked with the Welsh Government to launch Help to Buy – Wales, which has enabled hundreds of first-time buyers get onto the property ladder. Moreover we have continued to support The Mill development at Ely Bridge, which achieved planning consent for the development of around 800 homes close to the capital city, of which at least 50% will be affordable. Furthermore, we continued our support for the Welsh Housing Partnership, which is managed by four housing associations providing affordable rented homes in communities across the whole of Wales; this initiative has recently provided its 750th much needed home for the people of Wales.

### Delivering value to our loyal Members

Competition in the mortgage market has meant that interest rates for borrowers have been forced downwards and as a direct result of this savings rates have also been reducing. This parallel shift in rates is important to lenders to maintain profitability and the security of the business.

We do recognise the plight of savers in an environment of continuing low interest rates and we have implemented a number of initiatives to help alleviate this, but we cannot operate in isolation or against market trends as we need to ensure the safety of our mortgage business as well as our savings business. Our savers are fundamental to Principality with 91.4% per cent of the money we lend coming from them.

**WHAT WE HAVE DONE TO HELP SAVERS**

- £218m growth in Welsh savings balances in 2014
- Average savings rate paid to Welsh Members 1.63% vs. a market average of 1.37%**
- Members holding a Promise Saver benefited from a rate of up to 2.00% AER†, one of the best rates on the high street for this type of product
- In 2014, Members holding a Promise ISA benefited from a tax-free❖ rate of up to 2.30% AER†
- In 2014 we had 465 Best Buy Table mentions for savings and mortgages

* Source: GfK NOP Financial Research Survey (FRS), 12 months ending December 2014, NPS measure of 2,357 Welsh savings account customers. Competitor list includes the following: Barclays, Halifax, HSBC, Lloyds Bank, NatWest, Nationwide, NS&I, Santander, TSB.

** Source: CACI Current Account and Savings Market Database (CSDB)

† AER means Annual Equivalent Rate and illustrates what the interest rate would be if interest was paid and compounded once each year

❖ ISAs are tax-free. Tax-free means the interest you earn is exempt from UK Income Tax and Capital Gains Tax. Tax treatment depends on your individual circumstances and may not be maintained in future.

# **Group Chief Executive's** review (cont.)

for the year ended 31 December 2014

In 2014, we have continued to invest in the high street, celebrating the 50th anniversaries of our Shrewsbury and Hereford branches as well as opening our 18th agency (71st outlet) in Chepstow, whilst other organisations are pulling away from the high streets. We are not immune to the decline in branch transactions, which is being seen throughout the industry, but we recognise the benefit of branches and agencies coupled with continued investment in all channels of the business so that customers can deal with us in whichever way they wish. However, we are extremely aware that substantial further investment will need to be made in our business to remain relevant and meet the needs of future generations.

We have also retained our position as the most recommended savings provider in Wales this year, highlighting our impressive service levels throughout our branches and contact centre. This is something of which we are particularly proud, along with our community work in Wales and the borders. As a business, Principality has always donated time and money to enhance its local communities, to play our part in ensuring they can thrive. This year we have enhanced that commitment, donating over 1,600 hours of staff volunteering and investing over £40,000 into our local communities through sponsorship. This commitment has not gone unnoticed and we have won a range of community awards this year including the Corporate Social Responsibility and Community Services – Large Lenders awards at the Mortgage Finance Gazette Award 2015, in recognition of this work.

## Group businesses

This year we made the decision to sell our estate agency Peter Alan and outsource our surveying business to leading estate agency and property services provider the Connells Group for consideration of £16.4m. This decision was not taken lightly but we felt that it was the right decision for the Group and Peter Alan, which will be able to prosper under an owner that is a specialist in the estate agency field. It also reduces complexities, allowing the Society's management to focus on the delivery of the strategy for the core building society, and to deliver significant value for Members.

Our Group businesses continue to be an important part of our strategy and this year has seen a positive year for both of our other businesses as they face new market challenges and regulation.

Our secured lender Nemo Personal Finance Limited continues to perform strongly from a financial perspective, fulfilling an important role within the Group and helping consumers manage their finances more effectively. In 2014, the secured loan market has seen increased competition putting downward pressure on pricing and it faces a changing regulatory landscape over the next


The Morriston under 9s rugby team received their kit from their local Principality branch


Principality sponsored NoFit State Community Circus

12 to 18 months. However, Nemo is well positioned to deal with these challenges and it continues to perform well, seeing healthy profits for another year, despite a decrease to £13.9m (2013: £16.4m). This has been as a result of the increased competition in the market and as a result of work to strengthen the Nemo balance sheet but we are confident that it will continue to maintain a successful business with a strong presence in the second charge market.

Last year I expressed a view that a corner had been turned with regard to the commercial market and after some challenging years in this sector it was encouraging that Principality Commercial, our commercial arm, has returned to profit in 2014. Coupled with more than £100m of new lending in the last 12 months, this has been its most successful year since the downturn. Whilst there remains no room for complacency, investor appetite and occupier demand for commercial property has returned and we are extremely optimistic that this business will deliver improved returns over the next few years. The Society's Board recently reviewed the medium term plan for the division and believes it has a credible part to play in our future, not least given the value it delivers to the local economy in terms of development projects. A number of exciting schemes have been supported through the year in our core territory. Saundersfoot, Langland Bay, Merthyr Tydfil and Cardiff are just some of the locations where we have helped developers to build much needed homes for the people of Wales.

## Preparing for the future

The UK economy is showing increasing signs of a sustainable recovery but the wider market in Europe and beyond is still showing levels of uncertainty. That said, I expect continued growth in the UK and increased employment. Wages have started to rise more rapidly than prices and interest rates have now been at 0.5% for more than five years, allowing the economy time to grow.

After a number of difficult years savers will be hoping that 2015 signals the return to better interest rates. But latest indications show that with inflation dropping it is unlikely that the governor of the Bank of England will increase rates until at least the third quarter of 2015, maybe even 2016.

Whilst a change in bank rates and new entrants in the market should increase competition, unfortunately for savers I don't think that savings rates will grow as fast as they might hope. The relationship between the bank base rate and savings rates is broken and the difference between the two rates needs to be managed by lenders to ensure they are also able to offer competitive mortgage rates and continue to hold enough capital to keep their businesses secure. The gap regrettably is not sustainable and when rates rise it is unlikely that these increases in rates will be passed on in full by financial institutions. In fact, we have seen a number of financial institutions lower their savings rates in 2014 as a result of this differential being eroded and it is something that we are also not immune to if we want to keep the Society secure.

For us at Principality we hope that 2015 will see further opportunity for us to grow and demonstrate the value of our mutual model, whilst continuing to be prudent to ensure the safety of our Members' money.

More than 150 years ago we were established to help people buy their own home and to safeguard their hard earned savings. Today, this remains our core focus and our financial stability, our determination to meet our future growth strategy and our customer focus will ensure that we are able to support our customers for many years to come.

Graeme H. Yorston

Group Chief Executive
10 February 2015

# **Strategic** report

## for the year ended 31 December 2014

### Our strategy

Principality is Wales' largest building society and the 6th largest in the UK. We have over £7 billion in assets and account for 4.6% of the Welsh residential mortgage market and 12.7% of the total Welsh retail savings balances. The Group also operates successful commercial lending and secured lending businesses that support the core building society.

Providing a secure home for savings and helping people to buy homes are the two principles on which we have grown to a customer base of over 500,000 who trust us with their savings and mortgages and employing around 1,000 colleagues. This year alone we have helped over 2,300 customers become home owners for the first time and helped a further 5,800 customers move to their next home.

Our principal strategy is to focus on the core Society, through growing our retail mortgage lending and enhancing our overall proposition for Members. To make our strategy a reality, we strive to provide our Members with first class service where we put a fair outcome for our Members at the centre of everything we do. This is underpinned by the continuous improvement of our processes, through product development and through innovation delivered by our strongest asset: our colleagues. Recognising that our colleagues are a key component of our business, we focus on ensuring that they have the right environment to grow and that our culture is focused on being able to deliver what our Members expect of us, and what we expect ourselves to deliver to our Members.

Providing our Members with an exceptional service through all of our channels of distribution is a key part of our strategy and we are committed to becoming 'The most recommended financial services provider in Wales'.

A cornerstone of this strategy is the financial stability of the Society, and our growth strategy is underpinned by a clearly defined risk appetite. Sustainable financial performance is achieved through:

- Strong capital generation via on-going profitability
- Effective liquidity management to ensure the Society maintains a sufficient buffer of available funds
- Efficiency and effectiveness within the Society's processes

### Our business model

The Group's business model is underpinned by three key strategic business units, which together deliver the Group's strategic objectives. A summary of the products offered through each strategic business unit is set out below:

| | | LOANS | SAVINGS | OTHER | CHANNEL | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | BROKER | ONLINE | PHONE | BRANCH |
| PRINCIPALITY GROUP | PRINCIPALITY BUILDING SOCIETY | RESIDENTIAL MORTGAGES | | | ✓ | | ✓ | ✓ |
| | | BTL MORTGAGES | | | ✓ | | ✓ | ✓ |
| | | | FIXED RATE SAVINGS | | | ✓ | ✓ | ✓ |
| | | | VARIABLE RATE SAVINGS | | | ✓ | ✓ | ✓ |
| | | | | FINANCIAL PLANNING | | | | ✓ |
| | | | | LIFE INSURANCE | | | ✓ | ✓ |
| | | | | HOME INSURANCE | | ✓ | ✓ | ✓ |
| | PRINCIPALITY COMMERCIAL | COMMERCIAL LOANS | | | ✓ | | ✓ | ✓ |
| | nemo personal finance | SECOND CHARGE LOANS | | | ✓ | | ✓ | |

## Being a mutual building society

One of the things that Members consistently tell us is how important it is to them that we are a mutual building society. We have been a mutual building society for over 150 years and we remain committed to our mutual heritage because we believe that this is in the best long-term interests of our current and future Members. Being a truly mutual society means that we are owned by and run for the benefit of our Members – our savers and borrowers. Because we do not have any shareholder interests to satisfy, all our profits are put back into your Society to benefit Members. Our key priority is to keep our Members' money safe, and generating capital through making adequate profit is a vitally important part of this.

We continually review our Group businesses to ensure that they are thriving under our governance, providing the right value to Members and supporting our strategy of focusing on the core Society and growing retail mortgage lending. Through this process, this year, we felt that Peter Alan and our surveyors business would be better supported by an investor who could focus on their growth and as a result sold Peter Alan to the Connells Group, one of the largest estate agency businesses in the UK. We also chose to outsource our surveyors business to Connells Group as part of this review. The profit generated from the sale of Peter Alan and the outsourcing of our surveying business, provided further capital to our core business allowing us to focus on our strategy for the building society.

## Principal risks and uncertainties

The principal risks and uncertainties faced by the Group, together with the approach to managing these risks, are set out in the separate Risk Management Report on pages 17 to 24.

## Key performance indicators

The Society monitors a number of key performance indicators to assess progress towards the strategic objectives of the business. These are summarised in the following table:

| | 2014 | 2013 |
|---|---|---|
| **Member Experience** | | |
| Net Promoter Score – Savings (Wales) [1] | 1st | 1st |
| Customer Satisfaction [2] | 86.8% | 85.8% |
| **Financial Performance** | | |
| Group Profit Before Tax from continuing operations | £53.5m | £28.2m |
| Retail Mortgage Balances | £4,783.9m | £4,505.8m |
| Group Net Interest Margin | 1.87% | 1.68% |
| Management Expense Ratio [3] | 0.90% | 0.95% |
| **Financial Stability** | | |
| Common Equity Tier 1 Ratio [4] | 18.20% | 16.85% |
| Liquidity Ratio | 15.7% | 16.1% |
| Colleague Engagement [5] | 84% | 84% |

[1] Source: GfK NOP Financial Research Survey (FRS), 12 months ending December 2014, NPS measure of 2,357 Welsh savings account customers. Competitor list includes the following: Barclays, Halifax, HSBC, Lloyds Bank, NatWest, Nationwide, NS&I, Santander, TSB.

[2] Source: The Leadership Factory (TLF) Customer Satisfaction Survey, 12 months ending December 2014, 1983 responses.

[3] Includes the impact of the pensions past service credit of £10.1m, further detail of which can be found on page 16.

[4] 2013 comparative calculated under the Basel II rules in effect at December 2013.

[5] Average for financial services business per benchmarking data is 69%.

(Narrative explaining these key performance indicators is included within the Financial Performance section overleaf.)

# **Strategic** report (cont.)

for the year ended 31 December 2014

## Financial performance

**Discontinued operations - sale of Peter Alan**

On 30 July 2014, the Group sold Peter Alan Limited, its subsidiary businesses and the Group's surveyors business (together 'Peter Alan'), which together carried out the Group's estate agency, lettings and surveying operations. The sale (after deducting associated costs) generated a profit for the Group of £10.5m.

The sale is in line with the Group strategy of focusing on the core business of the building society and generating value for our Members. The Board considered that significant investment would be required to maximise the potential of Peter Alan, and the focus on the core Society had reduced the strategic rationale for maintaining an estate agency and letting business within the Group.

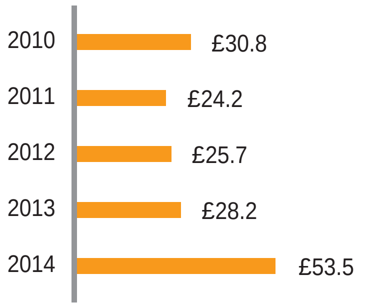
The performance of Peter Alan saw increased estate agency and lettings activity, generating income of £6.4m to the date of disposal (2013: £5.2m for the comparative period). This performance contributed to profit before tax for the discontinued operations of £0.2m for the period to the date of disposal (2013: £0.1m loss for the comparative period).

In order to allow meaningful comparison, all ratios and comparators opposite have been restated for 2013 to exclude the impact of discontinued operations unless stated otherwise. Comparatives for the years prior to 2013 remain unchanged.

**Income statement overview**

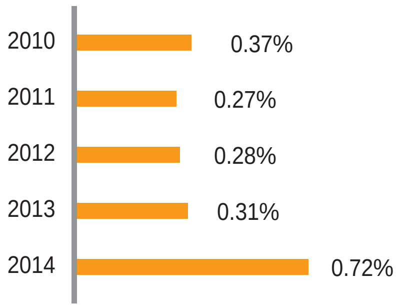
The Group recorded another year of strong financial performance, with pre-tax profit from continuing operations of £53.5m (2013: £28.2m). Included within this profit is an exceptional credit of £10.1m in relation to the defined benefit pension scheme, which is discussed in more detail on page 16.

**Profit before tax from continuing operations (£m)**




The Group's return on assets, calculated as statutory profit after tax divided by total assets, was as follows:

**Return on assets (%)**

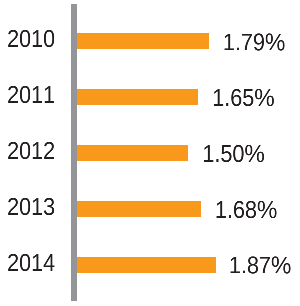



Underlying profit, adjusting for one off factors not reflective of current trading performance, increased to £51.9m (2013: £38.5m). The following items have been adjusted for in calculating underlying profit:

| | 2014 | 2013 |
|---|---|---|
| | £m | £m |
| Profit before tax from continuing operations | 53.5 | 28.2 |
| RPI/CPI pension inflation assumption change | (10.1) | - |
| Gain on the sale of Gilts | (0.2) | (0.6) |
| Provisions for other liabilities and charges | 8.7 | 12.5 |
| Profit on the disposal of loan portfolios | - | (1.6) |
| **Underlying profit** | **51.9** | **38.5** |

**Net interest margin**
Net interest margin increased in the year to 1.87% (2013: 1.68%), due to continuing lower cost of retail and wholesale funding. The Group continues to balance the need to offer attractive savings rates to Members with the requirement to maintain the long-term stability of the Group through the careful management of funding costs. The mortgage market continues to be extremely competitive, with historically low rates on offer, particularly for those with a significant deposit.

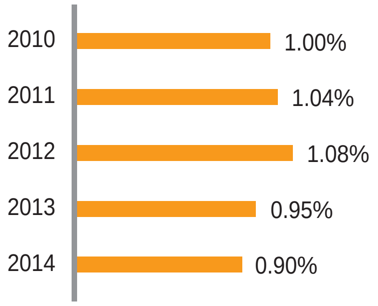
**Net interest margin (%)**



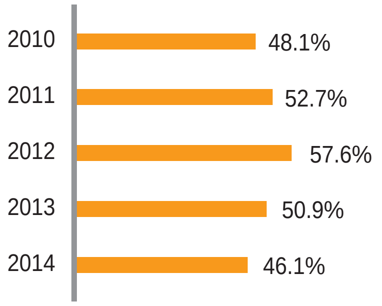

**Other income**
Other income from continuing activities at £8.1m (2013: £13.2m) is lower than the prior year. The primary reasons for the decrease are the sale of secured loan portfolios in 2013, which generated a profit of £1.6m in that year, and a reduction in income generated from insurance products of £3.2m, reflecting the competitiveness and changing nature of the insurance market and the Group's strategic focus on core mortgage and savings products, together with the timing of periodic cash receipts in relation to profit share agreements. The remainder of the difference is due to a reduction in sundry mortgage related fees and charges.

**Administrative expenses**
Administrative expenses remain a key focus for the Group. The Group's cost to income ratio for the year was 46.1% (2013: 50.9%), and the management expense ratio (cost as a proportion of mean assets) was 0.90% (2013: 0.95%). These ratios include the impact of the £10.1m credit in relation to the change in inflation assumptions used when calculating the pension scheme liability, described in further detail on page 16. Excluding this credit, the cost to income ratio would be 53.3% and the management expense ratio would be 1.05%. Total administrative expenses excluding the one off pension credit were £65.7m (2013: £58.9m). The increase reflects the investment in the business to ensure compliance with new regulatory requirements, and the ongoing investment in the services provided to Members.

**Management expense ratio (%)**




**Cost/income ratio (%)**



# **Strategic** report (cont.)
## for the year ended 31 December 2014

**Impairment provisions for losses on loans and advances**
The Group charge for impairment provisions of £13.5m (2013: £22.4m) was £8.9m lower than last year.

| | 2014 | 2013 |
|---|---|---|
| | £m | £m |
| Retail mortgage lending | 2.1 | 0.4 |
| Commercial lending | 9.2 | 16.7 |
| Secured personal lending | 2.2 | 5.3 |
| **Total** | **13.5** | **22.4** |

Low levels of arrears and increasing house prices have acted to reduce impairment charges against first charge retail mortgage loans in the year. However, the year on year charge has increased, primarily due to a change in provisioning methodology in the prior year which generated a release of £2.1m in that year. The same factors, together with the consumer credit act related remediation exercise described in the provisions for other liabilities and charges section below, have driven a decrease in impairment charges in second charge residential lending.

The improving outlook for the commercial lending market together with the resolution of a significant proportion of impaired or low credit quality loans has led to a decrease in levels of commercial lending impairment charge in the year.

The impairment provision balances have increased overall from the previous year. The total impairment provisions held on the statement of financial position were as follows:

| | 2014 | 2013 |
|---|---|---|
| | £m | £m |
| Retail mortgage lending | 6.1 | 5.8 |
| Commercial lending | 31.1 | 26.9 |
| Secured personal lending | 25.5 | 27.2 |
| **Total** | **62.7** | **59.9** |

**Provisions for other liabilities and charges**
During the year the Group completed the detailed and comprehensive review of its compliance with consumer credit legislation which had commenced in 2013. The total net remediation cost for the issues identified was £8.5m, of which £0.5m was charged in the current year (2013: £8.0m). As at the 31 December 2014 the Group holds no provision in relation to this issue (2013: £8.0m). The remediation process is substantially complete and no further costs are foreseen.

An additional provision of £0.5m (2013: £nil) was made during the period in relation to previous sales of payment protection insurance. Other provisions of £0.5m (2013: £0.3m) have been made in respect of various customer claims.

The Group has recognised a Financial Services Compensation Scheme (FSCS) interest charge of £2.3m in respect of scheme year April 2014 to March 2015 and the second instalment of the capital repayment of £2.0m.

Further information on the level of provisions and the uncertainties therein can be found in notes 2 and 38.

**Derivatives and hedge accounting**
All derivatives are recorded on the statement of financial position at fair value with any valuation movements being taken to the income statement. Derivatives are used solely to hedge risk exposures and not for speculative purposes. The primary use of derivatives in the Group is to hedge interest rate risk through interest rate swap agreements, but the Group also holds a small number of other hedging instruments such as cross currency swaps.

Where appropriate and allowable under accounting standards, the Group will hedge account for these exposures, with the effect of matching the accounting treatment of the derivative and the underlying asset. However, income statement volatility will still arise to the extent that these hedge relationships are ineffective, or because hedge accounting is not achievable. During the year the Group recognised a charge of £1.5m in the income statement (2013: £1.2m) in relation to these movements in fair value.

**Taxation**
The statutory rate of corporation tax was reduced to 21.0% from 1 April 2014. The Group was subject to corporation tax at a rate of 23.0% for the period 1 January to 31 March 2014, and 21.0% for the period 1 April to 31 December 2014, resulting in an effective statutory rate of corporation tax of 21.5% for the full year in 2014.

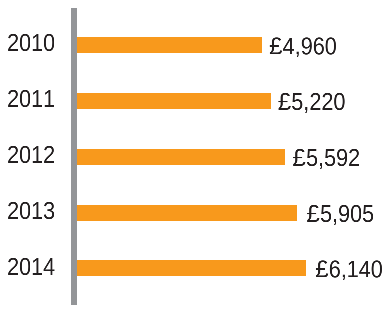
The actual effective tax rate from continuing operations for the Group was 21.9% (2013: 22.0%) compared with the statutory rate of tax of 21.5% (2013: 23.3%). The rate differential is primarily due to income statement expenditure which is disallowable for corporation tax purposes.

A reconciliation of the effective rate to the statutory rate is provided in note 13.

**Impairment of fixed assets**
Following the sale of Peter Alan, the Group undertook a review of all associated property assets for indicators of impairment. As a result, reflecting the reduced ongoing income generating capability of some assets, the Group considered a number of properties to be impaired and reduced their carrying value appropriately, recognising an impairment charge of £2.3m.

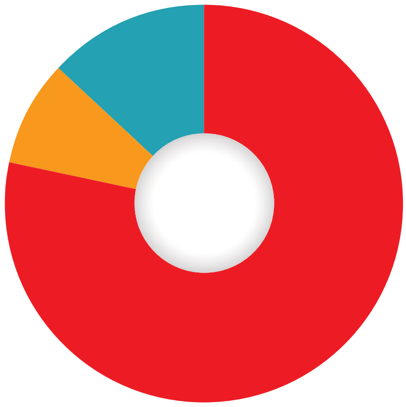
**Loans and advances to customers**
Loans and advances to customers increased by £235.3m in the year (2013: £312.9m) to a record £6,139.9m (2013: £5,904.6m), delivering against the Group's strategic objective of a growth in net residential mortgage lending. The Group continues to focus on the quality of business written, concentrating on affordability and credit risk in underwriting loans and mortgages.

**Loans and advances to customers (£m)**




The majority of the Group's lending is secured against prime first charge residential property, including buy-to-let properties. The Group's commercial lending business is weighted towards commercial property exposures, but also includes lending against residential property and to registered social landlords.

**Loans and advances to customers by portfolio (£m)◆**

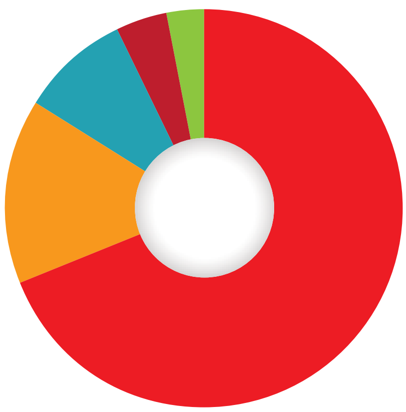


- Retail financial services £4,784.0
- Second charge £528.4
- Commercial £790.5

◆ Figures in the graph above exclude fair value adjustments.

The Group's residential mortgage portfolio (excluding any commercial lending exposures) reflects the prudent nature of the Group's lending policies, with 69% of exposures having a loan to indexed valuation of less than 70% and 84% less than 80%. The Group continues to offer new lending up to 95% of the property value.

**Residential mortgage lending by LTV (%)**



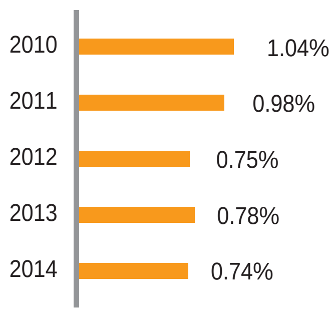
| | |
|---|---|
| Less than 70 | 69% |
| 70-80 | 15% |
| 80-90 | 9% |
| 90-100 | 4% |
| More than 100 | 3% |

The Group's exposures are well spread by geographical area, albeit with a larger share of lending in Wales (28.5% by value, 2013: 29.6%).

The strong credit quality of loans issued is reflected in the low value and volume of the Group's arrears against first and second charge residential lending. The percentage of retail mortgage lending cases fully secured by a first charge currently with arrears greater than 2.5% of the total outstanding balance is 0.74% (2013: 0.78%) which compares favourably with the industry average of 1.12%*.

The Group continues to support Members and customers who are experiencing financial difficulties and agree the most appropriate course of action. Short-term temporary actions could include revised payment schedules, payment holidays or a switch to 'interest only'. Where revised payment schedules are insufficient to meet normal contractual monthly instalments or where a customer fails to meet the revised payment terms, the case will continue to accrue arrears and impairment provisions will be made where appropriate. Our approach to dealing with Members and customers in financial difficulties means that we will only take possession of a property as a last resort. The number of properties taken into possession during the year was 109 (2013: 70).

**First charge mortgage loans where arrears are greater than 2.5% of the outstanding balance (%)**




The percentage of secured personal loans currently in arrears by number is 8.44% (2013: 8.74%), which by value is 10.14% (2013: 11.68%).

*CML arrears and possession data at 30 September 2014.

# Strategic report (cont.)

## for the year ended 31 December 2014

The commercial lending portfolio had just two exposures greater than three months in arrears at the year-end (2013: seven). Focus is maintained on all loans experiencing difficulty to ensure positions are tightly managed and the potential for losses arising is realistically and conservatively assessed. Joint action plans are implemented with borrowers wherever possible to minimise the likelihood and extent of defaults. There are no arrears in respect of lending to Registered Social Landlords.

**Liquidity**

The Group holds liquid assets to ensure it has sufficient access to funds to meet its financial obligations in both normal and stressed scenarios. The Group continues to maintain a robust liquidity position, with liquid assets at year end of 15.7% (2013: 16.1%) as a proportion of shares, deposits and loans (SDL). Whilst the absolute proportion of liquid assets to SDL has decreased from the prior year, a greater proportion now consists of High Quality Liquid Assets (HQLA) such as gilts. The Group has also secured access to alternative funding sources, as described further on.

The Liquid Asset Buffer (LAB) as defined by the Prudential Regulatory Authority (PRA) includes highly liquid assets, typically central bank and sovereign exposures. At the year end, the proportion of the Group's liquid assets which were buffer eligible was 74.1% (2013: 75.8%), and the total was well above the buffer liquidity requirement set by the PRA. Of the other liquid assets not assigned to the LAB, which typically comprise investments with other financial institutions, none (2013: 6.7%) are less than A rated under Fitch credit ratings. The Group's core liquidity ratio was 14.26% (2013: 13.18%).

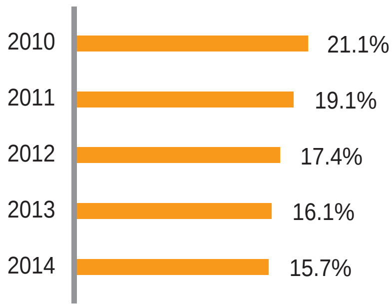
In addition, the Group has accessed the Government's Funding for Lending Scheme (FLS). At the end of the year the Group had drawn down £207.0m from the FLS in the form of Treasury Bills. Of this amount, £29.4m is retained and can readily be converted to liquidity.

The Group holds no direct exposure outside of the UK, other than £79.1m (2013: £116.0m) of AAA rated Supranational Bonds issued by the European Investment Bank, the International Bank for Reconstruction and Development and the Council of Europe.

Two new regulatory measures of liquidity were introduced in the year, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR is a measure of the Group's ability to withstand a short-term liquidity stress. Under the requirements of CRD IV the Group will need to maintain an LCR in excess of 60% from 1 October 2015 with a glide path rising to 100% by 1 January 2018, though the PRA is currently proposing that all financial institutions in the UK hold a minimum of 80% from 1 October 2015. The calculation of the LCR is still subject to change so there remains uncertainty over its final form. Based on the calculation used in its own internal monitoring the Group's LCR is currently in excess of 100%. The NSFR is a longer term stable funding metric, which measures the sustainability of the Group's long term funding. It is expected to be implemented from 2018. The calculation of the NSFR is also still subject to change so there remains uncertainty over its final form. However, based on its own internal monitoring, the Group's NSFR is in excess of 100%, and the Group holds sufficient stable funding to meet the new requirement.

The Group's liquid assets are set out in the table below:

**Liquidity ratio (%)**




| | 2014 | 2013 |
|---|---|---|
| | £m | £m |
| Cash and balances with the Bank of England | 432.6 | 355.6 |
| Securities issued by the UK Government and Multilateral Development Banks: | | |
| On balance sheet | 379.6 | 463.0 |
| Off balance sheet | 131.3 | 34.1 |
| Total Buffer Eligible Assets | 943.5 | 852.7 |
| Loans and advances to credit institutions and other debt securities | 225.2 | 223.5 |
| Contingent liquidity facilities[1] | 38.2 | 99.8 |
| **Total** | **1,206.9** | **1,176.0** |

[1] Contingent liquidity facilities consist of investment grade notes retained in own securitisations which can be readily converted to cash.

In addition, the Group held mortgage portfolios of £525.7m (2013: £329.0m) which have been approved for use in accessing Bank of England liquidity facilities.

**Capital**

The Group holds capital to protect Members' deposits by providing a buffer against unexpected losses. The amount of capital required is assessed in relation to the Group's overall risk appetite, the material risks to which the Group is exposed and the management strategies employed to manage those risks. Capital comprises the Group's general reserve, subscribed capital (Permanent Interest-Bearing Shares) and subordinated debt, adjusted in line with regulatory rules.

From 1 January 2014 the Group has been subject to Basel III regulations. The key elements of Basel III for capital requirements are as follows:

- Reduced capital resources through changes to the definition of capital and grandfathering of old instruments. Permanent Interest Bearing Shares (PIBS) will be phased out over eight years from 2014. Over the period 2014-18, there will be changes and additions to capital deductions from Common Equity Tier 1 and Tier 2 capital including pension deficit and AFS reserve;
- Increased capital requirements through Credit Valuation Adjustments and the treatment of deferred tax assets;
- New limits and capital buffers. Higher thresholds for all forms of capital with an increased focus on Common Equity Tier 1; and
- Introduction of the Leverage Ratio. The Basel Committee is using a period to 2017 to test a minimum Tier 1 leverage ratio of 3.0%.

The Group holds capital in each of three regulatory tiers: the Group's general reserve qualifies as Common Equity Tier 1 capital, the very highest quality of capital; the PIBS qualify as Additional Tier 1 capital under Basel III transitional rules; and the subordinated debt qualifies as Tier 2 capital under Basel III transitional rules.

Under transitional rules, the PIBS will be amortised out of Tier 1 capital on a straight line basis over eight years from 2014. The subordinated liabilities are scheduled to be repaid in July 2016, and under Basel III rules are required to be amortised out of Tier 2 capital on a straight line basis over the five years before maturity. As such, the contribution of each of these instruments to the Group's total capital will reduce each year.

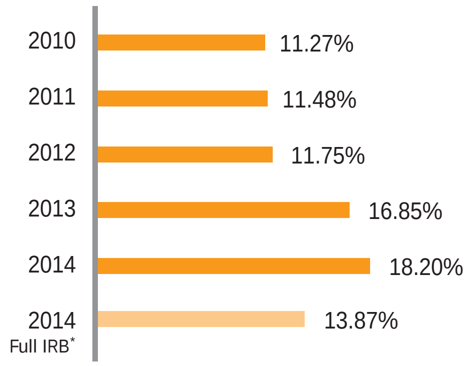
The Group's primary measure in assessing capital adequacy is the Common Equity Tier 1 (CET1) ratio, which expresses the highest quality capital as a proportion of the sum of the risk weighted assets of the Group. The risk weighting for each asset is calculated either through the use of internal models or through standardised calculations dependent on regulatory permissions for each portfolio of assets.

Group's CET1 ratio at 18.20% (2013: 16.85%) has increased, with the impact of the increased capital generated by the strong profitability in the year more than offsetting the increased risk weighted assets associated with the growth in the statement of financial position. This means the Group is generating sufficient capital through its strong financial performance to facilitate the increase in lending to households and businesses.

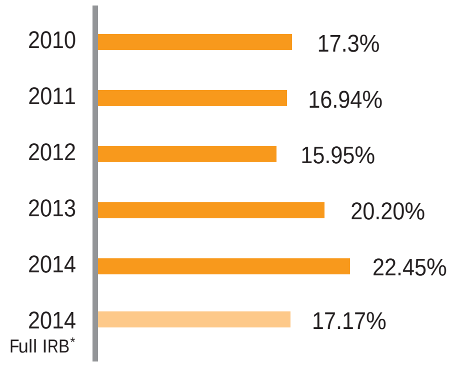
Another measure of capital strength is the Solvency ratio, calculated as the ratio of total capital to risk weighted assets. The solvency ratio has increased to 22.45% (2013: 20.20%).

In the prior year the Group obtained approval to adopt an Internal Ratings Based (IRB) approach for first-charge retail and commercial mortgage assets. The Group anticipates that its second charge mortgage assets will adopt the IRB approach during 2015. The impact of this approval for second charge mortgages would be to increase the risk weightings applied to those assets when compared to the standardised approach, and as such it would have a negative impact on both the CET1 and Solvency ratios. Were the Group to have adopted an IRB approach for second charge mortgages at the 2014 year end based on current models, the CET1 ratio would have been a still healthy 13.87% and the Solvency ratio 17.17%

**Common equity tier 1 capital ratio (%)**




**Solvency ratio (%)**




* Estimated ratios were the Group to have adopted an IRB approach for second charge mortgages at the 2014 year end

A further measure of capital strength is the Leverage ratio, a measure of Tier 1 capital held against total (non risk weighted) assets, including certain off-statement of financial position commitments. The Group's leverage ratio was 5.02% (2013: 4.59%), which is significantly above the minimum as proposed by the Bank of England Financial Policy Committee of 3%.

The Leverage ratio is calculated using quarter end values without taking account of Basel III transitional provisions for Capital. The Leverage ratio on a Basel II basis as at 31 December 2013 has been restated to take into account further guidance included within the "Basel III Leverage Ratio Framework and Disclosure Requirement" document issued by the Bank of International Settlements in January 2014.

# **Strategic** report (cont.)
## for the year ended 31 December 2014

The following table sets out the reconciliation of capital per the consolidated statement of financial position to regulatory capital:

| | 2014 £m (Basel III basis) | 2013 £m (Basel II basis) |
|---|---|---|
| **Capital available** | | |
| General reserve | 408.7 | 357.7 |
| Available for sale reserve | 2.6 | (3.0) |
| **Total capital per consolidated statement of financial position** | **411.3** | **354.7** |
| *Regulatory adjustments to obtain common equity tier 1* | | |
| Available for sale reserve not eligible for inclusion in regulatory capital | (2.6) | 3.0 |
| Intangible assets | (1.7) | - |
| Additional valuation adjustment | (0.5) | - |
| Excess of expected losses over impairments | (29.8) | - |
| Other adjustments | (1.0) | - |
| **Total common equity tier 1 capital** | **375.7** | **357.7** |
| **Additional tier 1 capital** | | |
| PIBS | 60.0 | 59.4 |
| Less amortisation under grandfathering rules | (12.0) | - |
| Excess of expected losses over impairments | - | (14.9) |
| Intangible assets | - | (4.4) |
| **Total tier 1 capital** | **423.7** | **397.8** |
| **Tier 2 capital** | | |
| Subordinated debt | 92.3 | 92.3 |
| Less amortisation of subordinated debt | (64.6) | (46.2) |
| Tier 2 allowance of amortised Tier 1 under grandfathering rules | 12.0 | - |
| **Total tier 2 capital** | **39.7** | **46.1** |
| Excess of expected losses over impairments | - | (14.9) |
| **Total regulatory capital** | **463.4** | **429.0** |

Further detail can be found in the Group's 2014 Pillar 3 disclosure, published on the Society's website (www.principality.co.uk).

**Funding**
The Group raises funds from a variety of sources in order to meet the strategic objective of maintaining a diversified funding mix. The largest component is retail savings, which at £5,613.0m (2013: £5,562.6m) represent 91.4% (2013: 94.2%) of all mortgage and loan balances. Retail savings balances have increased by £50.4m in the year (2013: £95.6m), reflecting the continued focus on offering attractive products to Members despite the challenging interest rate environment.

The Group remains a member of the FLS, but repaid funding of £143.0m in the year, leaving £207.0m of Treasury bills outstanding at the year end. Funding is obtained by using Treasury bills as collateral in a repurchase transaction for cash. At the year end, the Group had raised £175.0m of on-balance sheet drawn funding from this method, and retains a further £29.4m of off-balance sheet Treasury Bills. The Group does not intend to draw any further funding from the FLS scheme.

In June 2014 the Society entered into its second Residential Mortgage Backed Security (RMBS) issue, raising long-term wholesale funding of £475.0m secured against a mortgage pool of £520.5m. The mortgage pool remains on the statement of financial position of the Society as it retains the risks and rewards of the assets.

In addition to supporting the Group's interest margin, this furthers the Group's strategic objective of maintaining a diverse and balanced funding base.

The total value of RMBS notes in external issuance was £561.0m at the end of the year (2013: £510.4m). The Group holds retained notes of £344.1m (2013: £358.9m) in these securitisations, of which £170.6m (2013: £230.9m) was pledged or would be eligible as collateral for secured funding or repurchase transactions.

On 3 November 2014, Moody's upgraded the Group's long-term debt rating to Baa3 from Ba1, with a positive outlook. The Group's current credit ratings are set out in the table below.

| | Short-term | Long-term | Outlook |
|---|---|---|---|
| Moody's | P-3 | Baa3 | Positive |
| Fitch | F2 | BBB+ | Stable |

**Asset encumbrance**
The Group uses its assets as collateral to support the raising of secured funding, primarily as part of the RMBS issuances or pledged under the terms of the FLS. At the end of the year, 19.0% (2013: 16.8%) of the Group's assets were encumbered, being £1,247.5m (2013: £1,117.1m) of residential mortgage assets and £133.9m (2013: £67.1m) of other assets.

**Defined benefit pension scheme**
During the year, the Trustees of the Group's defined benefit pension plan and the Group decided to adopt the Consumer Prices Index (CPI), rather than the Retail Prices Index (RPI), as the basis for determining the rate of inflation in actuarial calculations of the scheme liability. The use of CPI as the inflationary assumption brings the pension scheme in line with wider market practice. The change in inflation assumptions caused a credit to the consolidated income statement of £10.1m in relation to a reduction of the estimated future liability arising as a result of past service costs.

The Group contributed £2.1m to the defined benefit pension scheme in the year. The pension scheme liability at the year-end was £6.9m (2013: £17.1m), and is reflected in the statement of financial position.

The defined benefit scheme is subject to a triennial valuation by the scheme's independent actuary. The most recent valuation was undertaken as at 30 September 2013, and was approved by the Trustees during the year.

**Member, colleague and community**
Member, Colleague and Community are the subject of a separate report on pages 25 to 30.

Stephen Hughes

Group Finance Director
10 February 2015

## Country-by-country reporting

In compliance with the Regulations of Article 89 of the Capital Requirements Directive IV (CRD IV) country-by-country reporting (CBCR) we disclose the following information:

**a) Name, nature of activities and geographical location**

Principality Building Society is the parent company and a list of the subsidiaries can be found in note 22 of these accounts.

The principal activities of the Group can be found in the Strategy Report and in note 22.

All group companies operate in the United Kingdom only.

**b) Average number of employees**

The average number of employees is disclosed in note 10.

**c) Annual turnover**

Net operating income is set out in the Consolidated Income Statement.

**d) Pre-tax profit or loss**

Pre-tax profit is set out in the Consolidated Income Statement.

**e) Corporation tax paid**

Corporation tax paid is set out in the Consolidated Statement of Cash flows.

**f) Public subsidies received**

No public subsidies were received in 2014.

# **Risk management** report

## for the year ended 31 December 2014

### Risk overview

In executing the Group's strategy and in undertaking day-to-day business, the Group is exposed to a diverse range of risks. The Group actively manages the risks that arise from its activities and believes that its risk management philosophy reflects a strong awareness of actual and potential risk exposures, enables the quantification of the probable impact of such exposures, with measures in place to manage these exposures within limits agreed by the Board.

### Governance structure

There is a formal structure for managing risks across the Group which is documented in detailed risk management policies. These policies, and associated limits, are owned and reviewed at least annually by functional risk committees which report to the Group Risk Committee and the Board.

Risk governance is provided by a structure consisting of five key risk management committees. Each committee includes appropriate representation from the Group Management Committee (GMC), divisional Management and risk specialists:

- Group Risk Committee (GRC) is chaired by a non-executive director, and has responsibility for ensuring a Group-wide co-ordinated approach towards the oversight and management of key strategic and corporate risks.

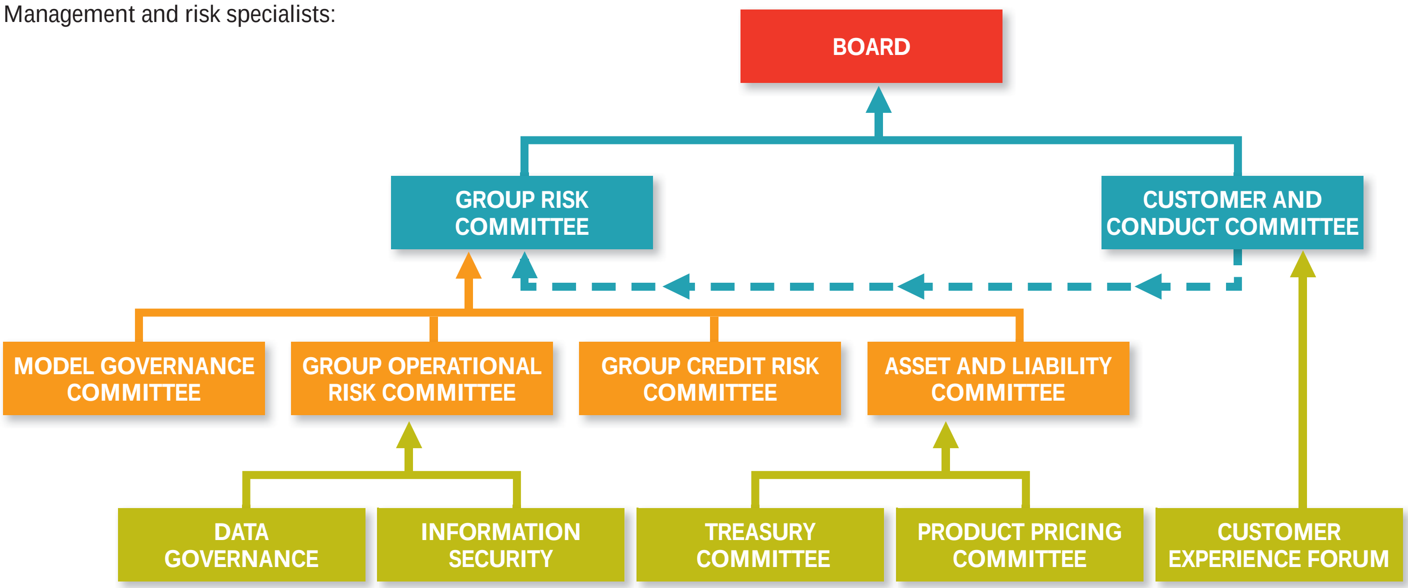
- Group Credit Risk Committee (GCRC) is chaired by the Group Risk Director and is responsible for monitoring and reviewing exposure to credit risks in the Group's retail and commercial loan portfolios.

- Asset and Liability Committee (ALCO) is chaired by the Group Finance Director and has responsibility for the assessment of exposure to Treasury Counterparty credit, liquidity and market risk. During the year, the Board changed the reporting line for ALCO, which now reports to GRC (previously to Group Management Committee). Weekly monitoring is conducted by the Society's Treasury Committee, which is a subsidiary of ALCO.

- Model Governance Committee (MGC) is chaired by the Group Finance Director and is responsible for the approval and oversight of models used by the Group to assess and quantify exposure to credit, liquidity and market risk.

- Group Operational Risk Committee (GORC) is chaired by the Group Risk Director, and is responsible for monitoring and reviewing exposure to operational risks arising from the Group's day-to-day activities. The Group Information Security Committee and Data Governance Committees report into the GORC and are responsible for providing specific oversight of these two key risks.

In addition, the Customer and Conduct Committee (CCC), a separate Board committee, is responsible for providing oversight of the Group's Business Conduct framework and strategy. Key Conduct risks are reviewed by the Committee and reported to the Group Risk Committee.



Primary responsibility for the identification, control and mitigation of risk rests with each strategic business unit. Oversight and governance are provided through specialist support functions including Group Risk, Group Treasury, Group Finance and Group Business Conduct. The role of these functional specialists is to maintain and review policies, establish limits and qualitative standards which are consistent with the Group's risk appetite, monitor and report on compliance with those limits and standards and generally to provide an oversight role in relation to the management of risk.

**Principal risks**

The key risks to which the Group is exposed include strategic risk (including reputational risk), credit risk, liquidity risk, market risk, conduct risk, operational risk and pension obligation risk. As a mutual, the Group maintains a relatively low risk appetite. Quantitative assessment of credit risk, liquidity risk and market risk can be found in note 39.

Group Internal Audit provides independent assurance regarding the activities of the strategic business units and the specialist functions across the Group and reports on the effectiveness of the control environment to the Audit Committee on a quarterly basis. The GRC monitors the arrangements for assessing risk inherent in the Group's business activities on behalf of the Board and receives quarterly risk reports. The Board receives risk reports at each of its meetings and regularly considers the impact of major strategic risks, taking account of changes in the macro-economic environment, new regulation, competitor strategy, customer preferences and emerging technology. The key risks to the Group are linked to the overall performance of the economy and the resultant effect on unemployment, house price indices, interest rates, commercial property market values and overall liquidity. The impact of continued regulatory change also represents a direct risk for the Group. Specific risks are reviewed as part of the Group's capital and liquidity assessments, the Internal Capital Adequacy Assessment Process (ICAAP) and the Individual Liquidity Adequacy Assessment (ILAA).

The Board is fully committed to and promotes a culture whereby our Members and customers are at the heart of what we do and where the fair treatment of our customers is central to all activities. We have an established framework for managing conduct risk across the Group – much has been done in the last 12 months to further develop this framework and we continue to review this with a view to identifying further opportunities to strengthen it. Delivering fair customer outcomes and our ability to assess whether we are achieving these consistently has been a key area of focus in developing the framework as has enhancing our ability to anticipate and respond to the emerging regulatory agenda. The Customer and Conduct Committee, chaired by a non-executive director, is responsible for overseeing the execution of the Group's conduct risk strategy, and overseeing the effective management of conduct risks and delivery of fair customer outcomes on behalf of the Board.

## Credit risk

Credit risk is the potential risk that a customer or counterparty will fail to meet its financial obligations to the Group as they become due. Credit risk arises primarily from loans to retail customers, loans to commercial customers and from the investments held by Group Treasury for liquidity requirements and for general business purposes.

**Market background**

Recent economic indicators have provided some encouragement, with the UK and Welsh economies showing modest growth. However, the sustainability of the recovery remains uncertain, given the relatively weak global outlook, and continued risk of recession across Europe. Whilst the likelihood of an imminent rise in interest rates has receded, this will, nevertheless, ultimately pose a threat to longer-term recovery in the UK and overseas. For that reason the Group's forecasts and plans continue to take account of scenarios that model stresses on the ability of customers and counterparties to repay their financial obligations. These stress factors include the risk of rising interest rates, decreases in house prices, impacts on commercial property market values, performance and the ability to re-finance at maturity, a sustained deterioration in the macro-economic environment and consequential increases in unemployment. These forecasts have been prepared by the Society's management and stressed accordingly in line with PRA guidance.

**Risk mitigation**

The controlled management of credit risk is critical to the success of the Group's lending strategy. The quality of individual lending decisions and subsequent management and control, together with the application of a credit policy that reflects the risk appetite of the Group, have a direct impact on the achievement of the financial objectives of the Group. Each of the four business areas, residential first and second charge lending, commercial lending and treasury, has its own individual Credit Risk Policy Statement setting out the Board's risk appetite including policy scope, structures and responsibilities, definitions of risk and risk measurement and approach to monitoring. In addition, each business area maintains a detailed procedures manual setting out operating rules and standards.

The Group has an approved waiver to use the advanced Internal Ratings Based (IRB) approach for the calculation of Credit Risk Capital requirements.

Day-to-day management of credit risk is undertaken by specialist teams working in each business area using credit risk management techniques adopted as part of the Group's overall approach to measure, mitigate and manage credit risk in a manner consistent with the risk appetite approved by the GRC and the Board. Credit risk portfolios are subject to regular stress testing to simulate outcomes and assess the potential impact on capital requirements.

**First and second charge retail credit risk**

The Group continues to focus on the underlying quality of business written, and lending criteria remain conservative. Applicant quality is monitored closely, defined in terms of creditworthiness, loan to value (LTV) and loan to income (LTI) ratios, and affordability profile. The GCRC receives regular reports on the performance of retail credit risk portfolios with further oversight provided by the GRC.

# **Risk management** report (cont.)
for the year ended 31 December 2014

The Group's collections and recoveries functions aim to provide a responsive and effective operation for the arrears management process. The Group encourages early two-way communication with borrowers, obtaining their commitment to maintain payment obligations, typically through repayment plans and forbearance measures. Experience in these areas allows for feedback into the underwriting process. We recognise that customers in financial difficulties need support at what may be a difficult time so careful consideration is given to the most appropriate realisation strategy likely to result in the best outcome for the Group and the customer.

**Commercial credit risk**
Commercial risk appetite is regularly reviewed in the light of changing economic and market conditions and is also subject to annual review. The Group remains cautious with regard to commercial lending which is undertaken on a prudent basis reflected in a reduction of loan balances on the statement of financial position year-on-year, and where management maintains a strategy geared towards reducing larger, single counterparty loans. Commercial lending continues to operate within a framework of conservative credit criteria, principally focusing on the underlying income stream and debt servicing cover as well as property value.

Concentration risk within the commercial portfolio is controlled and monitored via a series of credit exposure limits which are aimed at producing a diverse portfolio. Commercial lending relationships are subject to regular reviews to ensure that facilities are fully performing in accordance with the terms of original sanction. Watch-list procedures are in place which grade borrowers in line with the perceived severity of the risk and are designed to identify cases of potential cause for concern to facilitate early risk mitigation or forbearance activity where appropriate. When accounts are in default, careful consideration is given to the most appropriate realisation strategy likely to result in the fair outcome for the customer and the Group.

Responsibility for the overall quality of the lending book and the adequacy of credit procedures and controls rests with the commercial lending division with oversight provided by Group Risk, the GCRC and the GRC.

**Treasury credit risk**
Treasury credit risk arises from the investments held by Group Treasury in order to meet liquidity requirements and for general business purposes. Treasury is responsible for managing this aspect of credit risk within operational limits as set out in the Group's Treasury Policy Statement.

Treasury counterparty lines of credit are reviewed on a weekly basis by the Treasury Committee and on a monthly basis by ALCO. This entails an analysis of the counterparties' financial performance, their ratings status and recent market intelligence to ensure that limits remain consistent with the Group's risk appetite. Changes to lines and limits are approved by ALCO within a framework prescribed by the Board.

## Liquidity risk
Liquidity risk is the risk that the Group is not able to meet its financial obligations as they fall due, or can do so only at excessive cost. The objective of the Group's liquidity policy is therefore to maintain sufficient liquid assets to cover cash flow imbalances and fluctuations in funding, to maintain full public confidence in the Group and to ensure that all financial obligations are met.

**Market background**
In December 2010, the Basel Committee on Banking Supervision (BCBS) announced proposals to introduce two new liquidity metrics as part of the implementation of Basel III. These are a short-term liquidity stress metric, the Liquidity Coverage Ratio (LCR), and a longer-term funding metric, the Net Stable Funding Ratio (NSFR). The LCR is designed to promote short-term resilience of a firm's liquidity risk profile by ensuring it has sufficient high quality liquid assets to survive a significant stress scenario lasting for one month. The NSFR is designed to promote a sustainable funding maturity structure over at least 12 months.

In June 2013, the Capital Requirements Directive (CRR and CRD IV), which includes requirements for the LCR, was published in the Official Journal of the European Union. The LCR will become a European standard from January 2015 with firms required to have a ratio in excess of 60% increasing to 100% by January 2018.

In the UK, the PRA published a Consultation Paper CP27/14 'CRD IV: Liquidity' which seeks feedback on the proposal to implement LCR at 80% from October 2015 rising to 90% in January 2017 and 100% from January 2018. The NSFR is expected to be implemented at a minimum of 100% from January 2018. As this is a consultation paper, there remains some uncertainty regarding how and when the LCR and NSFR will be implemented. The Group continues to monitor its position relative to the anticipated requirement of both the LCR and the NSFR.

In October 2013 the Bank of England published developments to its Sterling Monetary Framework with the aim of increasing the availability and flexibility of liquidity provided to solvent UK financial institutions. This included confirmation that liquidity would be provided at longer duration, against a wider range of collateral, at lower cost, and with greater predictability of access. This allows firms to operate safely with lower levels of liquidity whilst meeting all the requirements of emerging European regulation for liquidity risk management.

**Risk mitigation**
The day-to-day management of liquidity is the responsibility of the Group Treasury department, which oversees the Group's portfolio of liquid assets and wholesale funding facilities.

The Treasury Committee and ALCO exercise control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving regular reports on current and projected liquidity positions including the impact of stress testing. The Group regularly conducts an Individual Liquidity Adequacy Assessment (ILAA). This is used to assess the Group's liquidity adequacy and determine the levels of liquid assets required to support the current and future liquidity risks in the Group. The resulting funding and liquidity strategy takes into consideration the full repayment of the FLS.

Based on current interpretations of regulatory requirements, and guidance including European CRR, as at 31 December 2014 the Group held LCR and NSFR ratios well in excess of the 100% ratio requirement due for implementation in January 2018.

The Group holds undrawn AAA notes issued under the Group's RMBSs. These self-issued securities represent eligible collateral for use in repurchase agreements with third parties. In addition, the Group holds a stock of unencumbered mortgage loan pools prepositioned with the Bank of England for use as collateral for contingency funding purposes.

The most recent ILAA was approved by the Board in December 2013. The Group's ILAA includes stress tests that consider a range of severe but plausible scenarios and their impact on the Group, particularly with respect to retail saving outflows. The ILAA concludes that the Group's liquidity reserves are adequate to sustain the Group over an extended severe stress during which contingent actions aimed at stabilising the situation would be deployed. The next ILAA will be submitted to the Board for approval in May 2015.

## Market risk

Market risk is the risk that the value of, or income arising from, the Group's assets and liabilities changes as a result of changes in market prices, the principal elements being interest rate risk, including the use of derivatives, and foreign currency risk.

The Group Treasury department is responsible for managing the Group's exposure to all aspects of market risk within the operational limits set out in the Group's Treasury Policies. Oversight is provided by the Treasury Committee, ALCO, and GRC which approves the market risk policy and receives regular reports on all aspects of market risk, including interest rate risk and foreign currency risk. Reporting lines and terms of reference are set out clearly by the Board which also receives monthly reports from the Group Finance Director covering significant issues dealt with by ALCO.

The Group's defined benefit pension scheme is also subject to market risk, and this risk is managed by the trustees of the scheme.

## Interest rate risk

Interest rate risk is the risk of loss resulting from adverse movements in market interest rates.

The Group is exposed to interest rate risk, principally arising from the provision of fixed rate lending and savings products. The various interest rate features and maturity profiles for these products, and the use of wholesale funds to support their delivery, create interest rate risk exposures due to the imperfect matching of interest rates between different financial instruments and the timing differences on the re-pricing of assets and liabilities.

Another significant form of interest rate risk arises from the imperfect correlation between re-pricing of interest rates on different assets and liabilities, often referred to as basis risk. The basis risk on the Group's statement of financial position arises from administered rate liabilities, the pricing of which is influenced by competition for retail funds, and which are used to fund mortgages and other assets priced relative to the Bank of England base rate, or LIBOR, albeit for relatively short durations.

### Market background

Whilst base rates have remained unchanged during the year, the provision of forward guidance from the Bank of England indicates that a Bank of England Base Rate rise could occur during the next 12 months. We remain mindful of the fact that an imminent rate rise along with an increase in the provision of mortgage advice following the Mortgage Market Review may lead to increased customer demand for fixed rate mortgage products. In contrast, savers are choosing to take advantage of variable rate products where there is an expectation that the increase in Base Rate, at least in part, would be passed onto them.

Interest earned on fixed rate mortgages will not increase; however, interest payable on variable rate savings is likely to increase and our plans take due account of the need to mitigate this potential risk to interest margin.

### Risk mitigation

Interest rate risk is subject to continual management, within the risk appetite set by the Board, using appropriate financial instruments including derivatives. Risks relating to specific products are mitigated through appropriate related product terms and conditions, offer procedures, as well as close analysis of the mortgage pipeline and early redemption behaviour. Derivative instruments are used to manage various aspects of interest rate risk including the net basis positions where appropriate.

On a monthly basis, ALCO considers the impact of a number of interest rate risk and basis risk stress tests on the Group's statement of financial position. In addition ALCO and GRC review the Society's options and strategies and the impact of any potential future increases in interest rates. The Group's forecasts and plans take account of the risk of interest rate changes and are stressed accordingly.

During the year the Group has commenced implementation of dynamic stress testing of its interest rate risk exposure. This is used to evaluate the impact of extreme but plausible events on the Group's interest income and expense. This will provide the Group with increased capability to monitor and manage interest rate risk and identify ways in which contingent actions, aimed at stabilising a stress event, could be deployed.

### Use of derivatives

Derivatives are only used to limit the extent to which the Group will be affected by changes in interest rates, foreign exchange rates or other indices which affect fair values or cash flows. Derivatives are therefore used exclusively to hedge risk exposures.

# **Risk management** report (cont.)

for the year ended 31 December 2014

The principal derivatives currently used by the Group are interest rate exchange contracts, commonly known as interest rate swaps. The table below describes the principal activities undertaken by the Group, the related interest rate risks associated with those activities and the types of derivatives which are typically used to manage such risks:

| Activity | Risk | Type of derivative |
|---|---|---|
| Fixed rate savings products and fixed rate funding | Sensitivity to changes in interest rates | Interest rate swaps |
| Fixed rate mortgage lending and fixed rate investments | Sensitivity to changes in interest rates | Interest rate swaps |
| Equity linked investment products | Sensitivity to equity indices | Interest rate swaps and equity linked options |

The Group uses derivatives in accordance with the terms of the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes and, accordingly, they are used exclusively to reduce the risk of loss arising from changes in interest rates, foreign exchange rates or other factors specified in the legislation.

### Foreign currency risk

Currency risk is the risk of a loss resulting from movements in foreign exchange rates or changes in foreign currency interest rates, particularly on the Group's non-sterling funding. The majority of currency balances arise from transactions instigated by Group Treasury to manage wholesale funding costs and returns on liquid assets and to provide diversity in funding and asset markets.

Currency risk is not considered to be material for the Group as almost all transactions are conducted in Sterling.

### Conduct risk

Conduct risk is the risk of the Principality Group treating its customers unfairly resulting in the delivery of inappropriate outcomes. The Board has no appetite for unfair customer outcomes arising at any stage and focus efforts in those areas where conduct risk is most likely to occur to ensure we mitigate those risks effectively.

**Market background**

The sustainability of the Group's business model and achievement of its longer-term strategy are dependent upon the consistent and fair treatment of customers. Principality has always been committed to ensuring that customers are treated fairly.

Furthermore, the current regulatory regime has resulted in increased scrutiny around the conduct of firms and their focus on delivering fair customer outcomes, with significant consequences for those firms that do not manage conduct risk effectively. Consequently, the Group has invested heavily during 2014 in its framework and approach to managing conduct risks.

**Risk mitigation**

The Group's framework for managing risk is outlined in the following diagram:

| | | | | |
|---|---|---|---|---|
| **Setting Clear Expectation** | Group Conduct Strategy | | | |
| | Conduct Risk Appetite | | | |
| | Conduct Infrastructure | | | |
| | Group Standards & Policies | | | |
| | Culture | | | |
| **Customer Lifecycle** | Four Pillars | | | |
| | Target Market & Customer Proposition | Distribution | Servicing and Arrears | Complaints Management |
| **How We Measure Success** | Conduct Risk Metrics | | | |
| | Customer Outcomes Testing | | | |
| | Second & Third Line Assurance Activity | | | |
| | Customer & Colleague Insight | | | |

The Group's conduct strategy was updated and approved by the Board in December. This sets out the Group's strategy for managing conduct risk and also articulates the Board's risk appetite in relation to conduct risk.

Conduct risk, in keeping with other risks, is managed using a three lines of defence model, with the business forming the first line, our Compliance and Conduct function the second and Internal Audit the third line. In its second line role, the Group's Compliance and Conduct function advises the Group on the management of conduct risks and oversees the effectiveness of controls in place to manage the risk of unfair customer outcomes. Recognising the pivotal role played by the Compliance and Conduct function in managing conduct risk, the function has been strengthened considerably during 2014. The Group's Customer and Conduct Committee is a Board Committee and forms part of the overall governance and control framework. Chaired by a non-executive director, and supported by the Customer Experience Forum, an operational committee which meets monthly, the Customer and Conduct Committee is responsible for overseeing the execution of the conduct strategy and all aspects of conduct risk management.

The Compliance and Conduct Policy sets out the Group's high level expectations in relation to the management of conduct risks and this is supported by a suite of ten customer treatment standards which cover specific areas of conduct such as vulnerable customers, complaints, servicing and helping customers in financial difficulty.

Our desired customer outcomes articulate the Group's conduct risk appetite and are defined against each of the four pillars of the conduct strategy:

| Pillar | Desired Outcome |
|---|---|
| Target Market & Customer Proposition | We only offer products and services which clearly meet an established customer need. |
| | We offer straight-forward products with clear literature which customers can readily understand. |
| | We regularly review the performance of our products and actively manage our product offering to ensure that it continues to deliver fair outcomes for our customers. |
| Distribution | Where customers receive advice, that advice is suitable and takes account of their needs and circumstances. |
| | We lend responsibly, ensuring that loans are affordable. |
| | We provide customers with clear information enabling them to make an informed choice about the products they purchase, whether the product is provided on an advised or non-advised basis. |
| Servicing and Arrears | Customers are provided with clear information and kept appropriately informed throughout the lifetime of the product or service. |
| | Minimum service standards are maintained which meet the realistic expectations of customers. These will be effectively communicated, monitored and reviewed. |
| | We take all reasonable steps to protect customers from financial crime, information security and business continuity risks. |
| | Borrowers in financial difficulty who work with us towards an appropriate resolution will be treated sympathetically and all appropriate forbearance options considered. We will only repossess when this is the fair outcome for the customer. |
| Complaints Management | Customers will not face unreasonable barriers to make a complaint. |
| | All complaints will be resolved promptly and fairly based on a review of the customer's individual circumstances. We will undertake root cause analysis promptly, thereby enabling us to understand how we can improve the outcomes we are achieving for our customers. |

We measure the effectiveness of our management of conduct risk in a variety of ways. Key conduct metrics which align to the Group's conduct risk appetite and the four pillars outlined above are reported on a monthly basis to key committees and the Board. In addition, we have recently commenced outcome testing which enables us to assess the extent to which we are achieving our aim of consistently delivering fair outcomes for customers. Second and third line monitoring and oversight activity enables us to assess how effectively conduct risks are being managed and whether or not we are delivering fair customer outcomes.

Finally, we seek regular feedback from our customers and our colleagues. We use a number of techniques to gather feedback with a view to understanding how we are performing and, importantly, how we can improve what we are doing.

# **Risk management** report (cont.)
for the year ended 31 December 2014

## Operational risk

Operational risk is the risk of a loss arising from inadequate or failed internal processes or systems, human error or external events.

**Market background**

The external environment continues to evolve with new challenges arising from technological innovation, increased customer expectations and emerging regulatory standards. The sector as a whole has become exposed to increased levels of operational risk, with greater reliance placed upon the resilience of technology platforms and staff capability. Growing levels of financial and cybercrime require the adoption of increasingly sophisticated anti-fraud controls.

**Risk mitigation**

The role of the Group's operational risk management function is to ensure appropriate strategies are in place to manage and mitigate the risks that could impact the ability of the Group to meet its business objectives whilst protecting its reputation. The Group manages its exposure to operational risk, considering the impact by reference to a number of discrete categories which include process management, systems failure, reputational issues, business continuity planning and fraud risk.

The Group's operational risk management framework sets out the strategy to identify, assess and manage operational risk, with senior management having responsibility for understanding the nature and extent of the impact on each business area and for embedding appropriate controls to mitigate those risks. The framework is updated periodically to take account of changes in business profile, new product development and the external operating environment.

Oversight is provided by the GORC, and the assessment of the Group's exposure to operational risks is based on both quantitative and qualitative considerations. The Information Security and the newly established Data Governance Committees provide specialist oversight in relation to these specific areas of operational risk and report directly to the GORC. The crystallisation of operational risks is captured through the recording of operational losses, near misses and incidents. The analysis of loss events is used to identify any potential systemic weaknesses in operational processes. The ICAAP includes a series of hypothetical scenarios designed to assess the ability of the Group to mitigate or withstand the impact of a range of operational failures. The scope and relevance of this analysis is reviewed not less than annually by the GORC, to ensure they continue to reflect emerging potential operational weaknesses or threats.

## Pension obligation risk

The Group has funding obligations for a defined benefit scheme which is closed to new entrants. It was closed to future accrual on 31 July 2010. Pension risk is the risk that the value of the Fund's assets, together with ongoing employer and member contributions, will be insufficient to cover the projected obligations of the Fund over time. The return on assets, which includes equities and bonds, will vary with movements in equity prices and interest rates. The projection of the Fund's obligations includes estimates of mortality, inflation and future salary rises, the actual out-turn of which may differ from the estimates. The Fund is also exposed to possible changes in pension legislation.

To mitigate these risks, Management and the Trustees of the Fund regularly review reports prepared by the Fund's independent actuaries and take appropriate action which may, for example, include adjusting the investment strategy and/or contribution levels.

The pension scheme was subject to a triennial valuation in September 2013 which was agreed by the Society and Trustees during the year. The agreed recovery plan results in payments of £1.5m per plan year (October to September) during the first three years after the valuation with an additional £1.1m to be paid during the fourth year after the valuation.


Principality friends of Forest Farm

During the first half of 2014, the Trustees agreed to change the basis for the inflation assumption used in the actuarial calculation of the scheme's liability from the Retail Price Index (RPI) to the Consumer Price Index (CPI). This change has recently been adopted by a large number of pension plans in both the public and private sectors throughout the UK. The effect of this change has been to decrease the scheme liability by £10.1m, which has been recognised in the first half of 2014 and, as a past service cost, is reflected as an increase to profit for the year in the consolidated income statement.

### Capital management

The Group conducts an Internal Capital Adequacy Assessment Process (ICAAP) to assess the Group's capital adequacy and determine the levels of capital required to support the current and future risks in the Group. The ICAAP covers all material risks to determine the capital requirement over a five-year horizon and includes stress scenarios which are intended to meet internal and regulatory requirements. The capital requirements are presented to the Board for approval with the most recent review being completed and approved by the Board in July 2014. The ICAAP is used by the PRA to determine and set the Group's Individual Capital Guidance (ICG). Basel III (CRD IV) was implemented in the UK in January 2014. This incorporated significant changes to the quality and quantity of capital that banks and building societies are expected to hold by imposing risk based deductions which were not recognised under Basel II and restricting the eligibility of non-core capital instruments either entirely or on a phased basis under transitional rules which extend to 31 December 2022. Risk weighted assets are also increased through adjustments aimed at recognising risk not deemed to have been fully met under Basel II.

The Financial Policy Committee (FPC) has undertaken a review into the leverage ratio framework. The conclusion of this review, published in October 2014, stated that firms should hold a minimum 3% leverage ratio at all times. Further to this, the FPC is proposing the introduction of two buffers, a supplementary leverage ratio buffer and a countercyclical leverage ratio buffer. The final calibration of the supplementary leverage ratio buffer is subject to industry consultation during 2015. As at 31 December 2014, the Group's leverage ratio (a measure of capital against non-risk weighted assets) was 5.02% (2013: 4.59%), well in excess of the minimum ratio.

The Group remains well capitalised against the underlying risks of the business with a strong Common Equity Tier 1 Ratio despite the more stringent requirements of the Basel III (CRD IV) package.

To meet Basel III Pillar 3 requirements, the Group publishes further information about its exposures and its risk management procedures and policies. This will be published on the Society's website (www.principality.co.uk) in April 2015.

R. Michael Jones

Group Risk Director
10 February 2015

# Member, colleague and community

for the year ended 31 December 2014

## Member

We know that listening to our Members is the best way to make sure we understand how to meet their needs and expectations, and achieve our goal of being recommended every day. Members often tell us that they value the friendliness and helpfulness of our staff. We encourage and reward colleagues for providing great service to our Members, and encourage the sharing of experience and expertise with others.

Member feedback is a key driver of change in the Society. For example, as a result of Member feedback we introduced more flexibility into our account opening procedure. We have also made changes to our environment, adding more frosting to our glass offices to provide more privacy. Our dedicated Customer Insight team is responsible for representing the 'voice of the customer'. It provides insight that helps to identify areas for improvement and develop customer strategies that increase member value. We generate this insight through a number of different methods, including primary and secondary research, the collation and analysis of the feedback we receive from our Members, recognising patterns of behaviours to try and anticipate Members' next steps where consistent trends occur, and by talking directly to Members. Outlined opposite are some of the ways in which we go about gathering this feedback.

**Annual General Meeting**

By opening up a savings account or taking out a mortgage with us, a customer will become a Member of the Society. Members have the right to make their opinion count, voice their thoughts and make a real difference to our future success and that's exactly why we invite all our eligible Members to register their vote at every year's Annual General Meeting (AGM). At the Meeting, Members have the chance to meet Principality staff and directors, hear more about our achievements over the past year and discover how we're planning to take the Society forward. But most importantly, eligible Members can vote on the election of directors and resolutions which are fundamental to our continued success. To us, being a Member of a mutual means ownership, openness, democracy, citizenship, participation, long-term, local and accountable.

Members are the cornerstone of our Society and as such our primary focus is on ensuring we provide a great experience for Members at all times throughout our relationship.

**Recommended every day**

Providing our Members with an exceptional service is of paramount importance to Principality and we are committed to becoming 'the most recommended financial services provider in Wales'. How well we are performing against this objective is measured by how likely our Members are to recommend us to family and friends based on the experience and service we offer. The key metric we use for this strategic objective is the industry-wide Net Promoter Score which measures Member loyalty based on a single question: 'How likely are you to recommend Principality's products or services?' In this past year we are proud to have achieved the number one status as the most recommended savings provider of high street banks and building societies in Wales.

To remain in this top spot we are continually asking our Members for feedback so we know what we've done well and ensure we keep doing it. Where Members have made suggestions to improve their experience with us we have where appropriate acted on them; Member feedback has helped us to understand the small differences that make a huge impact on Member satisfaction.

**Customer satisfaction**

This year we have introduced a new scheme for requesting feedback from Members which means that

Celebrating 10 years of the Principality Premiership

Coed Pen Maen Primary School, Pontypridd with their dream homes pictures

we will request feedback within 48 hours of a Member attending an appointment with us. This helps our colleagues get an immediate insight into how the customer felt after attending the appointment and gives them the chance to repeat what the customer liked and change what they didn't, ready for the very next appointment as well as their future appointments. Being asked for this immediate feedback has been very well-received by our Members who have welcomed the opportunity to tell us straight away what went well or what could be improved about an appointment. In fact, this initiative has been so positively received by our customers that we have a fantastic response rate of over 47% (a typical response rate is expected to be between two and ten per cent). Introducing this practice has been a very successful addition to our customer insight and has helped us to ensure we have consistency in our service levels and ensure we are driving a service, rather than a sales based culture right across the organisation.

In addition to the immediate post-appointment feedback we receive, we run a customer satisfaction survey every month that contacts a random sample of at least 160 customers. This provides us with an insight into satisfaction on a wider scale and we are very proud that this year our Members rated Customer Satisfaction at 86.8%*.

This year we also conducted a survey where we asked existing Members, and people who do not currently have a relationship with the Society, how different financial services providers (including the Principality) perform against a number of different measures. Not only did this help us understand what we might like to change in the future, it also gave us some extremely positive feedback about how we conduct our business right now. We were delighted to find that Principality was considered to offer the friendliest service, to be the most trustworthy and be the most customer focused financial services provider in Wales.**

**Research panel**
Another way in which we gather feedback is that we have a customer research panel which consists of 7,000 of our customers. The panel regularly helps us to understand the customer view on different elements of our business and is particularly helpful when we do something new. For example, we regularly ask the panel to read new product information leaflets and then we ask questions on the product to identify if we have presented the information in a clear way which is easily understood. The feedback we receive helps us to identify if there is anything else we can do to make it easier to understand. We also use our research panel to help us assess what new products and services our Members would like us to provide in the future and this helps us to map out the directions in which Members would like us to take the business.

**Talkback events**
We don't just rely on surveys to understand our Members' needs and desires; our senior leadership team holds regular Talkback events all over Wales which are open to all our Members. The Talkback sessions offer Members the opportunity to ask our senior leadership teams questions about the way we run our business. These sessions also give Members the chance to hear about our performance as a business and the different ways in which we support our local communities. The Talkback sessions are a great opportunity for us to find out what our Members like about us and what they would like us to change.

All of these different ways of gaining insight into our customers help us to ensure that whenever we are making decisions about our business we are putting the Member, and the best outcome for them, at the heart of everything we do. A great example of this it that our Members continue to

* Source: The Leadership Factory (TLF) Customer Satisfaction Survey, 12 months ending December 2014, 1983 responses.
** Source: Millward Brown Survey conducted in July 2014, customers and non-customers based in Wales were asked to select from a list of brand attributes that represented various financial services brands in Wales which included Principality, Nationwide, Lloyds Bank, Halifax, HSBC, NatWest, Santander, Barclays, First Direct, The Co-operative Bank, Tesco Bank, Virgin Money, TSB, M&S Bank, RBS.

# Member, colleague and community (cont.)

for the year ended 31 December 2014

tell us that our presence on the high street remains important to them, and so we remain committed to having a presence in our heartland of Wales and on the borders. So while many other banks and building societies are leaving town, this year we opened our Chepstow agency, increasing our network to a total of 71 outlets. We also understand that Members want greater accessibility through our digital and telephony channels and strongly believe that people deserve choice, diversity and excellent customer service in the financial marketplace however they choose to engage with us. This is why we continue to invest in our technology and telephony channels as well as our branch and agency network.

### Colleague

We recognise that our colleagues, and the way that they behave and deliver services for our Members, underpin the delivery of our strategy. Our ambition is for our colleagues to give their best, putting Member outcomes and service first. By doing this consistently, we anticipate that our Members will recommend us to their friends and family.

**Creating the right culture**

At Principality, we are committed to providing an environment in which our colleagues feel valued and respected so that everyone can contribute to building a successful building society. We recognise that our values and the way that we behave drive the culture of our organisation. Creating the right culture means having an organisation that people want to join and develop, and this drives staff satisfaction which in turn drives customer satisfaction. To unlock the great potential in our business and to ensure we are all aligned in supporting the strategy, we have four values:

- We're proud to be at the heart of our **communities**;
- Members and colleagues **trust** us to fulfil our promises;
- We challenge ourselves to always **perform** better; and
- We **work together** to build value for our Members.

Managers work with all our colleagues to help them achieve results through these values and behaviours, which are an important part of performance reviews and reward schemes. We believe that by focusing on our values, we will become even more resilient, effective and successful as an organisation.

**Colleagues**

A breakdown of colleagues by gender is presented below:

| | Female (% ) | Male (%) |
|---|---|---|
| Directors (including non-executive directors) | 32.0 | 68.0 |
| Senior managers | 46.0 | 54.0 |
| Colleagues | 64.8 | 36.2 |

Labour turnover, which measures how many of our colleagues are leaving of their own choice, is low at 11.24%. A number of factors contribute to this outcome:

- Colleague engagement;
- Job satisfaction;
- How our managers lead their teams; and
- The development of our colleagues to enhance their skills.

We are proud of how many of our employees have grown with us. The average length of service is approximately six and a half years.

Cwmbran branch celebrate their 1st birthday

Pentyrch Under 16s rugby team with their new Principality kit

**Diversity**
The Group is committed to providing employment practices and policies which recognise colleague diversity. We will not unfairly discriminate in our recruitment or employment practices on the basis of any factor which is not relevant to individuals' performance including sex, race, disability, age, sexual orientation or religious belief.

**Human rights**
The Group operates exclusively in the UK and, as such, is subject to the European Convention on Human Rights and the UK Human Rights Act 1998. We aspire to conduct business in a way that values and respects the human rights of our colleagues, Members, customers and those of the communities in which we operate.

**Listening to colleagues**
Our annual survey is an important way for us to listen to our colleagues, to find out how we are working together and to see how well we are building a service focused culture. Research shows there is a strong correlation between high levels of performance and engagement. With a high response rate of 87% (2013: 89%), we get a clear insight into how colleagues feel about working with us, especially through their individual comments.

Our recent survey showed that 83% of our colleagues are satisfied with the Group as their employer and 93% are proud to work for us. In addition, the survey revealed that:

- 95% of colleagues believe we are committed to customer satisfaction;
- 92% of colleagues believe fair treatment of customers is central to the way we do business; and
- 90% of our colleagues believe we place a genuine focus on serving the financial needs of our Members.

This year we have reached engagement levels of 84% compared to the financial services industry average of 69%.

We value the individual differences and input that people can bring to the Group, and we consistently look for ways to improve how we take account of the views of our colleagues. We hold annual colleague road shows, hold regular colleague meetings and Talkbacks, run "meet the executive" sessions, and circulate monthly newsletters and business briefings.

**Rewarding performance**
Managing performance plays a critical role in helping us to develop our colleagues to build long-term relationships with our Members as well as effective relationships internally.

Reflecting the regulatory environment, considerable progress has been made in realigning reward governance. We've continued to review our incentive frameworks to ensure that we are rewarding colleagues for not just what they achieve, but how they achieve it. This is supported by the performance management process.

We have reduced the maximum potential of variable pay and removed reliance on individual sales targets to ensure that our colleagues are motivated to deliver good customer outcomes for our Members. This is core to maintaining and enhancing the strong culture that underpins our commitment to being Recommended Every Day.

**Realising our potential**
Learning and development helps our colleagues to develop their ability to help us to provide the best customer service for our Members. We aim to benefit from the potential of our colleagues, so promotion from within and internal recruitment are strong aspects of the Society's culture. We actively encourage secondments to enable people to experience other areas of the organisation and share their knowledge.

2014 has seen a substantial development challenge to support the regulatory agenda, with a significant amount of time and resource being devoted to ensure that the building society, and therefore its Members, is secure. The changes to the mortgage regulations have seen over 100 colleagues developed to operate within this new regime. Additionally, and again with Members being at the heart of what we do, we've provided development to all customer facing colleagues in the areas of behaviours, a new customer feedback tool and new customer facing systems.

## Community
As Wales' largest building society we are extremely proud to be at the heart of our communities throughout Wales and its borders. For more than 150 years we

# Member, colleague and community (cont.)

for the year ended 31 December 2014

have embraced our mutual heritage and worked together to involve our colleagues, Members and local communities in activities that will benefit the people and areas around them.

We remain passionate about this and throughout 2014 we have increased our activities, giving our time to a range of school and community projects, supporting local organisations, raising money for our Charity of the Year and much more; really making a difference to those around us.

**Getting to the heart of our communities**

In 2014 colleagues at our 53 branches, 18 agencies and head office have been even more united with their communities than before. With over 1,600 hours of staff volunteering and over £40,000 invested in communities across Wales through local branch sponsorships, they have been out really making a difference to the people and the landscape of where they live.

Last year we launched Principality's Community Vote 2014, to help one community group or worthy cause win a gift of £5,000 to kick-start a project, in 2014 and a Christmas party. After whittling it down to five finalists our Members voted in their thousands to crown Pembrokeshire Young Carers the winners of the prize. The service supports young carers aged 8 to 25 years old who live in Pembrokeshire. They have used the money to take the young carers on day trips and holidays, giving them a break from their everyday caring roles, making a positive difference to their lives.

Resulting from the Community Vote 2014 we have also supported a number of the other nominated causes by volunteering, supporting stage shows for youngsters with special needs and putting on coaching sessions for children in Aberavon.

Our community outreach programme has also gone further this year, clearing beaches and national parks around Wales, building school gardens as well as providing sports kits, sponsoring choirs, circus groups, food festivals and much more.

One of our most exciting projects has been with Deaf Friendly Business Solutions where we have run a range of events to promote British Sign Language (BSL), including workshops for a selection of our staff to learn some basic sign language and financial terms that can be used in our branches. We have also brought together people from a range of organisations that we have worked with throughout the year to increase awareness of BSL. In November we held BSL workshops with representatives from organisations such as Neath Port Talbot College, Cardiff City Football Club, Touch Trust, Cardiff Volleyball Club, and the YMCA Housing Association and next year we hope to expand this initiative further to help even more people learn about BSL.

In 2014 we have worked with a range of organisations and with our partners, RSA and Legal & General, on projects including Dragons Den initiatives in schools, conservation work and community gardens. We have also tightened our relationship with Business in the Community Wales, working as a team to support a range of its Give and Gain projects around the country, as well as being one of the lead sponsors taking part in Wales Action Week.

**Supporting Welsh heritage and culture**

For the cost of a few pence per Member, our wide-reaching support for events and organisations throughout Wales positively impacts the lives of our Members as well as the people and the organisations throughout our communities in Wales.

This year we have celebrated some key milestones in our wide-reaching sponsorship programme with 2014 signalling the 35th anniversary of our support for the National Eisteddfod, the premier Welsh language festival. We are proud to have supported this important event in the Welsh cultural calendar, which has grown in popularity and size over the last 35 years, helping thousands of young people to highlight their skills and get an opportunity to perform on stage. We were delighted to win the Long-term Support Award at the Arts and Business Cymru Awards 2014 in recognition of this milestone.

2014 also marked the tenth year of our support for the Principality Premiership. Over the past ten years we have been proud to offer our support to grass roots sport in Wales, helping players to develop from the community playing field to the professional game. Today, as a highly competitive and progressive division, the Premiership is pivotal in the Welsh rugby environment. Celebrating the tenth anniversary of this league is a very special moment for us and highlights the pivotal relationships between us, the Welsh Rugby Union, the clubs and the communities in which they are based.

We have continued our support for the Royal Welsh Agricultural Show and extended our support for Only Boys Aloud, by sponsoring the choir for another three years. This will provide more opportunities for 14 to 19-year-old boys to develop life skills, whilst celebrating our Welsh heritage and culture as the choir expands its reach across Wales.

It has also been a year of firsts for Principality within our sponsorship programme. For the first time in his career, Tom Jones performed in North Wales as the global superstar took to the stage at Access All Eirias, which was supported by Principality for the third year in a row.

2014 was the first time that the Senior Open Championship golf had ever been played in Wales and Royal Porthcawl proved to be the perfect venue for this prestigious event. We were delighted that a number of our Members took up our offer of tickets and attended the event, meeting some of our staff, whilst also seeing some great golf over the course of the weekend.

The Principality Junior Wales Open made history in 2014 as the first mainstream open competition in Wales to accept disabled golfers playing under modified rules. The competition, which has been sponsored by Principality for four years, was a great success, showcasing the skills of our fantastic young male and female golfers from across Wales.

**Supporting future generations**
Leaving a legacy for future generations is something we are extremely passionate about and we have worked with a number of partners this year to increase our input into this. In 2014 we have continued our partnerships with two Cardiff high schools, Llanishen and Glyn Derw, giving pupils reading support from our colleagues and further help throughout the year.

Colleagues also took part in careers fairs and Dragons Den style workshops at schools in Chester, Llantwit Major, Newport and other areas of Wales, to improve young people's employability skills and foster the talent of future generations. Our continued focus on skills also led us to run our first employability workshops to help boost the confidence of unemployed people and get them ready for interviews with prospective employers. Working with Llamau and YMCA Housing Association we have run workshops and mock interviews with homeless people and people who need help with accommodation and support from around Cardiff.

In 2014, we have also joined Wales' pioneering Financial Services Graduate scheme working alongside Atradius, Admiral, GMAC UK PLC and Composite Legal Expenses to offer graduates the chance to experience a professional career in financial services first hand. The scheme gives participants two year paid placements across the business in order to foster home grown talent and create the future leaders and professionals in the sector, which has a strong - and growing - presence in Wales.

To foster Welsh talent further we have also taken on a range of students for summer placements and work experience across the business. We know that technology will be crucial to our business in the future so we have also introduced our own BI Academy, where people can become business intelligence developers through a series of training courses, group training, individual mentoring and practical exercises.

Additionally, we have partnered with the University of South Wales on its Network75 programme to offer students a five year placement at Principality. Network75 is a combined work and study route to a degree where undergraduates can apply their academic knowledge to real-life work within a host company. During term-time, Network75 students work in a local business three days per week and attend university two days per week. Network75 students also work full-time at their host company throughout holiday periods, apart from a 25 day holiday entitlement. From 2015 we will be taking in our first intake of undergraduates in our IT department and will look for other ways to support young people and increase their skills in other areas of our business.

**Helping people with Multiple Sclerosis with MS Society Cymru**
Every year we rely on the goodwill and inventiveness of our colleagues to nominate, vote and raise money for a Welsh charity that is close to their hearts. This year they chose MS Society Cymru as their Charity of the Year and we have not been disappointed with their efforts. For the last 12 months they have been holding bake sales, taking on triathlons, running competitions in our branches, bathing in beans and even shaving their heads to raise thousands of pounds for the charity.

In total we raised a record £86,000 for MS Society Cymru in 2014, which will go towards helping people with Multiple Sclerosis in Wales to hopefully make a positive difference to the lives of them and their families.

We are extremely passionate about our communities and in 2015 we want to extend our work even further to raise more money for our Charity of the Year Mind Cymru, to provide additional help to improve the Welsh economy and landscape and support more people and communities throughout Wales and the borders.

Nidus children's choir visit our Cwmbran branch

# Board of Directors
## for the year ended 31 December 2014

**Laurence Philip Adams MA (age 58)**
Chairman

Appointed a non-executive director of the Society in August 2013 and subsequently appointed Chairman in April 2014. He is a member of the Remuneration and Nominations Committees.

*Other Directorships and Appointments*
Non-executive director of Novae Group PLC and of Exane Limited.

**Gordon MacLean BA FCA (age 60)**
Senior Independent Director

Appointed a non-executive director in April 2006 and appointed to the role of Senior Independent Director in October 2013. He is Chairman of the Audit Committee and a member of the Nominations Committee. He is also a director of Nemo Personal Finance Limited and Loan Link Limited.

*Other Directorships and Appointments*
Director of 9 Highcliffe Road Management Company Limited.

**Graeme Howes Yorston FCIB MBA (age 57)**
Group Chief Executive

Joined the Society as Chief Operating Officer in July 2006. He was appointed as a director in October 2007 and became Group Chief Executive in October 2012. He is Chairman of Nemo Personal Finance Limited and Loan Link Limited.

Graeme is Chairman of the Group Management Committee, and a member of the Asset and Liability, Commercial Lending Asset & Liability Management Committees. He is a director of all the Society's subsidiary undertakings which have not carried on business throughout the year. These can be seen listed in note 22.

**Joanne Louise Kenrick LLB (age 48)**
Non-Executive Director

Appointed a non-executive director in January 2009, she is a member of the Customer and Conduct and Nominations Committees.

*Other Directorships and Appointments*
Marketing director of Homebase Limited, Board member of the Marketing Society, and a director of Safestore Limited and 53 Rosslyn Hill Residents Association Limited.

**Menna Richards BA OBE (age 61)**
Non-Executive Director

Appointed a non-executive director in June 2012, she is also Chair of the Customer and Conduct Committee and a member of the Nominations Committee.

*Other Directorships and Appointments*
Non-executive director of Glas Cymru and the Welsh National Opera, Pro-Chancellor of Cardiff University, Trustee of the ALOUD charity, and Vice-President of the Royal Welsh College of Music and Drama.

**Natalie Cecilia Elphicke LLB (age 44)**
Non-Executive Director

Appointed a non-executive director in July 2012, she is Chair of the Group Risk Committee, and a member of the Audit and Nominations Committees.

*Other Directorships and Appointments*
Co-founder of Million Homes, Million Lives, a not for profit organisation.

**Robert Michael Jones BA [Hons], MBA, ACIB (age 56)**
Group Risk Director

Joined the Society in 1997 and appointed to the Society's Board in February 2013. He is Chairman of the Group Credit Risk and Group Operational Risk Committees. He is also a member of the Group Management, Model Governance and the Asset and Liability Committees.

**Stephen James Hughes ACMA (age 42)**
Group Finance Director

Joined the Society in December 2011 as Group Deputy Finance Director. He was appointed to the Society's Board in March 2013. He is Chairman of the Society's Asset and Liability and Model Governance Committees and a member of the Group Management Committee and represents the Society on the Board of Arkose Limited. He is also Chairman of the Wales Advisory Board for Business in the Community (BITC).

**Nigel Charles Annett CBE, MSC, MA [Hons], DSC Econ (age 56)**
Non-Executive Director

Appointed a non-executive director of the Society in October 2013. He is Chairman of the Remuneration Committee and a member of the Customer and Conduct, Group Risk and Nominations Committees.

**Derek Anthony Howell BSc [Hons], FCA (age 60)**
Non-Executive Director

Appointed a non-executive director of the Society in April 2014. He is a member of the Audit, Group Risk and Nominations Committees.

*Other Directorships and Appointments*
Part-time consultant for PwC on the Lehman Brothers insolvency and Treasurer of St John Cymru Wales.

# Director's report
## for the year ended 31 December 2014

The directors are pleased to present the Annual Report and Accounts and Annual Business Statement of the Society and its subsidiary undertakings for the financial year ended 31 December 2014. The Audit Committee is responsible for considering on behalf of the Board whether the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary to Members to assess the Group's performance, business model and strategy.

In justifying this statement the Audit Committee has considered the robust process which operates in creating the report and accounts which includes the following actions:

- Revisions to regulatory requirements, including the UK Corporate Governance Code, are considered on an ongoing basis;
- Key accounting judgements are presented to Audit Committee for approval;
- Audit Committee consider whether the description of the Group's business model is accurate; whether the narrative reports explain the financial statements; whether the principal risks and uncertainties faced by the Group are clearly described, and whether projected solvency and liquidity positions over the next 24 months are adequate to support the going concern assumption;
- A thorough process of review and evaluation of the inputs in to the accounts is undertaken to verify accuracy and consistency, including review by senior management;
- A meeting of the Audit Committee is held to review and consider the draft annual report and accounts in advance of the final sign-off.

The Chairman of the Audit Committee reports the Committee's conclusions to the Board. Final sign off is provided by the Board of directors.

The directors confirm that, to the best of their knowledge, the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary to Members to assess the Group's performance, business model and strategy.

### Directors
The names of the directors at the date of this report, together with brief biographical details, are listed on pages 31 and 32.

Two non-executive directors, Dyfrig John (the former Chairman) and Langley Davies, resigned from the Board with effect from 17 April 2014 and 24 October 2014 respectively. One executive director, Guy Thomas, retired from the Board with effect from 31 October 2014. During the year, Derek Howell joined the Board on 1 April 2014. To comply with the UK Corporate Governance Code, and as permitted by Rule 26(1), all of the directors retire and stand for annual election at the Annual General Meeting. With the exception of Gordon MacLean, who will retire from the Board after the AGM in 2015, all are eligible and willing to continue serving on the Board and there have been no other nominations.

During the year no director of the Society was, or has since, been beneficially interested in shares in, or any debentures of, any connected undertaking of the Society.

### Auditor
At the Annual General Meeting on 17 April 2014 the Members passed a resolution that Deloitte LLP be reappointed as auditor for the ensuing year.

### Responsibilities of the directors
The following statement, which should be read in conjunction with the statement of the auditor's responsibilities on page 55, is made by the directors to explain their responsibilities in relation to the preparation of the Annual Accounts, the Report of the Remuneration Committee, the Annual Business Statement and the Directors' Report.

The directors are required by the Building Societies Act 1986 to prepare, for each financial year, Annual Accounts which give a true and fair view of the income and expenditure of the Society and the Group for the financial year and of the state of affairs of the Society and the Group as at the end of the financial year and which provide details of directors' emoluments in accordance with Part VIII of the Act and regulations made under it. In preparing the Annual Accounts, the directors are required to:

- Select appropriate accounting policies and apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable accounting standards have been followed; and
- Prepare the Annual Accounts on the going concern basis, unless it is inappropriate to presume that the Society will continue in business.

In addition to the Annual Accounts, the Act requires the directors to prepare, for each financial year, an Annual Business Statement and a Directors' Report, each containing prescribed information relating to the business of the Society and its connected undertakings.

### Directors' responsibilities for accounting records and internal controls
The directors are responsible for ensuring that the Group:

- Keeps accounting records in accordance with the Building Societies Act 1986; and
- Takes reasonable care to establish, maintain, document and review such systems and controls as are appropriate to its business in accordance with the rules made under the Financial Services and Markets Act 2000.

The directors have general responsibility for safeguarding the assets of the Group and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are also responsible for the integrity of the Society's website www.principality.co.uk. The work carried out by the auditor does not involve consideration of these matters and, accordingly, the auditor accepts no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website. Information published on the internet is accessible in many countries with different legal requirements relating to the preparation and dissemination of financial statements. Information in these financial statements is provided under the legislation of the United Kingdom.

### Going concern

The Chairman's statement and Chief Executive's review on pages 3 to 6, together with the Strategic Review on pages 7 to 16, set out a review of the Group's business for the year and the Society's future plans. In addition, note 39 to the financial statements on pages 95 to 110 gives details of the Group's financial instruments and hedging activities; and its exposures to credit, liquidity and market risk. The principal risks and uncertainties faced by the Society and the Group, financial risk management objectives and policies, and the way in which the Group uses financial derivatives, are summarised in the Risk Management report on pages 17 to 24 and in note 39.

As presented in the consolidated statement of financial position, the Group continues to meet its funding requirements, which include the need to maintain a sufficient liquidity buffer, mainly from retail sources. Whilst wholesale funding markets are currently open and liquid, the current economic conditions create some uncertainty regarding the continued availability of funding over the longer term.

The Group's forecasts and projections include scenario testing as carried out in accordance with the Internal Capital Adequacy Assessment Process (ICAAP) and Individual Liquidity Adequacy Assessment (ILAA), which are processes required by the Prudential Regulation Authority to demonstrate appropriate levels of capital and liquidity respectively under stressed scenarios reflecting the directors' views of different risks that might arise under varying economic conditions. These scenarios take account of reasonably possible changes in trading performance, and show that the Group will be able to operate within the sources of funding currently available to it, even under stressed scenarios. In addition to these sources, contingency funding plans are in place.

The assets held for liquidity purposes are assessed and regularly reviewed for counterparty risks, and the directors consider that the Group is not exposed to losses on those assets that would affect the decision to adopt the basis of going concern. The directors consider that the overall level of capital, including Common Equity Tier 1 capital of £375.7m (18.2% as a percentage of risk-weighted assets), and a solvency ratio of 22.45% are adequate.

Having considered the plans and forecasts for the Group, the directors are satisfied that there are adequate resources and no material uncertainties that lead to significant doubt on the Group's ability to continue in business for the foreseeable future. Accordingly, the financial statements continue to be prepared on a going concern basis.

### The future

Whilst 2014 has seen an improvement in the UK economic environment, concerns remain over the impact of uncertainty in the global economy and the potential impact on the UK. Public and political interest in financial services will not diminish and we continue to work closely with our regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

Despite the difficult environment, the Board remains confident of Principality's continued position as a key player in the Welsh economy, well placed to weather the challenges that lie ahead.

On behalf of the Board of Directors.

C. P. Adams

Laurence Philip Adams
Chairman
10 February 2015

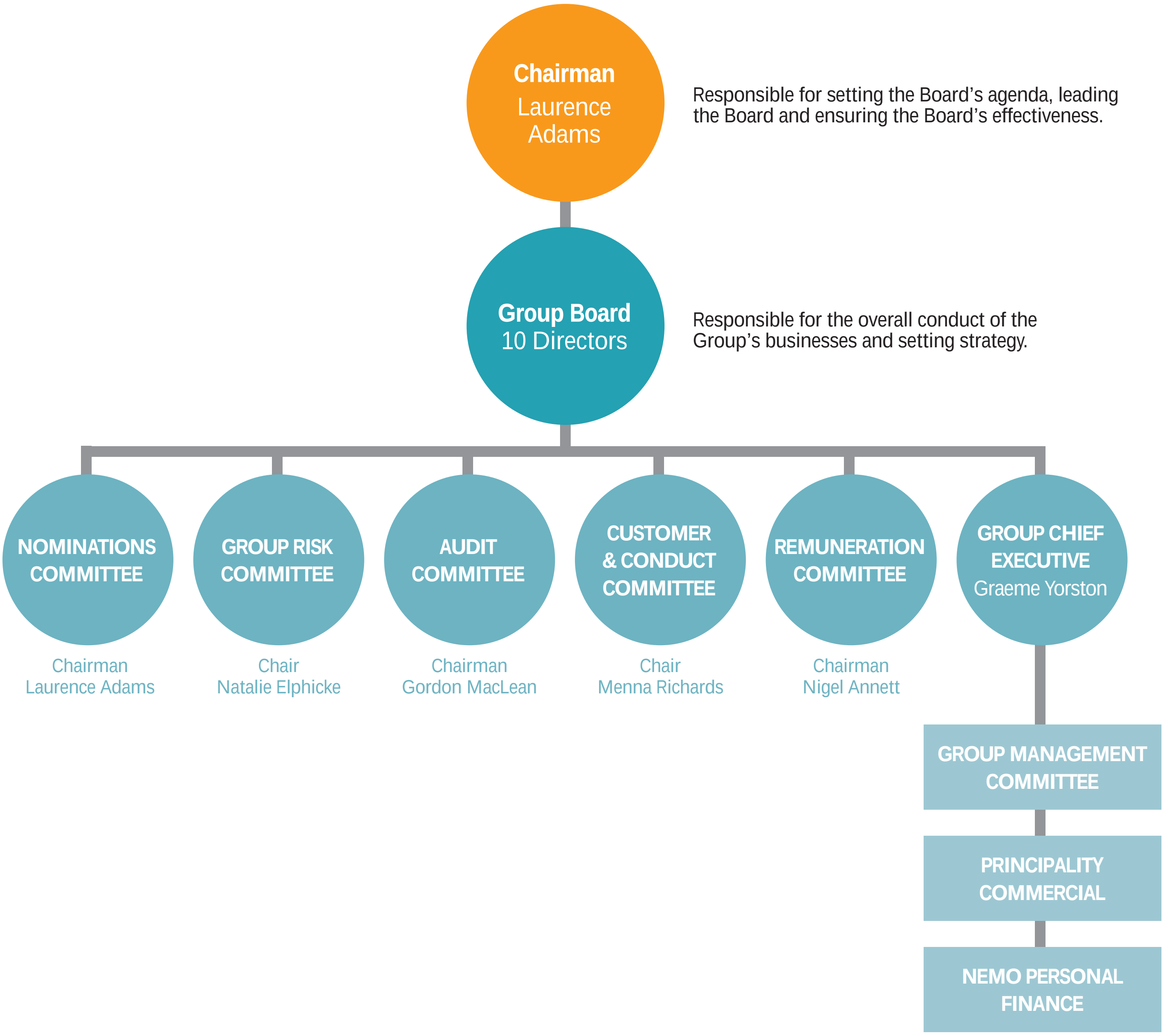
# **Corporate governance** report

## for the year ended 31 December 2014

The Society voluntarily complies with the UK Corporate Governance Code (the Code) issued by the Financial Reporting Council in so far as its provisions are relevant to building societies. The Code is designed to primarily apply to listed companies and sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and a number of other matters and is updated every two years. The new edition of the Code took effect for reporting periods beginning on or after 1 October 2014. Consequently for the year ending 31 December 2014, the Society continues to report against the version of the Code published in September 2012. The Code also provides guidance in relation to audit committees, risk, nominations and remuneration committees. This report summarises the Society's approach to corporate governance.

### Corporate governance framework

The Board is responsible for ensuring that a strong and effective governance system and appropriate culture is in place throughout the Group. The Board recognises that ensuring effective corporate governance is integral to the successful delivery of the Society's goals. The work of the Board is supplemented by the work performed by a number of Board sub-committees.



### How the board operates

At 31 December 2014, the Board comprised of three executive directors and seven non-executive directors. The offices of Chairman and Group Chief Executive are separate and held by different individuals. In accordance with the Code all directors stood for re-election in 2014 and were duly re-elected. All directors will again stand for re-election at the 2015 Annual General Meeting.

The Chairman is responsible for the leadership, operation and governance of the Board, ensuring the effectiveness of the Board, setting the Board's agenda, style and tone of Board discussions and ensuring that directors receive accurate, timely and clear information. The Chairman is not involved in the day-to-day management of the Society. The Chairman's role profile has been approved by the Board and is reviewed annually. The Senior Independent Director is responsible for acting as a sounding board for the Chairman, serving as an intermediary for other directors, being available to Members if they have concerns which they have not been able to resolve through the normal channels of the Chairman, Group Chief Executive or other executive directors or for which such contact is inappropriate.

The Group Chief Executive's responsibilities are set out in a role profile approved by the Board. He is responsible for managing the Group's businesses, implementing the Board approved strategy and policies and chairing the Group Management Committee. He maintains a close working relationship with the Society's Chairman.

The Board is responsible for the overall conduct of the Society and its subsidiary businesses and is accountable to the Society's Members for the proper conduct of those businesses. In addition to focusing on strategic issues, control of the business, review of operational and management performance, oversight of subsidiary companies and maintaining effective risk management and corporate governance systems the Board is also responsible for fostering transparency and honesty across the Group and ensuring that good standards of behaviour permeate throughout all levels of the organisation. The Board has a formal schedule of matters reserved for its decision which is reviewed annually by the Board. Amongst others, the following matters are reserved to the Board:

- Responsibility for the overall strategic management of the Group;
- Approval of the Group's long-term objectives;
- Prescription of minimum capital limits/ratios, changes relating to the Group's capital structure;
- Approval of the Annual Report and Accounts including the Corporate Governance Statement and remuneration report;
- Approval of the Group's Risk Appetite Statement; and
- Approval of any changes affecting the Group's risk management/governance frameworks.

A framework of delegated authority is in place, which extends to the Society's officers, management and various subsidiary company boards and management committees. This is reviewed annually by the Board. No political donations were made by the Society in the year.

### Board composition

The Board consists of ten directors including the Chairman (Laurence Adams), six independent non-executive directors (including Gordon MacLean – Senior Independent Director) and three executive directors. Executive and non-executive directors are equal members of the Board and are collectively responsible for setting the Group's strategy. In particular non-executive directors are required to have a wide range of skills and experience and exercise independent judgement on strategy, performance, risk management and corporate governance. In addition their role is to:

- Constructively challenge strategy proposals presented by the Group Chief Executive and executive directors;
- Scrutinise and challenge performance across the Group;
- Assess the integrity of the financial information and controls;
- Assess the adequacy of the Group's risk management framework;
- Determine the broad policy for executive remuneration and the remuneration packages for executive directors and the Chairman; and
- Be satisfied that an appropriate culture is in place across all Group businesses.

There have been a number of changes to the Board during the year, which have been detailed previously within the report. Derek Howell will stand for election for the first time in accordance with the Society's Rules at the 2015 Annual General Meeting.

Gordon MacLean has announced plans to retire from the Society's Board and consequently will not be standing for re-election at the 2015 Annual General Meeting.

### Tenure of non-executive directors

The UK Corporate Governance Code recognises that length of tenure is an important factor which should be considered when determining the independence of non-executive directors. The table below shows the tenure and independence of each non-executive director.

| | Date First Elected | Years from first election to 2014 AGM | Considered to be independent by the Board |
|---|---|---|---|
| Gordon MacLean | April 2007 | 7 | Yes |
| Joanne Kenrick | April 2010 | 4 | Yes |
| Natalie Elphicke | April 2013 | 1 | Yes |
| Menna Richards | April 2013 | 1 | Yes |
| Nigel Annett | April 2014 | N/A | Yes |
| Laurence Adams | April 2014 | N/A | Yes |
| Derek Howell | N/A | N/A | Yes |

# **Corporate governance** report (cont.)

## for the year ended 31 December 2014

### Conflicts of interest

The Board has established procedures leading to the disclosure of outside interests and the identification of potential conflicts of interest. The procedure is as follows:

- Changes to the commitments of all directors are reported to the Board.
- Directors are responsible for notifying the Group Secretary if they become aware of any actual or potential conflict situations.
- Actual or potential conflict of interest are noted in the minutes of Board meetings as appropriate.
- The Group Secretary maintains a register of potential conflicts of interest which is reviewed periodically.

No conflicts of interest were reported to the Board during the year.

All the Society's non-executive directors are considered by the Board to be independent in judgement and free of any relationships likely to affect his or her judgement having regard to this information.

The Board continues to be satisfied that, although having served more than two continuous terms of three years, Gordon MacLean continues to meet the independence criteria for non-executive directors.

The Board operates through its regular meetings and five committees – Audit, Remuneration, Nominations, Group Risk and Customer and Conduct Committee all of which have written terms of reference. Matters considered at all Board meetings include: the Group Chief Executive's report on strategic and business developments; the Group Finance Director's report including the latest management accounts; the Group Risk Director's report including updates on strategic, regulatory and operational risks to which the Group is exposed; operations report and, where applicable, reports from the Chairs of each of the Board's Committees.

With effect from September 2014 the Board resolved that the membership of Board committees should be reserved to non-executive directors although executive directors and members of the senior management team continue to attend meetings of those committees as appropriate. The terms of reference of all Board committees are reviewed annually together with the membership of those committees.

### Group management committee

The Group Management Committee is the principal management committee of the Society and its subsidiary businesses. It is responsible for:

- Making recommendations to the Board concerning strategy, policies and budgets.
- Making recommendations to the Board in connection with new business initiatives and submitting investment appraisals to the Board.
- Ensuring that strategic, prudential, conduct and operational risks arising in connection with the Group's activities are managed effectively within the Board approved appetite for risk.
- Monitoring the performance of the Society and its subsidiary businesses.

### Board and committee membership and attendance record

| | Board | Audit | Customer and Conduct | Group Risk | Nominations | Remuneration |
|---|---|---|---|---|---|---|
| Dyfrig John | 4/4 | - | 1/1 | - | - | 2/2 |
| Langley Davies | 10/10 | 5/5 | 1/1 | 4/4 | 1/1 | - |
| Gordon MacLean | 14/15 | 7/7 | 1/1 | - | 3/3 | - |
| Joanne Kenrick | 11/15 | - | 4/5 | - | 3/3 | - |
| Menna Richards | 14/15 | - | 5/5 | - | 3/3 | 1/1 |
| Natalie Elphicke | 15/15 | 7/7 | 1/1 | 7/7 | 3/3 | - |
| Nigel Annett | 14/14 | - | 5/5 | 5/5 | 3/3 | 4/4 |
| Laurence Adams | 14/15 | - | - | 2/2 | 2/2 | 4/4 |
| Derek Howell | 10/11 | 4/5 | 1/1 | 3/3 | 2/2 | - |
| Graeme Yorston | 15/15 | - | 3/3 | 3/4 | - | - |
| Guy Thomas | 11/12 | - | - | - | - | - |
| Michael Jones | 15/15 | - | 3/3 | 4/4 | - | - |
| Stephen Hughes | 15/15 | - | - | - | - | - |

Principality staff walk the 3 Peaks in aid of MS Cymru

## Nominations committee

The Nominations Committee is responsible for making recommendations for appointments to the Board. The Committee consists of all non-executive directors. It is chaired by Laurence Adams, the Society's Chairman, and meets as and when required to consider and recommend new appointments to the Board.

Non-executive candidates are sought in various ways, including through press advertisements and with the assistance of external search consultants. Candidates must meet the tests of fitness and propriety as prescribed by the FCA and must receive approval from the FCA and PRA as an Approved Person before taking up their role. In addition, the Society's Rules require that new directors must stand for election at the Annual General Meeting in the year following the year in which they are appointed.

When assessing new appointments to the Board, the combined skills and experience of the existing Board members is reviewed to determine what characteristics are required from a new director. Each Board member must have the skills, experience and character that will enable him or her to contribute both individually, and as part of a team, to the effectiveness of the Board and the success of the Society. The Society believes that diversity amongst Board members is of great value but that diversity is a far wider subject than just gender. Careful consideration is given to issues of overall Board balance and diversity in making new appointments to the Board.

The Committee has written terms of reference which are reviewed annually. The Committee is responsible for succession planning and acts as a nomination committee for all new Board appointments. The terms upon which directors are appointed are available from the Group Secretary on request. The Committee reports on its activities to the Board.

A copy of the letter of appointment for a non-executive director can be obtained on request from the Group Secretary.

## Audit committee

The Committee is chaired by Gordon MacLean with Derek Howell (appointed 1 April 2014) and Natalie Elphicke as its other members. All of these are independent non-executive directors. Gordon MacLean and Derek Howell have recent and relevant financial experience. Langley Davies retired from the Committee on 24 October 2014. The Group Chief Executive, the Group Finance Director, the Group Secretary, the Chief Internal Auditor, and representatives of Deloitte, the external auditor, attend each meeting. The Assistant Secretary acts as secretary to the Committee. The Committee acts as an Audit Committee for the Society and its subsidiary companies.

The Committee's responsibilities include:

- Monitoring the integrity of the Group's financial reporting;
- Reviewing the Group's internal control and risk management systems;
- Monitoring and reviewing the effectiveness of the Group's internal audit function;
- Ensuring that the systems and controls for regulatory compliance are effective;
- Monitoring the effectiveness of the Group's Financial Crime Prevention function; and
- Monitoring the relationship between the Group and the external auditor.

During the year the Committee met on seven occasions. It monitored the integrity of the financial statements and formal announcements relating to the Group's financial performance and reviewed relevant accounting policies and any significant financial judgements.

The Committee has conducted detailed reviews of the interim and year-end financial statements, which have included consideration of the narrative reports, description of the Society's business model, strategy and risks faced by the Group, and recommended them to the Board for approval. Following discussion with both Management and the external auditor, the Audit Committee determined that the key risks of misstatement of the Group's financial statements related to the following areas where judgements are required:

- Going concern assessment;
- Impairment provisions on loans and advances;
- Provisions for regulatory and customer complaints;
- Financial Services Compensation Scheme levy;
- Revenue recognition under IAS39 using the effective interest rate method;
- Hedge accounting;
- Fair value measurements;
- Financing and funding transactions;
- Retirement benefit obligations; and
- Profit on disposal of Peter Alan.

# **Corporate governance** report (cont.)

for the year ended 31 December 2014

After reviewing reports presented by Management and after consulting with the Society's auditor, the Audit Committee is satisfied that the financial statements appropriately address the critical judgements and key estimates. The Committee is also satisfied that the significant assumptions used for determining the value of assets and liabilities have been appropriately scrutinised, challenged and are sufficiently robust.

The auditor has reported on both the interim and year-end financial statements and those reports were considered by the Committee prior to recommending approval of the financial statements to the Board. In particular the auditor reported on the work carried out on the most significant areas of audit risk and where accounting assumptions and estimates have been applied and on how it satisfied itself that these were reasonable.

Management confirmed to the Committee that they were not aware of any material misstatements or immaterial misstatements made intentionally to achieve a particular presentation. The auditor provided the Committee with a summary of misstatements identified during the course of the testing and no material amounts remain unadjusted.

During the year the Audit Committee also approved the Pillar 3 disclosures made in accordance with the PRA's Handbook.

The Committee is responsible for making recommendations to the Board on the appointment, reappointment, remuneration and removal of the external auditor and for the maintenance of an appropriate relationship with the Society's external auditor. During the year the Committee has reviewed and approved the external auditor's overall work plan and considered in detail the results of the audit, the performance and independence and the effectiveness of the overall audit process.

The Committee receives regular reports on the effectiveness of the Group's systems and controls framework including financial controls, internal control and risk management systems and controls. It has approved the Group Internal Audit plan and regularly reviewed the progress being made by the Internal Audit department, the adequacy of the resources available to that department, and Management's implementation of its recommendations. The Chief Internal Auditor has direct access to the Committee Chairman and the Society's Chairman. During the year the reporting line has changed with the Head of Internal Audit now reporting directly to the Committee Chairman. The Committee has held private meetings with the Chief Internal Auditor and Deloitte during the year. The Committee has held four private meetings in the absence of Management during the year.

The Committee has received regular reports from the Head of Group Financial Crime Prevention on financial crime matters, the progress of the Financial Crime team and adequacy of the resources available to that team. It has also reviewed the Group's "whistleblowing" procedures and has been satisfied that arrangements are in place to enable individual employees to raise concerns about possible improprieties on a confidential basis. The Group maintains a financial crime policy and the Audit Committee receives an update at each meeting in relation to any material fraud and associated action taken.

Immediately following each Audit Committee meeting the Chairman of the Audit Committee provides a verbal update to the Society's Board of Directors on matters considered by the Committee. In addition, the Board also receives the agenda and minutes of meetings of the Committee.

Principality sponsored the kit of Pen Y Banc Ladies RFC

Local branch sponsor the kit at Rumney Bowls Club

The Committee conducts an annual review of its own effectiveness. This process involves a collective review by members of the Committee of: its own procedures; resources available to the Committee; the means by which the Committee performs its role; review of its relationship with the Board; and arrangements for reporting to Members on the work of the Committee.

## Auditor independence

The Audit Committee is responsible for assessing the effectiveness of the annual audit process, for monitoring the independence and objectivity of the external auditor and for making recommendations to the Board in relation to the appointment of the external auditor.

In order to safeguard auditor objectivity and independence, the Audit Committee maintains a formal policy which governs the engagement of the external auditor (presently Deloitte LLP) for non audit services. The policy is designed to ensure that the provision of such services does not have an impact on the external auditor's independence and objectivity. It identifies engagements that can only be undertaken with appropriate authority from the Committee Chairman or the Committee where non-audit fees will exceed pre-set thresholds. The Committee receives a schedule of fees for non-audit work paid to the audit firm at each meeting and an annual report on the non-audit services being provided and the cumulative total of non-audit fees. The audit fee for the year in respect of the Group was £181k. Non-audit fees, primarily in relation to the provision other assurance and taxation services, were £230k.

The Audit Committee assesses annually the qualification, expertise, resources and independence of the external auditor. The Committee conducts a formal review of the effectiveness of the annual audit. Members of the Committee and senior members of the Group Finance team consider a number of relevant questions. The Committee conducts this evaluation without the auditors being present. There is regular rotation of the audit partner responsible for the audit engagement (the present audit partner has been in place since 2012), and each year the external audit firm confirms to the Audit Committee that it considers itself to be independent as defined by the rules of the Institute of Chartered Accountants in England and Wales.

In considering the re-appointment of the audit firm, the Audit Committee has discussed the length of tenure of Deloitte LLP and the circumstances under which a re-tender for the provision of external audit services would be appropriate. Deloitte LLP took up their role as the Society's auditor in 2007 following the completion of a tender process in that year. As a consequence of the fact that the existing auditor has served for longer than five years and in accordance with the existing policy framework, the Audit Committee considers annually whether to commence the competitive tender process for the audit. In 2014 the Committee concluded that the external auditor continued to meet the test for independence and agreed that it was not necessary to commence the competitive tender process in 2015. Taking account of these factors the Audit Committee recommended the re-appointment of Deloitte LLP as auditor to the Board and this resolution will be put to Members at the 2015 Annual General Meeting.

## Remuneration committee

This Committee is chaired by Nigel Annett. The other members of the Committee during the year were, Laurence Adams and Dyfrig John (until April 2014) and, from September 2014, Menna Richards. It considers remuneration policy and the Board delegates to this Committee decisions on executives' remuneration and compensation packages. The Committee monitors changing trends in directors' remuneration in the marketplace including consideration of the FCA Code on Remuneration Practice. The Committee is responsible for maintaining the Group's Remuneration Policy. In performing its duties the Committee draws on the advice of independent consultants who have no other connection with the Society. No individual is present at a meeting when his or her own pay is decided. Fees payable to the Chairman and other non-executive directors are determined by the Board on recommendations from the executive directors. Details of directors' remuneration are set out on page 49.

The Committee reports on its activities to the Board.

## Group Risk Committee

A full report on the work performed by the Group Risk Committee can be found on page 17.

# Corporate governance report (cont.)

for the year ended 31 December 2014

## Customer and conduct committee

This Committee is chaired by Menna Richards. The other members of the Committee during the year were Joanne Kenrick, and Nigel Annett. Graeme Yorston (Group Chief Executive) and Julie-Ann Haines (Customer Director) served as members of the Committee until 31 August 2014. The Group Chief Executive, Customer Director, Group Risk Director, Group Human Resources Director, Group Secretary and a number of other senior managers from across the Group also continue to attend meetings of the Committee. The Committee is responsible for maintaining an appropriate Business Conduct Strategy and setting standards leading to fair outcomes for customers across the Group. Amongst other activities the Committee also ensures that: the principles underpinning the Conduct Strategy are adhered to across the Group; the needs of customers are central to the Group's operations and that a clear, customer focused culture is maintained. The Committee reports on its activities to the Board.

Copies of the Terms of Reference for each Board Committee are available on request from the Group Secretary. They can also be found on the Society's website: www.principality.co.uk

## Information and training

The Board has full and timely access to all relevant information to enable it to discharge its duties effectively. The Chairman is responsible for ensuring that all directors are properly briefed on issues arising at Board meetings.

All directors have access to the advice and services of the Group Secretary. Members of the Board may take independent professional advice at the Society's expense in the furtherance of their duties. The Group Secretary is responsible for ensuring that Board procedures are followed.

The Chairman is responsible for ensuring that each director receives induction training on joining the Board and receives the subsequent on-going training he or she requires. The Society maintains a programme for meeting directors' training requirements. Keeping up to date with key business developments is essential in order that directors may maintain and enhance their effectiveness. This is achieved through:

- Presentations made to the Board from executives and senior managers drawn from within the business on key developments and significant matters;
- Providing the Board with updated financial plans, budgets and forecasts which are discussed regularly by the Board;
- Providing the Board with regular updates on the economic and regulatory environments within which the Society operates and providing non-executive directors with briefings and meetings with senior executives and managers; and
- Providing Board members with access to external training sources.

## Performance evaluation

The Chairman conducts an annual performance evaluation interview with each non-executive director and the Group Chief Executive. The Group Chief Executive carries out an annual performance appraisal with each of the other executive directors. The Senior Independent Director evaluates the performance of the Chairman annually.

During 2014 the Board undertook an evaluation of the performance of the Chairman and an evaluation of its own performance. The Audit, Remuneration, Customer and Conduct Committee and Group Risk Committees each undertake annual reviews of their own effectiveness.


Staff cycled to every Principality branch in the East Region

Principality's Group Finance Director, Steve Hughes, talking to Members at our 2014 AGM

### Communication with Members and the Annual General Meeting

The Society is committed to maintaining good communications with Members. During the year three meetings were held by the Members' Forum as well as three talkback sessions with groups of Members. These meetings were attended by various Society directors. These meetings provide valuable means for Members' opinions about the Society to be canvassed by directors.

The Society encourages all eligible Members to participate in the Annual General Meeting, either by attending in person or by voting by proxy. A resolution on the Report on Directors' Remuneration is included on the agenda. Voting is encouraged through a donation to charity for each voting paper received. All proxy votes are returned to independent scrutineers, who also attend the Meeting in person to count votes cast by Members. In accordance with the Society's rules, all eligible Members are sent the Notice of the Annual General Meeting at least 21 days prior to the Meeting.

### Risk management and internal control

The Board has overall responsibility for maintaining sound risk management and internal control systems and for reviewing their effectiveness. It includes financial, operational and compliance controls as well as risk management. The processes used to assess the effectiveness of the internal control system, and which have been in place throughout the year, include the following:

- Regular operational and financial reviews of performance against budgets and forecasts by management and the Board;
- Regular reviews by management and the Audit Committee of the scope and results of internal audit work across the Group. The scope of the work covers all key activities of the Group and concentrates on higher risk areas;
- Reviews by the Audit Committee of the scope of the work of the external auditor and any significant issues arising;
- Reviews by the Audit Committee and the Board of accounting policies; and
- Consideration by the Group Risk Committee and the Board of the major risks facing the Group and procedures to manage them.

There is an on-going process for identifying, evaluating and managing the significant risks faced by the Group. The process currently consists of:

- Formal identification by management across the Group through a self-assessment process of the key risks to achieving its business objectives and the controls in place to manage them. The likelihood and potential impact of each risk is evaluated;
- Independent review by Group Internal Audit as to the existence and effectiveness of the risk management activities; and
- Regular review by the Board, the Group Risk Committee and the Customer and Conduct Committee of perceived strategic, prudential, conduct and operational risks.

This process has been in place throughout the year. The Group Risk Committee receives reports on the status of these risks. The Committee reports on this to the Board which in addition carries out regular exercises to validate management's conclusions on the major strategic risks facing the Group.

Laurence Philip Adams

Chairman
10 February 2015

# Report of the **Remuneration Committee**

## for the year ended 31 December 2014

On behalf of the Board, I am pleased to present the Remuneration Committee's 2014 Report which sets out our Remuneration Policy and provides for our Members details of the basic salary, variable pay and benefits earned by directors in the year to 31 December 2014.

Our Remuneration Policy aims to align executive remuneration with the delivery of the Board's strategy, which is to deliver the best outcomes for our Members and ensure that the business is run safely and successfully.

We keep our Remuneration Policy under review so that it continues to support what we aim to achieve for the Society and our Members. In recent years, the Committee has made a number of important changes to the application of our Policy by, for instance, strengthening the importance of achieving fair outcomes for Members and customers in the calculation of variable pay and by reducing significantly the maximum variable pay award that could be achieved.

The Committee continues to believe that a carefully controlled performance related variable pay policy is in the interests of the Society and Members. Not only does it reward the achievement of stretching targets set by the Board each year allowing remuneration to be aligned with results but it also means that costs can be reduced if for any reason financial performance deteriorates. At the same time, the Committee is alert to the risks arising from excessive variable pay awards and it is partly for this reason that the Committee has set the potential for variable remuneration at a level below that of our peer group of major building societies and very significantly lower than other major financial institutions.

Our executive leadership team has delivered another strong performance this year. Sound management and the benefits of strategies put in place in previous years have meant that the Society has a secure financial position which is key to ensuring that our Members' savings are safe and our products and services are competitive and provide real value. The Committee believes that having appropriate remuneration policies in place, as summarised in this 2014 Report, has contributed to this satisfactory result.

### 2014 key decisions and annual variable awards

The Remuneration Committee consists of non-executive directors only and has delegated authority from the Board to review and approve the Society's Remuneration Policy, approve remuneration of the executive directors and (in consultation with the Group Chief Executive) senior management. It also oversees the remuneration of all other staff who have a material role with respect to the Society's risk profile, approves all variable pay schemes together with relevant targets, and reviews proposals on the remuneration of the non-executive directors, including the Chairman for recommendation to and approval by the Board.

In 2014, the Remuneration Committee decided that the basic salary of executive directors (with the exception of the Group Chief Executive and Group Risk Director) should increase by 2.25%. This increase was equal to the average pay increase awarded to all other colleagues in the Group.

Graeme Yorston was appointed as Group Chief Executive for the Society in September 2012 and his basic salary was not reviewed in 2013. The Remuneration Committee commissioned a report from remuneration consultants, New Bridge Street, and, based on their recommendation, agreed to increase the Group Chief Executive's basic salary by 8% to £335,000, from 1 January 2014, with no further review until February 2016. This means that over the three year period, 2012 to 2015, the average annual increase in basic salary for the Group Chief Executive is 2.7%.

In February 2014 we reviewed the remuneration of Michael Jones, Group Risk Director, in the light of his greatly increased responsibilities. Having reviewed remuneration levels for this key role across the sector, the Remuneration Committee agreed to increase his basic salary by 24% to £230,000. Importantly, given his special responsibilities, the Group Risk Director does not participate in any variable pay scheme.

Turning to variable pay, the maximum annual variable pay award for all executive directors (other than the Group Risk Director) for the year ended 31 December 2014 was 40% of base salary, with 20% of base salary payable for achieving "on target" performance which would represent a very satisfactory result for the Society and Members. Variable pay is based on two key financial measures and two key customer satisfaction measures and is subject to personal objectives being achieved as well as critical financial metrics for the Society's overall capital, liquidity and risk position being met.

The executive variable pay awards have been calculated on the basis of profit before tax before excluding the exceptional items which have arisen from the sale of Peter Alan and the change made to the closed defined benefit pension scheme. The Committee has approved a variable pay award of 29.5% of basic salary in respect of 2014, of which half is deferred for one year except for Graeme Yorston and Guy Thomas. The Committee agreed that Guy Thomas, who retired on 31 October 2014, should receive a pro rata payment for the 10 months he was in post in 2014. In line with the Remuneration Code, 40% of the award for Graeme Yorston and Guy Thomas will be paid in 2015 with the balance of 60% of the variable pay award being paid in equal instalments over the following three years. Any deferred remuneration may be reduced or forfeited if for any reason the basis on which it was calculated proves to have been incorrect, or for any other reason at the discretion of the Remuneration Committee. The Committee applied this discretion in 2014 and we will continue to ensure that all deferred pay is only payable when confirmed by the group's performance in subsequent years.

Further details regarding basic salary and variable pay awards for the executive directors are set out on page 49 of this 2014 Remuneration report.

Dyfrig John retired as Chairman following the 2014 Annual General Meeting and was succeeded by Laurence Adams who was appointed following a thorough selection process. As part of this process, the level of fee for this role was benchmarked against the same role for our peer group of major building societies and the Board agreed to increase the annual fee by 18% to £110,000. (Notwithstanding this increase the fee payable to our Chairman continues to be the lowest in our peer group).

### Looking ahead

The Committee's approach to executive and senior management remuneration for 2015 will remain broadly unchanged from 2014. However, we will keep under review our overall remuneration policy particularly in the light of regulatory requirements and other changes being implemented in the wider financial


Principality staff working hard on Flatholm Island

services sector more generally. That said, we will always seek to ensure that our remuneration policy produces for the business a framework for reward that is as straightforward and simple as possible, is competitive and in particular places most importance on sound risk management.

The basic salaries for executive directors (excluding the Group Chief Executive) will be determined in February 2015 at the same time as all other colleagues. The maximum potential variable pay award for executive directors, which was reduced from 100% to 40% of basic salary in 2013, will remain unchanged at 40% with 20% of basic salary being the award for achieving the challenging targets set for the business by the Board. The Committee is satisfied that the targets set for 2015 will drive significant sustained improvement in the performance of the Group.

Principality is committed to best practice in corporate governance and as such we provide full details of our directors' remuneration and ask our Members to approve our Remuneration Report through an advisory vote at the Annual General Meeting. Our 2014 Report includes the key disclosure requirements of the UK Corporate Governance Code and follows the best practice that applies to our sector as well as complying with regulatory requirements including in particular the Financial Conduct Authority's Remuneration Code.

On behalf of the Remuneration Committee of the Board I am happy to recommend our 2014 Report to Members for approval at our Annual General Meeting.

Nigel Annett

Chair of the Remuneration Committee

## Introduction

We are proud to be a mutual building society owned by our Members. Our purpose is to deliver good outcomes for our Members, both savers and borrowers. This means we must keep our Members' savings safe and we must offer good and competitive products and services to our Members that meet their needs. Our team right across the business has to be well trained and motivated and understand what it means to be a mutual building society and the trust our Members place with us. We must ensure we generate sufficient profits to ensure that we maintain a strong capital position and run the business efficiently keeping our costs under control.

This thinking underpins our Remuneration Policy which is above all designed to ensure that the business is run safely and successfully for our Members.

Our Remuneration Policy aims to:

- Attract, motivate, reward and retain high quality people who can ensure that Principality continues to deliver value to Members and to be profitable in a competitive, and often uncertain, marketplace by positioning basic salaries and benefits, both in terms of total amount and structure (i.e. the balance of fixed and variable pay), at around market levels for similar roles within the UK mutual building society sector, as well as more broadly where this is appropriate;
- Incentivise performance by having a competitive variable pay scheme which rewards our executive directors for the achievement of challenging objectives set by the Board each year where performance is judged against a range of critical financial and other key customer service measures while ensuring that the executive team is not encouraged to focus on any one measure at the possible expense of other priorities;
- Promote the right behaviours that align with the Society's position on risk as well as its culture as a Member owned mutual building society; and
- Encourage sound conduct and risk management practices, in particular by setting capital and liquidity hurdles that must be met before any variable pay award can be made, and by deferring an element of variable pay which allows the Remuneration Committee to reduce or withhold the deferred element if it turns out that the basis on which the variable pay award was made was wrong or that financial performance has deteriorated materially before the deferred payment is made.

# Report of the **Remuneration Committee (cont.)**
## for the year ended 31 December 2014

The table below provides a summary of the different elements of remuneration for the executive directors:

| Component | Purpose | Operation | Performance metrics | Opportunity |
|---|---|---|---|---|
| Basic salary | Fixed remuneration set to attract and retain executives of sufficient calibre through the payment of competitive rates. | Reviewed annually (or more frequently if required). | Influencing factors include:<br>• Role and experience<br>• Personal performance<br>• Benchmarking comparisons<br>• Salary increases awarded across the Society. | Set at a level considered appropriate, taking into account the relevant factors tabled. The Committee considers very carefully any pay awards which do not reflect the wider increases across the Society and will only make them where there is a clear commercial rationale for doing so having taken independent advice as appropriate. |
| Variable pay | Linked to the delivery of Society and personal objectives. Used to reward executive directors within the context of achieving the Society's goals and objectives. | The award is paid out in two tranches. The deferred award is subject to annual review and recommendation by the Remuneration Committee and requires approval by the non-executive members of the Board. The deferred element can be reduced or withdrawn by the Remuneration Committee. All awards are non-pensionable. | Based on a number of measures, including:<br>• Financial<br>• Customer<br>• Risk<br>• Strategy.<br><br>Reviewed by the Committee annually to ensure that the measures are appropriate. | Maximum annual opportunity is 40% of basic salary. |
| Pension or Pension Allowance | A part of fixed remuneration intended to attract and retain executive directors of sufficient calibre. | Executive directors are invited to join the Society's pension plan or, as an alternative, be provided with an equivalent cash allowance. | Not applicable. | Pension Contribution of 15% of base salary or paid as a cash allowance. |
| Benefits | A part of fixed remuneration intended to attract and retain executive directors of sufficient calibre. | Executive directors receive benefits in line with market practice, which include a car allowance, private medical care for themselves and their family, critical illness insurance and life insurance. | Not applicable. | Set at a level considered appropriate by the Committee. |

### Explanation of the executive variable pay scheme

The variable pay for executive directors is a maximum of 40% and "on target" variable pay is 20% of basic salary. Within the Society, the variable pay of customer service colleagues has been reduced during 2014 and is now based on team performance, customer satisfaction, behaviours and personal objectives, rather than sales volumes.

Variable pay for executive directors is calculated on the basis of performance against targets set by the Board for the following four measures, two of which are financial and two of which capture customer satisfaction with the service that is given to Members. In addition, each executive director has personal objectives which, if not achieved, can reduce the variable pay award. The Committee reviews and approves actual variable pay awards, having considered what has been achieved by the Group and by each executive director.

### Basket of financial and customer satisfaction measures

| Metric | Note | Weighting | On target | Maximum | Actual results |
|---|---|---|---|---|---|
| Return on assets ratio compared with our peer group of major building societies | 1 | 25% | 10 basis points better than the average result of our peer group | 20 basis points better than the average result of our peer group | Will not be available until June 2015 |
| Group profit before tax | 2 | 25% | £34.9m | £41.9m | £45.6 m |
| Customer satisfaction | 3 | 25% | Score of 85% | Score of 87% | Score of 86.8% |
| Customer net promoter score for savings | 4 | 25% | 6th best | 3rd best or above | 3rd best |

Notes:
1 Return on assets ratio is the Society's post-tax profit expressed as a percentage of the average value assets held during the year. This ratio is used by the sector as a comparator of financial performance.
2 Adjusted for significant one-off items.
3 Customer satisfaction is measured by an independent company which carries out research with a random sample of our Members over a 12 month period.
4 The customer net promoter score for savings is compiled by an independent company which carries out research across the financial services sector with customers to gauge the standing of each firm by asking customers if they would recommend to others the firm they have their savings with; this allows us to judge where we rank against other firms in the financial services sector.

Certain additional conduct and risk conditions must be satisfied before any variable pay can be awarded. In particular, the variable pay scheme specifies capital and liquidity hurdles, set above minimum regulatory requirements, which the Society must meet before any variable pay award can be made. These capital and liquidity hurdles relate to the capital and cash or cash equivalents we must hold to support lending activities. At the end of 2014 capital and liquidity levels were materially above the minimum regulatory requirements. Furthermore, in the event that any material weaknesses or failures in the management of prudential or conduct risks are identified, the Remuneration Committee retains the right to withdraw, reduce or claw back payments due or already paid in accordance with the terms of the Executive Variable Pay Scheme. The Committee is satisfied that no adjustments of this nature are required in relation to the 12 month period ended 31 December 2014.

In accordance with the variable pay scheme rules, for executive directors, other than Graeme Yorston and Guy Thomas, half of the scheme's award for 2014 will be paid in two tranches, in February and in June 2015 when we will know how the return on assets ratio compares with peers. Under the scheme rules, the remaining half of the award will be deferred and paid in February 2016. The variable pay award for Graeme Yorston and Guy Thomas will be paid in four tranches with 40% being paid in 2015 and the balance of 60% payable in three equal instalments in February 2016, 2017 and 2018.
The Remuneration Committee reviews all deferred awards annually, and may at its discretion reduce or withdraw the awards due for payment in the event that the original assessment of performance was misleading or if performance declines substantially prior to the payment of any deferred award. The Committee applied this discretion in 2014 and we will continue to ensure that all deferred pay is only payable when confirmed by the group's performance in subsequent years.

### Recruitment policy for executive directors

When agreeing the components of a remuneration package for the appointment of executive directors, the Committee will apply the following principles:

- The packages will be sufficient to facilitate the recruitment of individuals of the required calibre to lead the business and effectively execute the Board's strategy for the business;
- The Committee will look to align the remuneration package offered with the Group's broader Remuneration Policy; and
- The Committee will ensure that the level of remuneration is competitive, but not excessive.

The Committee has discretion within the Policy to make remuneration decisions where it considers it necessary to do so.

In determining appropriate remuneration arrangements, the Committee will consider, without limitation, the quantum of the package on offer compared to similar positions elsewhere in the sector, the structure of the remuneration and the experience of the candidate to ensure that arrangements are made in the best interests of both the Group and its Members without paying in excess of what is deemed necessary to recruit a director of the required calibre.

As a matter of policy and only in exceptional circumstances, the Committee may make awards on hiring an external candidate to compensate the candidate for the forfeiture of any variable pay awards entered into with a previous employer. In determining any such 'buy-out', the Committee will consider all the relevant factors, including the likelihood of the awards vesting should the external candidate have remained in their previous employment, the form in which they were awarded and the time over which they would have vested. The Committee would seek to implement buy-out and recruitment awards in line with the Group's remuneration framework in so far as practical. This policy has not been applied in 2014.

### Directors' service contracts

The executive directors have entered into contracts that can be terminated by either party on one year's notice or by the payment by the Group of an amount equivalent to one year's remuneration.

# Report of the **remuneration committee (cont.)**

for the year ended 31 December 2014

## Payments for loss of office of executive directors

The Group's policy on the principles on which the determination of payments for loss of office will be approached are summarised below:

| Provision | Policy |
|---|---|
| Termination payment | Payment of basic salary and other contractual benefits for the notice period.<br>If a payment in lieu of notice is made, the provisions of the relevant service contract will apply to determine the amount of any payment due. |
| Annual variable pay plan leaver provisions | On termination of office, the leaver provisions within the annual variable pay scheme will apply. Under 'good leaver' circumstances, the annual variable pay scheme rules state that any variable pay will be pro-rated to reflect the time served during the performance period. Any deferred payments are due subject to future performance conditions and payable at the end of the corresponding performance periods, as they would be for continuing colleagues.<br>If an individual is deemed to have not left under 'good leaver' circumstances, no variable pay payment(s) will be made.<br>In the case of death, there is the assumption of eligibility to the date of death and payments are made on this basis. The payment of any deferred amounts, including deferred amounts from previous years, is accelerated and payable at the next payment date. |

## Recruitment of non-executive directors

Non-executive directors are appointed for an initial term of three years. They will generally be expected to serve a second three year term. Where the Board considers that it is in the interests of the Group, a non-executive director may be asked to serve a further term by exception.

The Chairman, Deputy Chairman, Senior Independent Director and non-executive directors do not have service contracts and all are subject to re-election at each year's Annual General Meeting.

The table below shows the policy for non-executive directors:

| Component | Purpose | Operation | Measure/factors considered | Application |
|---|---|---|---|---|
| Fees | To attract and retain non-executive directors at the right calibre for the Society. | Fees are reviewed annually for non-executive directors by the Chairman and executive directors. Fees for the Chairman are recommended by the executives and approved by the Board. The Chairman is not present when his fees are discussed or approved. | Not applicable. | Fees are set at a level to attract individuals with the appropriate knowledge and experience to reflect the responsibilities and time commitment for Board and Board committees, taking into account market practice. |
| Performance-related pay, pension and other benefits | Non-executive directors are not eligible to receive any performance-related pay, pension or other benefits | | Whilst non-executive directors do not participate in any performance-related pay scheme, their overall performance is reviewed annually by the Chairman. | |

Non-executive directors are paid a basic fee for participation on the Board. The non-executive directors receive additional fees payable for providing services on Board committees and for their membership of subsidiary company boards. The fees for the Chairman, Deputy Chairman, Senior Independent Director and non-executive directors are set by the Board, based on recommendations from the executive directors to the Remuneration Committee and external benchmarking from time to time.

In January 2014 the Chairman, Deputy Chairman, Senior Independent Director and non-executive director basic fees were increased by 2.25%, equal to the average increase for all colleagues, while the fees for services on Board committees and subsidiary company boards were not increased.

On 23 September 2014 Natalie Elphicke was appointed as Chair of the Group Risk Committee. Two non-executive directors joined the Group Risk Committee - Nigel Annett joined on 1 June, and Derek Howell on 1 September. On 1 September Menna Richards was appointed to the Remuneration Committee. Derek Howell joined the Audit Committee on 1 April. The fees in 2014 reflect these additional responsibilities. Details of non-executive directors' remuneration are set out on page 49.

### The work of the Remuneration Committee

The members of the Remuneration Committee during 2014 were Nigel Annett (as Chairman) and Laurence Adams; Dyfrig John served on the Committee until April 2014, and Menna Richards was appointed to the Committee in September 2014. All members of the Remuneration Committee are independent non-executive directors.

The Committee is responsible for determining, on behalf of the Board, the overall remuneration practices and policies for all colleagues and, in particular, the level of remuneration of the executive directors as well as other senior staff, which are key individuals who have been identified by the Committee as having a potential material impact on the Society's risk profile. The Terms of Reference for the Remuneration Committee can be found on the Principality website.

The Committee met formally on four occasions during the year (2013: three). Activities during the year included:

- The implementation of the new variable pay scheme for our branch and customer facing staff, with the focus now being on behaviours and customer outcomes rather than sales targets as was the case in the past;
- Agreeing the performance targets for awards to be made under the 2014 executive variable pay scheme and reviewing the outcomes which were paid in respect of the year;
- On-going work in relation to reviewing and monitoring the remaining sales incentive schemes in Nemo in the light of the Financial Conduct Authority guidance paper on "Risks to Customers from Financial Incentives"; and
- Approval of the annual pay review.

The Committee draws on the advice of independent external advisors as necessary and used the services of New Bridge Street in 2014.

Elaine Morris, Group Secretary, acts as secretary to the Committee. The Group HR Director and the Group Risk Director attend most Committee meetings and provide specialist advice as required. The Group Chief Executive is also asked to attend the Committee's meetings when his input is required on specific issues. Executives are not involved in any Remuneration Committee discussions concerning their own pay.


A musician warming up at the National Eisteddfod, Llanelli 2014

# Report of the **remuneration committee (cont.)**
## for the year ended 31 December 2014

Audited information

**Directors' remuneration in respect of the year to 31 December 2014**

The following disclosure in this report (and the following section concerning executive directors' pension arrangements) contains information which is audited.

| | Salary & fees £000 | Benefits £000 | Annual bonus £000 | Sub-total £000 | Pension £000 | Total £000 |
|---|---|---|---|---|---|---|
| **Executive 2014** | | | | | | |
| Graeme Yorston | 335 | 14 | 107 | 456 | 48 | 504 |
| Guy Thomas ( to 31 October 2014)[7] | 420 | 19 | 69 | 508 | 30 | 538 |
| R Michael Jones | 227 | 15 | - | 242 | 34 | 276 |
| Stephen Hughes | 240 | 12 | 77 | 329 | 36 | 365 |
| **Total** | **1,222** | **60** | **253** | **1,535** | **148** | **1,683** |
| **Executive 2013** | | | | | | |
| Graeme Yorston | 310 | 14 | 83 | 407 | 47 | 454 |
| Guy Thomas | 256 | 14 | 68 | 338 | 38 | 376 |
| R Michael Jones (from 1 February 2013) | 170 | 7 | - | 177 | 26 | 203 |
| Stephen Hughes (from 7 March 2013) | 176 | 9 | 63 | 248 | 26 | 274 |
| **Total** | **912** | **44** | **214** | **1,170** | **137** | **1,307** |

| | Fees | |
|---|---|---|
| | **2014 £000** | **2013 £000** |
| **Non-executive directors** | | |
| Dyfrig John (to 17 April 2014) | 31 | 91 |
| Laurence Adams (Chair from April 2014) | 95 | 12 |
| Gordon MacLean | 68 | 61 |
| Langley Davies (to 24 October 2014) | 56 | 63 |
| Joanne Kenrick | 46 | 45 |
| Menna Richards | 53 | 45 |
| Natalie Elphicke | 53 | 49 |
| Nigel Annett | 61 | 12 |
| Derek Howell | 36 | - |
| Christopher Jones (to 18 April 2013) | - | 15 |
| Keith Brooks (to 29 September 2013) | - | 50 |
| Sub-total | 499 | 443 |
| Executive remuneration total | 1,683 | 1,307 |
| **Total** | **2,182** | **1,750** |

Notes

1 The 2013 variable pay scheme contained a return on assets measure against the average performance of a comparator group of mutual building societies. This was recalculated in June 2014 once the full set of comparator information was available. This resulted in an additional variable pay award of £18k earned by executive directors. This sum is payable over two years.

2 The 2014 variable pay scheme contains a return on assets measure against the average performance of a comparator group of mutual building societies. Since all the results of other societies are not available until May 2015 an assumption has been made that Principality's performance will be in line with the comparator group and that therefore that no amount will be payable in respect of this measure. This figure will be adjusted upwards or downwards to reflect actual performance once the 2014 results for the comparator group are published.

3 50% of the variable pay award is paid in 2015 and 50% is paid in 2016 other than for Graeme Yorston and Guy Thomas where 40% of the variable pay award is paid in 2015 and 60% is paid in equal instalments in 2016, 2017 and 2018. All deferred awards are subject to review and confirmation by the Remuneration Committee which has the discretion to reduce or withdraw any deferred awards in the event that the basis upon which the original performance measures were established proves unsustainable. This may not only relate to performance in the current year but also performance in previous years where relevant information has only come to light subsequent to the period for which the variable pay award was calculated .

4 The figures under benefits include company car/car allowance, fuel allowance, critical illness and personal medical insurance.

5 Awards under the variable pay scheme are non-pensionable.

6 Guy Thomas who retired on 31 October 2014, is eligible for a pro rata payment for 10 months service. The award will be paid out in line with the deferral arrangements set out in note 3.

7 Guy Thomas did not work his full notice and was paid the gross sum of £197k together with a cash allowance of £30k for pension, as pay in lieu of his contractual notice period.

## Executive directors' pension arrangements

In addition to the current pension arrangements, Guy Thomas was a member of the Society's defined benefit pension scheme which closed to future accrual in 2010. The scheme is a 'career average' scheme whereby members earn a pension of 1/60th of their salary each year, index linked to the Consumer Prices Index, up to retirement age.

Guy Thomas's accrued annual pension entitlement at 31 December 2014 was £22k (2013: £21k). Guy Thomas retired on 31 October 2014. Michael Jones' accrued annual pension entitlement at 31 December 2014 was £18k (2013: £18k). His normal retirement date is 19 June 2018.

Principality staff help children paint baby Dylan the Dragons at our stand at the Royal Welsh

# **Opinion** on the financial statements of Principality Building Society

In our opinion the financial statements:

- give a true and fair view, in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, of the state of the Group's and the Society's affairs as at 31 December 2014 and of the Group's and the Society's income and expenditure for the year then ended; and
- have been prepared in accordance with the requirements of the Building Societies Act 1986 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

The financial statements comprise the Group and Society Income Statements, the Group and Society Statements of Comprehensive Income, the Group and Society Statements of Financial Position, the Group and Society Cash Flow Statements, and the related Notes 1 to 39. The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union.

## Going concern

We have reviewed the directors' statement contained within the Directors' Report on page 33 that the group is a going concern. We confirm that:

- we have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate; and
- we have not identified any material uncertainties that may cast significant doubt on the group's ability to continue as a going concern.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the group's ability to continue as a going concern.

## Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team. For all assessed risks, we tested the design and implementation of the associated key controls identified.

| Risk | How the scope of our audit responded to the risk |
|---|---|
| **Loan loss provisions**<br>The Group holds £62.7 million of impairment provisions at year-end (2013: £59.9 million) against total loans and advances to customers of £6,139.9 million (2013: £5,904.6 million). Determining impairment provisions against loans to customers is a judgemental area requiring an estimate to be made of the incurred loss within the residential mortgage, commercial and secured personal lending portfolios. This requires the estimation of customer default rates, property values and movements, sales costs, forced sale discounts, likelihood of repossession, and potential impairment indicators all of which may be sensitive to changes in the economic environment.<br><br>Loan loss provision balances are detailed within Notes 20 and 39c. Management's associated accounting policies are detailed on page 66 with detail about judgements in applying accounting policies and critical accounting estimates on page 69. | We challenged the appropriateness of management's key assumptions used in the impairment calculations for loans and receivables, including the impairment trigger point, the estimation of property values, sales costs, forced sale discounts and the likelihood of repossession. This was achieved through: benchmarking against internal and external data; reviewing historical levels of write-offs; performing a detailed review of a sample of performing commercial loans and those included on the Watch list (as explained on page 106); and using our internal valuation specialists to review a sample of property valuations for the commercial lending portfolio.<br><br>We involved our IT specialists to test the accuracy of the provisioning models through independent re-calculation in accordance with the approved provisioning policy and at the same time assessed the completeness and accuracy of data used by the models. |
| **Revenue recognition**<br>The recognition of revenue on loans using an effective interest rate method requires judgement by management to determine key assumptions related to the expected life of each loan and the associated cash flows. Such assumptions are also sensitive to changes in the economic environment. The Group held £15.2 million of unamortised origination fees on the balance sheet at year-end which will be amortised over the expected life of the associated loan portfolios (2013: £18.4 million).<br><br>Management's associated accounting policies are detailed on page 65 with detail about judgements in applying accounting policies and critical accounting estimates on page 70. | We challenged the appropriateness of management's key assumptions used in the recognition of revenue using the effective interest rate method by comparison against historical customer behaviour, performing analytical procedures using our own approximation of the model and assessing the sensitivity of key assumptions.<br><br>We involved our IT specialists to independently recalculate the settlement curves that underpin the calculation on a sample basis and at the same time assessed the completeness and accuracy of data used by the models. |

| Risk | How the scope of our audit responded to the risk |
|---|---|
| **Provisions for customer remediation**<br>The assessment of the Group's calculation of provisions for customer remediation in relation to compliance with consumer credit legislation is judgemental due to the uncertainty of complaint volumes, uptake rates and redress and other costs.<br><br>Management's associated accounting policies are detailed on page 69 with detail about judgements in applying accounting policies and critical accounting estimates on page 70. | As described in Note 38b, the remediation was largely completed during the year. We challenged the completeness of the provision through review of management's detailed assessment of compliance with the consumer credit legislation legal advice provided to management, customer complaints and regulatory correspondence. We also reviewed journal entries to test appropriate utilisation of the provision. |
| **Financial Services Compensation (FSCS) Scheme levy**<br>The Group holds a provision for the Financial Services Compensation Scheme levy of £2.2 million at year-end (2013: £2.3 million). Accounting for the Financial Services Compensation Scheme (FSCS) is reliant on data extracted from the core savings system and involves making assumptions regarding the Group's share of industry protected deposits. There is also uncertainty regarding the extent to which additional levies will be raised to cover future capital shortfalls on the loans to HM Treasury and therefore the extent of any contingent liabilities to be disclosed in the financial statements.<br><br>Management's associated accounting policies are detailed on page 69 with detail about judgements in applying accounting policies and critical accounting estimates on page 70. Details of the contingent liability are included in Note 38a. | We challenged the accuracy and completeness of the provision for the FSCS levy by performing an independent calculation of the amount based on information published by the FSCS and internal data from the core savings system. In respect of the deposit balances guaranteed by the FSCS we have tested the extraction of the data from the core savings system. |
| **Retirement benefit obligations**<br>At the year-end a retirement benefit obligation deficit of £6.9 million was recognised (2013: £17.1 million). The calculation of the present value of the retirement benefit obligations requires judgement in the selection of key assumptions and is highly sensitive to such assumptions. Management make judgements in respect of mortality, price inflation, discount rates, pension increases and earnings growth. Of these inputs, discount rate and general price inflation have the most material impact on the pension liability balance sheet value.<br><br>During the year a £10.1 million gain was recognised in the income statement following adoption of CPI rather than RPI as the basis for determining the rate of inflation in the actuarial calculations of the scheme liability during the year.<br><br>Management's associated accounting policies are detailed on page 68 with detail about judgements in applying accounting policies and critical accounting estimates on page 70. The year-end pension disclosures are detailed in Note 12. | We evaluated the appropriateness of management's assumptions in deriving the defined benefit pension balance by assessing the Group's use of specialists in deriving the liability and benchmarking the assumptions in respect of the discount rate, inflation and mortality assumptions to those used in the market at 31 December 2014 using our internal specialists.<br><br>We also reviewed the accounting treatment of the £10.1 million gain recognised in then income statement following adoption of CPI rather than RPI as the basis for determining the rate of inflation in the actuarial calculations of the scheme liability during the year. |
| **Financing transactions**<br>As described on page 83, the Group issued Residential Mortgage Backed Securities attracting £475 million of funding during the year. The accounting treatment for the issue is complex (as described by the accounting policy set out on page 65) and requires skilled input and oversight by management and thorough understanding of the terms of each transaction to ensure appropriate recognition, derecognition and fair value measurement of associated assets and liabilities. Appropriate disclosures regarding encumbrance levels are also required. | We challenged management's accounting treatment of financing transactions including verification to supporting documentation. We also reviewed the disclosure of such transactions in the annual report including disclosed levels of encumbrance. |

# **Opinion** on the financial statements of Principality Building Society (cont.)

| Risk | How the scope of our audit responded to the risk |
|---|---|
| **Valuation of structured products**<br>The Group has structured products that provide a return depending on performance of RPI and FTSE indices. Derivatives are used to hedge against the associated risk of such products. These instruments are held at fair value on the balance sheet and require skilled input to value as calculations are complex, requiring multiple sources of market data to be obtained. The fair value of such derivatives totalled £2.7 million at the year-end (2013: £3.0 million).<br><br>Management's associated accounting policies are detailed on page 65 with detail about judgements in applying accounting policies and critical accounting estimates on page 69. | Using our internal financial instrument specialists and obtaining independent market data, we recalculated the value of a sample of FTSE and RPI derivatives. Using the experience of our internal financial instrument specialists, we also tested management's assessment of any required adjustment to valuations for credit risk by challenging the methodology applied and input data used. |

The description of risks above should be read in conjunction with the significant issues considered by the Audit Committee discussed on page 38.

Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures. Our opinion on the financial statements is not modified with respect to any of the risks described above, and we do not express an opinion on these individual matters.

In the prior year, we identified additional risks which are no longer considered to have the greatest effect on our audit strategy and as such required a lower level of resources in the current year audit. The details of these areas and the reasons we have identified for the change are set out below.

| Risk | Reason for removal |
|---|---|
| Recoverability of the investment in and loan to subsidiary | The carrying value of the Group's investment in, and loan to its subsidiary, Nemo, is material to the Society. The recoverability of the loan is assessed with reference to Nemo's ability to generate profits and cash flows which it has consistently done for a number of years and on this basis the risk is no longer deemed significant in terms of the need for enhanced audit procedures. |
| Hedge accounting | The Society has applied hedge accounting for a number of years. Our testing has not historically identified issues with the modelling of effectiveness testing of those hedged relationships. While we still perform work on this area, on this basis the risk is no longer deemed significant enough to be included in our audit report. Our risk assessment in 2014 identified that valuation of structured products was more appropriate as a significant risk in terms of the complexity of the models. |

## Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

The accumulation of profits is critical to maintaining and building capital for regulatory purposes and allowing the Group to invest in activities for its members. We have therefore selected profit before tax as benchmark for determining materiality. We have calculated materiality by applying 5.0% of this benchmark. The reduction from 7.5% in the prior year has not impacted the way in which we assess the significant risk areas. We have changed the percentage applied to align more closely with other comparable societies.

We determined planning materiality for the Group to be £2.2 million (2013: £2.1 million) which represents 0.03% of total Group assets (2013: 0.03%). This was calculated on the basis of profit before tax, adjusted for following exceptional gains recognised during the year:

- £10.1 million gain following the adoption of CPI rather than RPI as a basis for determining the rate of inflation in actuarial calculations of the pension scheme liability (see page 16 for further detail); and
- £10.5 million gain following the sale of a Group subsidiary, Peter Alan (see page 5 for further detail).

We agreed with the Audit Committee that we would report to the committee all audit differences in excess of £42,000 (2013: £42,000), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

### An overview of the scope for our audit

As in the prior year, our group audit scope involved performing full audits on the Group's parent and main subsidiaries which accounted for more than 99% of the Group's net assets and profit before tax. These audits were performed directly by the group audit team and executed at levels of materiality applicable to each individual entity which were lower than group materiality and ranged from £1,068,000 to £2,150,000.

At the parent entity level we also tested the consolidation process and carried out analytical procedures to confirm our conclusion that there were no significant risks of material misstatement of the aggregated financial information of the remaining subsidiaries not subject to audit or audit of specified account balances.

### Opinion on other matters prescribed by the Building Societies Act 1986

In our opinion:

- the Annual Business Statement and the Directors' Report have been prepared in accordance with the requirements of the Building Societies Act 1986;
- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the accounting records and the financial statements; and
- the information given in the Annual Business Statement (other than the information upon which we are not required to report) gives a true representation of the matters in respect of which it is given.

### Opinion on other matters prescribed by the Capital Requirements (Country-by-Country Reporting) Regulations 2013

In our opinion the information given on page 16 for the financial year ended 31 December 2014 has been properly prepared, in all material respects, in accordance with the Capital Requirements (Country-by-Country Reporting) Regulations 2013.

### Matters on which we are required to report by exception

| | |
|---|---|
| Adequacy of explanations received and accounting records | Under the Building Societies Act 1986 we are required to report to you if, in our opinion:<br>• proper accounting records have not been kept by the Society; or<br>• the Society financial statements are not in agreement with the accounting records; or<br>• we have not received all the information and explanations and access to documents we require for our audit.<br>We have nothing to report in respect of these matters. |
| Our duty to read other information in the Annual Report | Under International Standards on Auditing (UK and Ireland), we are required to report to you if, in our opinion, information in the annual report is:<br>• materially inconsistent with the information in the audited financial statements; or<br>• apparently materially incorrect based on, or materially inconsistent with, our knowledge of the group acquired in the course of performing our audit; or<br>• otherwise misleading.<br>In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the audit committee which we consider should have been disclosed. We confirm that we have not identified any such inconsistencies or misleading statements. |

# **Opinion** on the financial statements of Principality Building Society (cont.)

## Matters on which we are required to report by exception (cont.)

| | |
|---|---|
| Respective responsibilities of directors and auditor | As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of financial statements which give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors. We also comply with International Standard on Quality Control 1 (UK and Ireland). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team and independent partner reviews.<br><br>This report is made solely to the Society's members, as a body, in accordance with section 78 of the Building Societies Act 1986. Our audit work has been undertaken so that we might state to the Society's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Society or the Society's members as a body, for our audit work, for this report, or for the opinions we have formed. |
| Scope of the audit of the financial statements | An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Society's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. |

Matthew Perkins ACA (Senior statutory auditor)

Matthew Perkins

for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor, Cardiff
10 February 2015

# FINANCIAL STATEMENTS

# Consolidated income statement
## for the year ended 31 December 2014

| | Notes | 2014 £m | 2013 (restated*) £m |
|---|---|---|---|
| **Continuing operations** | | | |
| Interest receivable and similar income | 4 | 258.0 | 261.6 |
| Interest payable and similar charges | 5 | (124.2) | (145.2) |
| Net interest income | | 133.8 | 116.4 |
| Fees and commission receivable | 6 | 7.6 | 13.4 |
| Fees and commission payable | 7 | (1.0) | (1.1) |
| Net fee and commission income | | 6.6 | 12.3 |
| Other operating income | | 1.5 | 0.9 |
| Other fair value (losses) | 8 | (1.5) | (1.2) |
| **Net operating income** | | **140.4** | **128.4** |
| Administrative expenses | 9 | (55.6) | (58.9) |
| Depreciation and amortisation | 23 & 24 | (9.1) | (6.4) |
| Operating expenses | | (64.7) | (65.3) |
| Impairment provision for losses on loans and advances | 20 | (13.5) | (22.4) |
| Provision for other liabilities and charges | 21 | (8.7) | (12.5) |
| **Operating profit and profit before taxation from continuing operations** | | **53.5** | **28.2** |
| Taxation expense | 13 | (11.7) | (6.2) |
| **Profit for the year from continuing operations** | | **41.8** | **22.0** |
| Profit for the year from discontinued operations | 14 | 10.5 | 0.2 |
| **Total profit for the year** | | **52.3** | **22.2** |

## Consolidated statement of other comprehensive income

| | Notes | 2014 £m | 2013 (restated*) £m |
|---|---|---|---|
| Profit for the year | | 52.3 | 22.2 |
| Items that will not be reclassified subsequently to profit and loss: | | | |
| Actuarial loss on retirement benefit obligations | 12 | (1.6) | (4.3) |
| Income tax | 13 | 0.4 | 0.4 |
| Items that may be reclassified subsequently to profit and loss: | | | |
| Gain/(loss) on available-for-sale assets | 37 | 7.1 | (8.2) |
| Income tax | 13 | (1.5) | 1.8 |
| **Total comprehensive income for the year** | **36 & 37** | **56.7** | **11.9** |

The accounting policies and notes on pages 63 to 111 form part of these accounts.

*Restated to reflect the reclassification of discontinued operations. Further information can be found in note 1.

# Income statement of the Society

## for the year ended 31 December 2014

| | Notes | 2014 £m | 2013 (restated*) £m |
|---|---|---|---|
| **Continuing operations** | | | |
| Interest receivable and similar income | 4 | 225.9 | 224.9 |
| Interest payable and similar charges | 5 | (126.0) | (145.2) |
| Net interest income | | 99.9 | 79.7 |
| Fees and commission receivable | 6 | 6.9 | 8.9 |
| Fees and commission payable | 7 | (0.6) | (0.6) |
| Net fee and commission income | | 6.3 | 8.3 |
| Other operating income | | 3.1 | 3.0 |
| Other fair value gains/(losses) | 8 | 0.5 | (1.2) |
| **Net operating income** | | **109.8** | **89.8** |
| Administrative expenses | 9 | (46.2) | (50.8) |
| Depreciation and amortisation | 23 & 24 | (8.0) | (5.6) |
| Operating expenses | | (54.2) | (56.4) |
| Impairment provision for losses on loans and advances | 20 | (11.3) | (17.1) |
| Provision for other liabilities and charges | 21 | (4.8) | (4.5) |
| **Operating profit** | | **39.5** | **11.8** |
| Profit from sale of investment in subsidiary | 14 | 12.3 | - |
| Profit before taxation from continuing activities | | 51.8 | 11.8 |
| Taxation expense | 13 | (9.0) | (2.6) |
| **Profit for the year from continuing operations** | | **42.8** | **9.2** |
| Loss for the year from discontinued operations | 14 | (0.4) | (0.5) |
| **Total profit for the year** | | **42.4** | **8.7** |

## Statement of other comprehensive income of the Society

| | Notes | 2014 £m | 2013 (restated*) £m |
|---|---|---|---|
| Profit for the year | | 42.4 | 8.7 |
| Items that will not be reclassified subsequently to profit and loss: | | | |
| Remeasurement of net defined benefit liability | 12 | (1.6) | (4.3) |
| Income tax | 13 | 0.4 | 0.4 |
| Items that may be reclassified subsequently to profit and loss: | | | |
| Gain/(loss) on available-for-sale assets | 37 | 7.1 | (8.2) |
| Income tax | 13 | (1.5) | 1.8 |
| **Total comprehensive income for the year** | **36 & 37** | **46.8** | **(1.6)** |

The accounting policies and notes on pages 63 to 111 form part of these accounts.

*Restated to reflect the reclassification of discontinued operations. Further information can be found in note 1.

# Consolidated statement of financial position
## at 31 December 2014

| | Notes | 2014 £m | 2013 £m |
|---|---|---|---|
| **Assets** | | | |
| Liquid assets: | | | |
| Cash in hand and balances with the Bank of England | | 432.6 | 355.6 |
| Loans and advances to credit institutions | 15 | 150.7 | 120.5 |
| Debt securities | 16 | 454.1 | 566.0 |
| | | 1,037.4 | 1,042.1 |
| Derivative financial instruments | 17 | 30.9 | 37.6 |
| Loans and advances to customers: | | | |
| Loans fully secured on residential property | | 5,720.4 | 5,409.0 |
| Other loans fully secured on land | | 370.6 | 446.5 |
| Other loans | | 48.9 | 49.1 |
| | 19 | 6,139.9 | 5,904.6 |
| Intangible fixed assets | 23 | 1.8 | 4.4 |
| Property, plant and equipment | 24 | 43.9 | 47.8 |
| Deferred tax assets | 33 | 2.0 | 4.3 |
| Other assets | 25 | 3.0 | 6.3 |
| Prepayments and accrued income | 26 | 6.1 | 11.0 |
| **Total assets** | | **7,265.0** | **7,058.1** |
| | | | |
| **Liabilities** | | | |
| Shares | 27 | 5,613.0 | 5,562.6 |
| Deposits and debt securities: | | | |
| Amounts owed to credit institutions | 28 | 227.5 | 499.7 |
| Amounts owed to other customers | 29 | 173.9 | 225.1 |
| Debt securities in issue | 30 | 600.3 | 178.0 |
| | | 1,001.7 | 902.8 |
| Derivative financial instruments | 17 | 42.8 | 26.2 |
| Current tax liabilities | | 7.0 | 1.9 |
| Other liabilities | 31 | 4.4 | 8.4 |
| Provisions for liabilities | 21 | 3.9 | 12.7 |
| Accruals and deferred income | 32 | 9.5 | 8.7 |
| Deferred tax liabilities | 33 | 0.3 | 0.5 |
| Retirement benefit obligations | 12 | 6.9 | 17.1 |
| Subordinated liabilities | 34 | 92.3 | 92.3 |
| Subscribed capital | 35 | 71.9 | 70.2 |
| Total liabilities | | 6,853.7 | 6,703.4 |
| General reserve | 36 | 408.7 | 357.7 |
| Other reserves | 37 | 2.6 | (3.0) |
| **Total equity and liabilities** | | **7,265.0** | **7,058.1** |

The accounting policies and notes on pages 63 to 111 form part of these accounts.

These accounts were approved by the Board on 10 February 2015.
Signed on behalf of the Board:

**Laurence Philip Adams** Chairman

**Graeme H. Yorston** Group Chief Executive

**Stephen Hughes** Group Finance Director

# Statement of financial position of the Society

## at 31 December 2014

| | Notes | 2014 £m | 2013 £m |
|---|---|---|---|
| **Assets** | | | |
| Liquid assets: | | | |
| Cash in hand and balances with the Bank of England | | 432.6 | 355.6 |
| Loans and advances to credit institutions | 15 | 49.7 | 49.8 |
| Debt securities | 16 | 454.1 | 566.0 |
| | | 936.4 | 971.4 |
| Derivative financial instruments | 17 | 30.9 | 37.6 |
| Loans and advances to customers: | | | |
| Loans fully secured on residential property | | 5,240.8 | 4,892.2 |
| Other loans fully secured on land | | 370.6 | 446.5 |
| | 19 | 5,611.4 | 5,338.7 |
| Investments in subsidiary undertakings | 22 | 475.4 | 523.2 |
| Intangible fixed assets | 23 | 1.8 | 2.0 |
| Property, plant and equipment | 24 | 42.6 | 43.1 |
| Deferred tax assets | 33 | 2.0 | 4.1 |
| Other assets | 25 | 1.8 | 3.0 |
| Prepayments and accrued income | 26 | 5.7 | 9.9 |
| **Total assets** | | **7,108.0** | **6,933.0** |
| | | | |
| **Liabilities** | | | |
| Shares | 27 | 5,613.0 | 5,562.6 |
| Deposits and debt securities: | | | |
| Amounts owed to credit institutions | 28 | 689.1 | 582.4 |
| Amounts owed to other customers | 29 | 173.9 | 225.1 |
| Debt securities in issue | 30 | 38.3 | 26.2 |
| | | 901.3 | 833.7 |
| Derivative financial instruments | 17 | 40.8 | 26.2 |
| Current tax liabilities | | 5.4 | 0.6 |
| Other liabilities | 31 | 4.3 | 5.2 |
| Provisions for liabilities | 21 | 3.4 | 3.6 |
| Accruals and deferred income | 32 | 8.0 | 7.6 |
| Deferred tax liabilities | 33 | 0.5 | 0.5 |
| Retirement benefit obligations | 12 | 6.9 | 17.1 |
| Subordinated liabilities | 34 | 92.3 | 92.3 |
| Subscribed capital | 35 | 71.9 | 70.2 |
| Total liabilities | | 6,747.8 | 6,619.6 |
| General reserve | 36 | 357.6 | 316.4 |
| Other reserves | 37 | 2.6 | (3.0) |
| **Total equity and liabilities** | | **7,108.0** | **6,933.0** |

The accounting policies and notes on pages 63 to 111 form part of these accounts.

These accounts were approved by the Board on 10 February 2015
Signed on behalf of the Board:

**Laurence Philip Adams** Chairman

**Graeme H. Yorston** Group Chief Executive

**Stephen Hughes** Group Finance Director

# Consolidated statement of cash flows

## for the year ended 31 December 2014

| | 2014 £m | 2013 £m |
|---|---|---|
| **Net cash outflow from operating activities (see below)** | (9.3) | (0.9) |
| **Cash flows from investing activities** | | |
| Purchase of companies | - | (1.3) |
| Purchase of intangible assets and property, plant and equipment | (7.6) | (8.7) |
| Purchase of investment securities | (232.1) | (476.2) |
| Proceeds from sale and maturity of investment securities | 351.2 | 349.5 |
| Net proceeds from disposal of discontinued operations | 15.2 | - |
| **Cash flows from financing activities** | - | - |
| Increase/(decrease) in cash and cash equivalents | 117.4 | (137.6) |
| Cash and cash equivalents at beginning of year | 466.0 | 603.6 |
| **Cash and cash equivalents at end of year** | **583.4** | **466.0** |
| **Represented by:** | | |
| Cash and balances with the Bank of England | 432.6 | 355.6 |
| Loans and advances to credit institutions repayable on demand | 150.8 | 110.4 |
| | **583.4** | **466.0** |
| **Net cash inflow from operating activities** | | |
| Profit after taxation | 52.3 | 22.2 |
| **Adjusted for:** | | |
| Depreciation and amortisation | 6.2 | 6.9 |
| Impairment losses on sale of property, plant and equipment | 3.0 | - |
| Impairment losses on loans and advances to customers | 13.5 | 22.4 |
| Change in fair values | (20.7) | 18.0 |
| Taxatation charge | 11.7 | 6.5 |
| Gain on disposal of discontinued operations | (10.5) | - |
| Other non-cash movements | (10.7) | 0.3 |
| **Changes in net operating assets** | | |
| Decrease in loans and advances to credit institutions | 10.0 | 13.1 |
| (Increase) in loans and advances to customers | (221.1) | (372.9) |
| Decrease/(increase) in other assets | 3.2 | (0.1) |
| Decrease in prepayments and accrued income | 4.8 | 4.4 |
| Change in derivative financial instruments | 23.3 | (17.2) |
| Increase in shares | 45.2 | 108.7 |
| Increase in deposits and debt securities | 99.3 | 192.5 |
| (Decrease) in other liabilities | (3.9) | (0.6) |
| (Decrease)/increase in provisions for liabilities | (8.9) | 2.8 |
| Increase/(decrease) in accruals and deferred income | 0.8 | (1.1) |
| (Decrease) in pension fund obligations | (1.8) | (0.3) |
| **Taxation** | (5.0) | (6.5) |
| | **(9.3)** | **(0.9)** |

The Group is required to maintain interest-free balances with the Bank of England which at 31 December 2014 amounted to £11.2m (2013: £10.4m).

# Statement of cash flows of the Society

## for the year ended 31 December 2014

| | 2014 £m | 2013 £m |
|---|---|---|
| **Net cash outflow from operating activities (see below)** | (40.1) | (6.6) |
| **Cash flows from investing activities** | | |
| Purchase of intangible assets and property, plant and equipment | (7.2) | (6.9) |
| Purchase of investment securities | (232.1) | (476.2) |
| Proceeds from sale and maturity of investment securities | 351.2 | 349.5 |
| Net proceeds from disposal of subsidiary company | 15.2 | - |
| **Cash flows from financing activities** | - | - |
| Increase/(decrease) in cash and cash equivalents | 87.0 | (140.2) |
| Cash and cash equivalents at beginning of year | 395.3 | 535.5 |
| **Cash and cash equivalents at end of year** | **482.3** | **395.3** |
| **Represented by:** | | |
| Cash and balances with the Bank of England | 432.6 | 355.6 |
| Loans and advances to credit institutions repayable on demand | 49.7 | 39.7 |
| | **482.3** | **395.3** |
| **Net cash inflow from operating activities** | | |
| Profit after taxation | 42.4 | 8.7 |
| **Adjusted for:** | | |
| Depreciation and amortisation | 5.7 | 5.6 |
| Impairment loss on sale of property, plant and equipment | 2.4 | - |
| Impairment losses on loans and advances to customers | 11.3 | 17.1 |
| Change in fair values | (20.7) | 18.0 |
| Taxation charge | 9.0 | 2.6 |
| Gain on disposal of subsidiary company | (12.3) | - |
| Other non-cash movements | (9.5) | (0.1) |
| **Changes in net operating assets** | | |
| Decrease in loans and advances to credit institutions | 10.0 | 3.1 |
| (Increase) in loans and advances to customers | (256.9) | (378.6) |
| Decrease in loans to subsidiary companies | 44.8 | 22.4 |
| Decrease in other assets | 1.2 | 0.7 |
| Decrease in prepayments and accrued income | 4.2 | 4.5 |
| Change in derivative financial instruments | 21.3 | (17.2) |
| Increase in shares | 45.3 | 108.7 |
| Increase in deposits and debt securities | 68.0 | 201.8 |
| (Decrease) in other liabilities | (1.0) | (0.8) |
| (Decrease)in provisions for liabilities | (0.2) | (0.1) |
| Increase/(decrease) in accruals and deferred income | 0.4 | (1.2) |
| (Decrease) in pension fund obligations | (1.8) | (0.3) |
| **Taxation** | (3.7) | (1.5) |
| | **(40.1)** | **(6.6)** |

# Notes to the accounts
for the year ended 31 December 2014

## 1. Accounting policies

Basis of preparation

The Group and Society's financial statements for the year ended 31 December 2014 have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) as adopted by the European Union (EU) and those parts of the Building Societies (Accounts and Related Provisions) Regulations 1998 applicable to Societies reporting under IFRS.

The financial statements have been prepared on a going concern basis. This is discussed in the Directors' Report on page 34, under the heading 'Going concern'. At the date of authorisation of these financial statements the following standards and interpretations which have not been applied in these financial statements were in issue but not yet effective:

| Pronouncement | Nature of change | Effective date |
|---|---|---|
| IFRS 2<br>Share-based Payment | The amendments clarify the definition of 'vesting condition' by separately defining 'performance condition' and 'service condition.' No impact on the Group is expected as it does not typically offer share-based compensation. | Accounting periods beginning on or after 1 July 2014 |
| IFRS 3<br>Business Combinations | The amendments clarify the classification and measurement of contingent consideration in a business combination. Entities will be required to treat contingent consideration according to IAS 32 Financial Instruments: Presentation when the consideration is a financial instrument. Further, the consideration must always be measured at fair value when it is classified as an asset or a liability. The amendment is not expected to have a significant impact on the Group's accounts. | Accounting periods beginning on or after 1 July 2014 |
| IFRS 8<br>Operating Segments | The amendments require the explicit disclosure of judgements made by Management in applying criteria for the aggregation of operating segments. As the Group's operating segments are quite clear-cut, the extent of the impact to the Group is expected to be limited to the possible addition of wording to the Business segments note describing how the operating segments are determined. | Accounting periods beginning on or after 1 July 2014 |
| IFRS 13<br>Fair Value Measurement | The amendments clarify that the standard does not intend to prevent entities from measuring short-term receivables and payables with no stated interest rate at their invoiced amounts without discounting if the effect of the discounting is immaterial. They also clarify that the exception whereby entities are allowed to measure the fair value of a group of financial assets and financial liabilities with offsetting risk positions on a net basis if certain conditions are met applies to contracts in the scope of IAS 39 and IFRS 9 without regard to whether they meet the definition of a financial asset or liability under IAS 32. These amendments are not expected to have any significant impact on the Group's accounts. | Accounting periods beginning on or after 1 July 2014 |
| IAS 16<br>Property, Plant and Equipment,<br>IAS 38<br>Intangible Assets | The amendments clarify that upon revaluing relevant assets, the amount by which accumulated depreciation or amortisation is adjusted need not be proportionate to the change in the gross carrying amount of the asset. These amendments are not expected to have any significant impact on the Group's accounts. | Accounting periods beginning on or after 1 July 2014 |
| IAS 19<br>Employee Benefits | The amendment to the standard seeks to clarify the accounting for employee contributions in a defined benefit plan. This amendment is not expected to have any impact on the Group's accounts. | Accounting periods beginning on or after 1 July 2014 |
| IAS 24<br>Related Party Disclosures | The amendment has extended the definition of related parties to include a management entity that provides key management personnel services to the reporting entity. This amendment is not expected to have any impact on the Group's accounts. | Accounting periods beginning on or after 1 July 2014 |

# Notes to the accounts
for the year ended 31 December 2014

## 1. Accounting policies (continued)

Basis of preparation (continued)

| Pronouncement | Nature of change | Effective date |
|---|---|---|
| IAS 40 Investment Property | The amendments clarify that an entity should assess acquired properties to determine whether they are investment properties under IAS 40 or new businesses as defined by IFRS 3. This amendment is not expected to a have any significant impact on the Group's accounts. | Accounting periods beginning on or after 1 July 2014 |
| IFRS 9 Financial Instruments | In July 2014, the IASB published the final version of IFRS9 Financial Instruments. This standard adopts a phased approach to replace IAS 39 Financial Instruments: Recognition and Measurement. The new standard affects a number of areas of the accounts with the final version of the standard requiring the use of the expected loss impairment model. | Accounting periods beginning on or after 1 January 2018 |

The directors anticipate that the adoption of these standards and interpretations in future periods, with the exception of IFRS 9, will not have a material impact on the financial statements of the Group. The impact of IFRS 9 is being considered but is expected to have a material effect on the impairment provisions against loans and advances for the Group.

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements.

### Accounting convention

The Group prepares its accounts under the historical cost convention, except for the revaluation of debt securities - available-for-sale, certain financial assets and liabilities held at fair value and all derivative contracts.

### Basis of consolidation

The Group financial statements consist of the financial statements of the ultimate parent (Principality Building Society) and all entities controlled by the Society (its subsidiaries and special purpose entities).

**Subsidiaries**

A subsidiary is an entity the operating and financing policies of which are controlled directly or indirectly by the Society. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commenced. Intra-group balances and transactions are eliminated in preparing the consolidated financial statements.

# Notes to the accounts
for the year ended 31 December 2014

## 1. Accounting policies (continued)

### Securitisation transactions
The Group has securitised certain mortgage loans by the transfer of the loans to special purpose entities (SPEs) controlled by the Group. The securitisation enables a subsequent issuance of debt by the SPEs to investors who gain the security of the underlying assets as collateral. The SPEs are fully consolidated into the Group's accounts under IFRS 10 - Consolidated Financial Statements. The transfer of the mortgage loans to the SPEs is not treated as a sale by the Society. The Society continues to recognise the mortgage loans on its own statement of financial position after the transfer because it retains their risks and rewards through the receipt of substantially all of the profits or losses of the SPEs. In the accounts of the Society, the proceeds received from the transfer are accounted for as a deemed loan repayable to the SPEs. To manage interest rate risk, the Society enters into derivative transactions with the SPEs, receiving a rate of interest based on the securitised mortgages and paying a rate inherent in the debt issuance. In accordance with IAS 39, these internal derivatives are treated as part of the deemed loan and not separately fair valued because the relevant mortgage loans are not derecognised. Cash flows arising from these internal derivatives are accounted for on an accruals basis. Interest rate swaps with external counterparties in relation to securitisation transactions are recognised in accordance with IAS 39.

### Interest receivable and payable
Interest receivable and payable for loans and advances to customers and customer accounts are recognised in the income statement using the effective interest method.

The effective interest method calculates the amortised cost of a financial asset or a financial liability, and allocates the interest income or interest expense over the expected product life. The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the product or, when appropriate, a shorter period, to the net book value of the financial asset or financial liability. Where calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the product (for example prepayment options) but does not consider future credit losses. The calculation includes all amounts received or paid by the Group that are an integral part of the overall return and the direct incremental transaction costs related to the acquisition or issue of a product.

Interest income on available-for-sale investments, derivatives and other financial assets accounted at fair value through the statement of other comprehensive income is included in interest receivable and similar income.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

### Fees and commissions
Loan origination fees are reflected in the calculation of the effective interest rate on the loan.

Fees received under loan servicing and other business process outsourcing is reflected in the income statement in the period that the servicing is carried out. Other than at the point of loan de-recognition, all service contracts provide for charging clients on a monthly basis by reference to the portfolio size.

The Group receives trail commission based on the performance of previous sales of Payment Protection Insurance at the discretion of the life assurance company. The commission is recognised when payment is received.

Other fees and commissions are recognised on an accruals basis when the service has been provided.

### Financial assets
Financial assets are classified as:

**i) Loans and receivables**
Loans and receivables are non-derivative fixed assets with fixed or determinable payments that are not quoted in an active market. The Group's residential and commercial mortgage loans are classified as loans and receivables and are measured at amortised cost using the effective interest method, net of impairment provisions, with all movements being recognised in the income statement.

**ii) Available-for-sale financial assets**
Available-for-sale financial assets are non-derivative financial assets, principally but not exclusively investment securities intended to be held for an indefinite period of time and which may be sold in response to needs for liquidity. They are measured at fair value with changes in fair value being recognised in reserves except for impairment losses which are recognised in the income statement. The fair value of available-for-sale assets is derived from market data. Where this market data is not available, an independent third party provides a valuation. If the asset is sold before maturity, cumulative gains and losses recognised in reserves are recycled to the income statement.

**iii) Held to maturity financial assets**
Held to maturity financial assets are non-derivative financial assets that the Group has the ability and intention to hold to maturity. They are measured at amortised cost using the effective interest method with all movements being recognised in the income statement.

**iv) Financial assets at fair value accounted**
Through the income statement
This category consists of derivative financial assets which are held at fair value. These financial assets are initially measured at fair value with transaction costs taken directly to the income statement. Subsequent measurement is at fair value with changes in value reflected in the income statement.

**v) Financial assets held-for-trading**
The Group does not hold any financial assets classified as held for trading.

### Financial liabilities
Financial liabilities are measured at:

**i) Amortised cost**
The Group's borrowings, including Member shares, deposits, debt securities in issue and subordinated liabilities, are recognised initially at fair value, being the issue proceeds net of premiums, discounts and transaction costs incurred.

Borrowings are subsequently measured at amortised cost using the effective interest method. Amortised cost is adjusted for the amortisation of any transaction

# Notes to the accounts
for the year ended 31 December 2014

## 1. Accounting policies (continued)

costs and premiums and discounts. The amortisation is recognised in interest expense and similar charges using the effective interest method.

Permanent Interest Bearing Shares (subscribed capital) which are redeemable at specific dates at the option of the Society are classified as liabilities.

**ii) Fair Value Through Profit and Loss (FVTPL)**
Financial liabilities are classified as at FVTPL when the financial liability is designated as at FVTPL.

A financial liability may be designated as at FVTPL upon initial recognition if:

a) Such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise; or

b) The financial liability forms part of a group of financial assets or financial liabilities or both, which is managed and its performance is evaluated on a fair value basis, in accordance with the Group's documented risk management or investment strategy, and information about the grouping is provided internally on that basis; or

c) It forms part of a contract containing one or more embedded derivatives, and IAS 39 Financial Instruments: Recognition and Measurement permits the entire combined contract (asset or liability) to be designated as at FVTPL.

Financial liabilities at FVTPL are stated at fair value, with any gains or losses arising on remeasurement recognised in profit or loss. The net gain or loss recognised in profit or loss incorporates any interest paid on the financial liability and is included in the 'other gains and losses' line item in the income statement. Fair value is determined in the manner described in note 39.

### Impairment losses on loans and advances to customers and credit institutions

The Group assesses at the date of each statement of financial position whether, as a result of one or more events that occurred after initial recognition, there is objective evidence that a financial asset or group of financial assets is impaired. Evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficulty, default or delinquency in interest or principal payments, the debt being restructured to reduce the burden on the borrower, the disappearance or depression of active markets for certain, lending, asset categories and other overall economic conditions.

The Group first assesses whether objective evidence of impairment exists either individually for assets that are separately significant, or collectively for assets that are not separately significant. If there is no objective evidence of impairment for an individually assessed asset it is included in a group of assets with similar credit risk characteristics. For example, accounts subject to forbearance are collectively assessed for impairment.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The resultant provisions have been deducted from the appropriate asset values in the statement of financial position.

In the case of commercial loans that are considered individually significant, cash flows are estimated on a case-by-case basis considering the following factors:

i) Total aggregate exposure to the customer including cross collateralisation;

ii) The viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;

iii) The amount and timing of expected receipts and recoveries;

iv) The likely funds available on liquidation or bankruptcy including any guarantees;

v) The extent of other creditors' commitments ranking ahead of the Society, and the likelihood of other creditors continuing to support the company;

vi) The realisable value of security at the expected date of sale and likelihood of successful repossession; and

vii) The deduction of any likely costs involved in recovery of amounts outstanding.

In the case of commercial loans that are not considered individually significant, cash flows are estimated based on past experience taking into account the total exposure to the customer, the likelihood that the loan will progress through the various stages of delinquency, including being written off and the amount and timing of expected receipts and recoveries.

The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any difference between loss estimates and actual loss experience.

If, in a subsequent period, the amount for the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the provision is adjusted and the amount of the reversal is recognised in the income statement.

Where a loan is not recoverable, it is written off against the related provision for loan impairment once all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. Loans subject to individual impairment assessment are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

Loans are assessed separately for impairment where they have been subject to previous forbearance activity and there is evidence that forbearance will have an impact on the future performance of the loan. For assessment purposes, loans are collectively assessed by forbearance type, taking into account historical performance. Definitions of forbearance are considered in note 39 and in relation to the FSA's paper titled 'Forbearance and Impairment Provisions – Mortgages' issued in October 2011. The Arrears Management Department maintains forbearance information which is reported regularly to Group Risk Committee.

For listed and unlisted investments classified as available-for-sale, a significant

# Notes to the accounts
for the year ended 31 December 2014

## 1. Accounting policies (continued)

or prolonged decline in the fair value of the security below its cost is considered to be objective evidence of impairment. Loans and advances to credit institutions are reviewed on a weekly basis by the Treasury Committee for current and expected credit risk with a view to highlighting the likelihood of any future performance difficulties and losses based on emerging published data and intelligence.

### Derivative financial instruments and hedge accounting

The Group undertakes transactions in derivative financial instruments, which include currency swaps, interest rate swaps, interest rate caps, forward rate agreements, options, and similar instruments. The Group's derivative activities are entered into for the purpose of matching or eliminating risk from potential movements in interest rates, foreign exchange rates and market indices inherent in the Group's assets, liabilities and positions. All derivative transactions are for economic hedging purposes. Financial instruments are initially recognised at fair value.

**i) Derivative financial instruments**

Derivatives are initially measured at fair value and are subsequently re-measured to fair value at each reporting date with movements recorded in the income statement. Fair values are calculated by discounted cash flow models using yield curves that are based on observable market data or are based on valuations from counterparties. Fair values are calculated using mid-prices. All derivatives are classified as assets where their fair value is positive and liabilities where their fair value is negative. Where there is the legal ability and intention to settle net, the derivative is classified as a net asset or liability, as appropriate.

Where cash collateral is received, to mitigate the risk inherent in amounts due to the Group, it is included as a liability within 'amounts owed to credit institutions'. Where collateral is given, to mitigate the risk inherent in amounts due from the Group, it is included as an asset in 'loans and advances to credit institutions'.

**ii) Embedded derivatives**

Certain derivatives are embedded within other non-derivative host instruments to create a hybrid instrument. Where the economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risk of the host instrument, the Group separates the embedded derivative from the host instrument and measures it at fair value with the changes in fair value recognised in the income statement.

**iii) Hedge accounting**

When transactions meet the criteria specified in IAS39, the Group applies fair value hedge accounting so that changes in the fair value of the underlying asset or liability that are attributable to the hedged risk are recorded in the income statement to offset the fair value movement of the related derivative.

To qualify for hedge accounting at inception the hedge relationship must be clearly documented. At inception the derivative must be expected to be highly effective in offsetting the hedged risk, and effectiveness must be tested throughout the life of the hedge relationship.

The Group discontinues hedge accounting when:

i) It is evident from testing that a derivative is not, or has ceased to be, highly effective as a hedge;

ii) The derivative expires, or is sold, terminated or exercised; or

iii) The underlying item matures or is sold or repaid.

The Group may also decide to cease hedge accounting even though the hedge relationship continues to be highly effective by ceasing to designate the financial instrument as a hedge. If the derivative no longer meets the criteria for hedge accounting, the cumulative fair value hedging adjustment is amortised over the period to maturity of the previously designated hedge relationship. If the underlying item is sold or repaid, the unamortised fair value adjustment is immediately reflected in the income statement.

In a micro hedge, the carrying value of the hedged item is adjusted for the change in value of the hedged risk. In the case of a portfolio hedge, the adjustment is included in fair value adjustments for hedged risk.

### Foreign currency translation

The consolidated financial statements are presented in Sterling which is the functional currency of the parent undertaking. Foreign currency transactions are translated into Sterling using the exchange rates prevailing at the dates of the transactions. Monetary items denominated in foreign currencies are translated at the rate prevailing at the date of the statement of financial position.

### Intangible assets

**i) Goodwill**

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisition of subsidiaries is included as an intangible asset. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. The impairment test compares the carrying value of goodwill to the underlying associated asset value in use. If the carrying value exceeds the value in use, goodwill is considered impaired and recognised in the income statement immediately.

Goodwill written off to reserves under UK GAAP prior to the introduction of FRS 10 'Goodwill and Intangible Assets' in 1998 has not been reinstated and will not be included in determining any subsequent profit or loss on disposal.

**ii) Computer software**

IAS38 'Intangible Assets' requires the capitalisation of certain expenditure relating to software development costs. Software development costs are capitalised if it is probable that the asset created will generate future economic benefits. Costs incurred to establish technological feasibility or to maintain existing levels of performance are recognised as an expense.

Web costs are capitalised where the expenditure is incurred on developing an income-generating website.

Where software costs are capitalised, they are amortised using the straight-line method over their estimated useful lives which is three to five years. The amortisation periods used are reviewed annually.

Costs associated with maintaining software are expensed as they are incurred.

# Notes to the accounts

for the year ended 31 December 2014

## 1. Accounting policies (continued)

### Taxation

The tax expense represents the sum of the tax currently payable and deferred tax.

The tax currently payable is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the statement of financial position liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences. In contrast, deferred tax assets are only recognised to the extent that it is probable that future taxable profits will be available against which the temporary differences can be utilised.

Deferred tax related to fair value re-measurement of available-for-sale investments, which is charged or credited directly to the available-for-sale reserve, is also credited or charged directly to the available-for-sale reserve and is subsequently recognised in the income statement together with the deferred gain or loss.

Both current and deferred tax balances are calculated using tax rates that have been enacted or substantively enacted by the date of the statement of financial position and are expected to apply to the period when the liability is settled or the asset is realised.

### Property, plant and equipment

Freehold and long leasehold properties comprise mainly of branches and office buildings. Valuations are completed annually by independent surveyors.

Property, plant and equipment are stated at cost less accumulated depreciation and provision for impairment, as appropriate. Additions and subsequent expenditure are included in the asset's carrying value or are recognised as a separate asset only when they improve the expected future economic benefits to be derived from the asset.

All other repairs and maintenance are charged to the income statement in the period in which they are incurred.

Properties in the course of construction for production, supply or administrative purposes, or for purposes not yet determined, are carried at cost, less any recognised impairment loss. Cost includes professional fees and, for qualifying assets, borrowing costs capitalised in accordance with the Group's accounting policy. Depreciation of these assets, on the same basis as other property assets, commences when the assets are ready for their intended use.

Land is not depreciated. Depreciation on other assets is provided using the straight-line method to allocate costs less residual values over estimated useful lives, as follows:

| | |
|---|---|
| Freehold property | 2% |
| Leasehold property (or unexpired period of the lease) | 2% |
| Major alterations to buildings | 10% |
| Plant, equipment, fixtures and fittings | 10%-15% |
| Computer equipment | 20%-33% |
| Motor vehicles | 25% |

Residual values and useful lives of assets are reviewed, and adjusted if appropriate, at the date of each statement of financial position. Where the cost of freehold land can be identified separately from buildings, the land value is not depreciated. Fixed assets are subject to impairment testing, where it is considered necessary. Any impairment is recognised immediately in the Income Statement.

Gains and losses on disposal are determined by comparing the net disposal proceeds with the carrying amount of the asset and are included in the income statement.

### Pension costs

The Society operates two pension schemes, a defined contribution scheme and a defined benefit scheme.
A defined contribution scheme is one into which the Group and the employee pay fixed contributions, without any obligation to pay further contributions. Payments into the defined contribution scheme are charged to the income statement as they become payable in accordance with the rules of the scheme. The majority of the Group's employees are members of this scheme.

A defined benefit scheme is one that defines the benefit an employee will receive on retirement, depending on such factors as age and length of service. Defined benefit pension scheme assets are measured using closing market values. Whereas scheme liabilities are measured using the projected unit method and discounted at the current rate of return on a high quality corporate bond of equivalent term and currency to the liability. This scheme closed to future accruals on 31 July 2010.

The increase in the present value of the liabilities of the defined benefit scheme expected to arise from employee service in the period is charged to the income statement. The expected return on the scheme's assets and the increase during the period in the present value of the scheme's liabilities, arising from the passage of time, are included in other operating income.

Actuarial gains and losses are recognised in full in the statement of other comprehensive income.

Qualifying insurance policies are reflected in plan assets at their fair value, which is defined as the present value of the related defined benefit obligations. The difference between the fair value of plan assets and the cost of the policy is treated as an actuarial loss which is recognised in full in the statement of other comprehensive income.

### Leases

Leases entered into by the Group are operating leases. Operating leases are leases that do not transfer substantially all the risks and rewards incidental to the ownership of the lease.

**i) As lessee**

Operating lease payments are charged to the income statement on a straight-line basis over the life of the lease.

# Notes to the accounts

for the year ended 31 December 2014

## 1. Accounting policies (continued)

**ii) As lessor**

Lease income receivable under operating leases is credited to the income statement on a straight-line basis over the life of the lease.

### Debt securities in issue, subordinated liabilities and Permanent Interest-Bearing Shares

Premiums and discounts, together with costs associated with the issue of debt securities, subordinated liabilities and permanent interest-bearing shares, are accounted for as an adjustment to the amount of the liability and amortised using the effective interest method.

### Segmental reporting

A business segment is defined as a group of assets and operations providing products and services that are subject to different risks and returns from the other business segments. The Group considers that business segments are its primary reporting format for segmental analysis. Business segments are reported in a manner consistent with the internal reporting provided to the Board which has been identified as the chief operating decision maker.

### Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, including: cash and non-restricted balances with central banks, treasury bills and other eligible bills, loans and advances to banks, other amounts due from banks and short-term Government securities.

### Provisions and contingent liabilities

A provision is recognised when there is a present obligation as a result of a past event, it is probable that the obligation will be settled and it can be reliably estimated.

Where it is not probable that the obligation will be settled and/or it cannot be reliably estimated, a contingent liability is disclosed in the notes to the accounts.

### Sale and repurchase agreements

Investment and other securities may be lent or sold subject to a commitment to repurchase them (a 'repo'). Such securities are retained on the statement of financial position when substantially all the risks and rewards of ownership remain within the Group, and the counterparty liability is included separately on the statement of financial position as appropriate.

Similarly, where the Group borrows or purchases securities subject to a commitment to resell them (a 'reverse repo') but does not acquire the risks and rewards of ownership, the transactions are treated as collateralised loans, and the securities are not included in the statement of financial position.

## 2. Judgements in applying accounting policies and critical accounting estimates

The Group has to make judgements in applying its accounting policies which affect the amounts recognised in the financial statements. In addition, estimates and assumptions are made that could affect the reported amounts of assets and liabilities within the following financial year. The most significant areas where judgements and estimates are made are as follows:

### Impairment provision on loans and advances

In accordance with the accounting policy on the impairment of financial assets carried at amortised cost where objective evidence exists that a loss has been incurred, the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate.

Key assumptions included in the measurement of the incurred loss include data regarding the probability of any account going into default, the probability of defaulted accounts progressing to possession and the eventual loss incurred in the event of forced sale or write-off. The House Price Index (HPI) and the discount applied on forced sale are key assumptions on the residential mortgage books. To the extent the HPI movements were to differ from current observations by 1%, the impact on provisions would be £0.7m. The impact of a 1% change in the forced sale discounts currently being experienced would impact provisions by £0.3m.

The loan loss provision against the Commercial lending portfolio is sensitive to a number of factors including: Commercial real estate values at the expected date of sale; the customer's business model and their capacity to trade successfully out of financial difficulties; and the likely funds available on liquidation or bankruptcy, including any guarantees.

These assumptions are based on observed historical data and updated as management considers appropriate to reflect current and future conditions. The accuracy of the impairment provision would therefore be affected by unexpected changes in the above assumptions.

Collateral values are updated at the date of each statement of financial position based on the best information publicly available. Land Registry data is used in the Retail Financial Services sector with Hometrack being used in the Secured Personal Lending sector. External valuations are used to estimate commercial security values and future cash flows.

### Fair value of derivatives and available-for-sale assets

Derivative financial instruments and available-for-sale assets are stated at fair value. Derivative financial instruments are valued by discounted cash flow models using yield curves that are based on observable market data. Available-for-sale assets are, in the majority of cases, valued using market prices or prices obtained from counterparties. In cases where market prices are not available, discounted cash flow models are used. Changes in the assumptions used in the models could affect the reported fair value of available-for-sale assets.

The Group applies fair value hedge accounting which relies on a number of assumptions, the most significant of which relates to estimates in respect of loan prepayments.

# Notes to the accounts

for the year ended 31 December 2014

## 2. Judgements in applying accounting policies and critical accounting estimates (cont.)

### Retirement benefit obligations

The Group has to make assumptions on the expected return on pension plan assets, mortality inflation and future salary rises when valuing its pension liability and the cost of benefits provided. Changes in assumptions could affect the reported liability, service cost and expected return on pension plan assets.

The impact of a 0.1% increase in the inflation assumptions would be to increase the carrying value of the pension obligations by approximately £0.9m. The impact of a 0.1% increase in the discount rate would be to reduce the value of pension obligations by approximately £0.8m.

Further details on the assumptions used in valuing retirement benefit obligations and other sensitivity analysis can be found in note 12.

### Effective interest rate (EIR)

The Group uses the EIR method to recognise income for certain financial instruments held at amortised cost. To calculate the appropriate EIR, the Group makes assumptions of the expected lives of financial instruments and the anticipated level of early redemption charges.

The impact of a 10% change in the expected lives of financial instruments would result in an increase/decrease in the value of the loans in the statement of financial position by £0.4m/(£0.4m) respectively. The impact of a 10% change in the anticipated level of early redemption would result in an increase/decrease in the value of the loans in the statement of financial position by £0.5m/(£0.5m) respectively.

### Other provisions for liabilities and charges

**i) Customer and regulatory complaints**

The Group holds provisions for customer and regulatory complaints.

During the year the Group completed the detailed and comprehensive review of its compliance with consumer credit legislation which had commenced in 2013. The total net remediation costs for the issues identified were £8.5m, of which £0.5m was charged in the current year (2013: £8.0m).

Provisions have been made in respect of claims in relation to previous sales of Payment Protection Insurance (PPI) which, in the Group's case, relate to secured personal lending PPI products. The PPI remediation process is nearing completion. At 31 December 2014, the Group holds a provision of £0.4m (2013: £1.1m), which it expects to be sufficient to meet obligations in relation to previous sales of PPI. The level of provision is calculated based upon estimates of complaint volumes, the rate at which these claims are upheld and the level of redress paid on each complaint.

**ii) Financial Services Compensation Scheme (FSCS) levy**

Along with other deposit-taking institutions, the Group has a provision for liabilities under the FSCS. The group took early adoption of IFRIC 21 Levies in the 2013 annual accounts.

As at 31 December 2014, the Group holds a provision of £2.2m in respect of levies payable in September 2015. The principal assumption underlying the provision relates to the interest charged on the loans funding the scheme by HM Treasury. A 1% increase in the expected level of interest would increase the value of the required provision by £1.1m.

The Group's ultimate liability for levies payable to the FSCS in respect of failed financial institutions remains uncertain. The provided amount is dependent upon the following factors:

- Future interest rates;
- Capital shortfalls from insufficient recoveries to fully repay loans from HM Treasury;
- The Group's share of industry protected deposits as at 31 December 2014; and
- The future structure of any replacement scheme.

Further detail of the FSCS and the provision held are included in note 38.

# Notes to the accounts
for the year ended 31 December 2014

## 3. Business segments

The Group operates three main business segments: retail financial services, secured personal lending and commercial lending. These segments are used for internal reporting to the Board which is responsible for all significant decisions. Transactions between the business segments are on normal commercial terms and conditions.

| | 2014 – continuing activities | | | | |
|---|---|---|---|---|---|
| | Retail financial services | Commercial lending | Secured personal lending | Adjustment for Group transactions* | Total |
| | £m | £m | £m | £m | £m |
| **Net interest income** | 88.7 | 13.1 | 32.0 | - | 133.8 |
| Other income and charges | 4.4 | 1.9 | 0.3 | - | 6.6 |
| **Net operating income** | 93.1 | 15.0 | 32.3 | - | 140.4 |
| Administrative expenses | (60.3) | (4.0) | (11.9) | 11.5 | (64.7) |
| Impairment provision for losses on loans and advances | (2.1) | (9.2) | (2.2) | - | (13.5) |
| Provision for other liabilities and charges | (3.8) | (0.6) | (4.3) | - | (8.7) |
| **Operating profit/(loss)** | 26.9 | 1.2 | 13.9 | 11.5 | 53.5 |
| Other gains | - | - | - | - | - |
| **Profit/(loss) before taxation** | **26.9** | **1.2** | **13.9** | **11.5** | **53.5** |
| Tax | - | - | - | - | (11.7) |
| Profit for the period from discontinued operations | | | | | 10.5 |
| **Profit for the year** | | | | | **52.3** |

*The administrative expenses include the impact of the pension past service costs relating to the change from RPI to CPI.

| | 2013 Restated** – continuing activities | | | | |
|---|---|---|---|---|---|
| | Retail financial services | Commercial lending | Secured personal lending | Adjustment for Group transactions | Total |
| | £m | £m | £m | £m | £m |
| **Net interest income** | 68.6 | 11.0 | 36.8 | - | 116.4 |
| Other income and charges | 6.3 | 2.0 | 4.0 | (0.3) | 12.0 |
| **Net operating income** | 74.9 | 13.0 | 40.8 | (0.3) | 128.4 |
| Administrative expenses | (53.1) | (4.2) | (10.7) | 2.7 | (65.3) |
| Impairment provision for losses on loans and advances | (0.4) | (16.7) | (5.3) | - | (22.4) |
| Provision for other liabilities and charges | (3.5) | (0.6) | (8.4) | - | (12.5) |
| **Operating profit/(loss)** | 17.9 | (8.5) | 16.4 | 2.4 | 28.2 |
| Other gains | - | - | - | - | - |
| **Profit/(loss) before taxation** | **17.9** | **(8.5)** | **16.4** | **2.4** | **28.2** |
| **Tax** | | | | | (6.2) |
| Profit for the period from discontinued operations | | | | | 0.2 |
| **Profit for the year** | | | | | **22.2** |

**Restated to reflect the reclassification of discontinued operations. Further information can be found in note 1.

# Notes to the accounts
for the year ended 31 December 2014

## 3. Business segments (continued)

| | Group | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| **Total assets by business segment** | | |
| Retail financial services | 5,921.6 | 5,653.2 |
| Secured personal lending | 530.9 | 572.9 |
| Commercial lending | 812.5 | 822.9 |
| Property services | - | 9.1 |
| **Total assets** | **7,265.0** | **7,058.1** |
| **Total liabilities and equity by business segment** | | |
| Retail financial services | 6,734.1 | 6,478.3 |
| Secured personal lending | 530.9 | 570.7 |
| Commercial lending | - | - |
| Property services | - | 9.1 |
| **Total liabilities and equity** | **7,265.0** | **7,058.1** |

The Group operates entirely within the UK and therefore a geographical segment analysis is not presented.

## 4. Interest receivable and similar income

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| On loans fully secured on residential property | 248.8 | 252.1 | 203.7 | 201.8 |
| On other loans fully secured on land | 17.6 | 20.0 | 17.6 | 20.0 |
| On other loans to subsidiaries | - | - | 13.0 | 13.6 |
| On debt securities | 5.6 | 5.4 | 5.6 | 5.4 |
| Profit on realisation of investments | 0.2 | 0.6 | 0.2 | 0.6 |
| On other liquid assets | 2.4 | 2.1 | 2.4 | 2.1 |
| On derivative financial instruments | (16.6) | (18.6) | (16.6) | (18.6) |
| | **258.0** | **261.6** | **225.9** | **224.9** |

# Notes to the accounts
for the year ended 31 December 2014

## 5. Interest payable and similar charges

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| On shares held by individuals | 113.9 | 137.0 | 113.9 | 137.0 |
| On deposits and debt securities | 15.6 | 11.1 | 18.9 | 11.1 |
| On subscribed capital | 4.2 | 4.2 | 4.2 | 4.2 |
| On subordinated liabilities | 1.4 | 1.4 | 1.4 | 1.4 |
| On derivative financial instruments | (10.9) | (8.5) | (12.4) | (8.5) |
| | **124.2** | **145.2** | **126.0** | **145.2** |

## 6. Fees and commission receivable

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Insurance and related financial service products | 2.5 | 5.8 | 2.5 | 3.6 |
| Mortgage related fees | 4.3 | 5.1 | 4.3 | 5.1 |
| Other fees and commission | 0.8 | 2.5 | 0.1 | 0.2 |
| | **7.6** | **13.4** | **6.9** | **8.9** |

## 7. Fees and commission payable

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Mortgage related fees | 0.6 | 0.7 | 0.2 | 0.2 |
| Bank charges | 0.4 | 0.4 | 0.4 | 0.4 |
| | **1.0** | **1.1** | **0.6** | **0.6** |

## 8. Other fair value gains and losses

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| (Losses)/gains on derivatives | (23.3) | 17.3 | (21.3) | 17.3 |
| Gains/(losses) on hedged items attributable to the hedged risk | 21.8 | (18.5) | 21.8 | (18.5) |
| | **(1.5)** | **(1.2)** | **0.5** | **(1.2)** |

Other fair value gains and losses represent the difference between changes in the fair values excluding interest flows of the hedging derivatives and the changes in the fair values excluding interest flows of the underlying hedged items.

# Notes to the accounts
for the year ended 31 December 2014

## 9. Administrative expenses

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Wages and salaries | 33.7 | 31.8 | 28.9 | 26.9 |
| Social security costs | 3.4 | 3.1 | 3.0 | 2.6 |
| Other pension costs* | (8.2) | 1.8 | (8.4) | 1.7 |
| | 28.9 | 36.7 | 23.5 | 31.2 |
| Other administrative expenses | 26.7 | 22.2 | 22.7 | 19.6 |
| | **55.6** | **58.9** | **46.2** | **50.8** |

*Included in other pensions costs for 2014 is the pension past service credit of £10.1m. Further details can be found in Note 12.

| | | £000 | £000 | £000 | £000 |
|---|---|---|---|---|---|
| **Other administrative expenses include:** | | | | | |
| **Auditor's remuneration:** | | | | | |
| For audit of the Society's Annual Accounts | | 168 | 142 | 168 | 142 |
| For audit of the Society's subsidiaries | | 13 | 8 | - | - |
| **Total** | | **181** | **150** | **168** | **142** |
| **For other services:** | | | | | |
| Tax advisory | | 86 | 174 | 86 | 174 |
| Specialist consultancy | | - | 11 | - | 11 |
| Further assurance services | | 124 | 16 | 124 | - |
| All other services | | 20 | - | 20 | - |
| **Total other services** | | **230** | **201** | **230** | **185** |
| | | | | | |
| Operating lease charges | - motor vehicles | 243 | 261 | 243 | 232 |
| | - land and buildings | 1,492 | 1,640 | 987 | 935 |

## 10. Employees

The average number employed including executive directors was:

| | Full-time | | Part-time | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | Number | Number | Number | Number |
| Society's Customer Support Centre and administration office | 572 | 559 | 80 | 75 |
| Society branch offices | 191 | 194 | 134 | 145 |
| Employed by the Society | 763 | 753 | 214 | 220 |
| Subsidiaries | 199 | 280 | 45 | 64 |
| **Employed by the Group** | **962** | **1,033** | **259** | **284** |

## 11. Emoluments of the Society's directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on page 49 in accordance with Schedule 5, paragraphs 4 and 5 to the Building Societies (Accounts and Related Provisions) Regulations 1998. Total directors' emoluments for the year were £2.2m (2013: £1.8m).

# Notes to the accounts
for the year ended 31 December 2014

## 12. Retirement benefit obligations

The Group operates two pension schemes, a defined contribution scheme and a defined benefit scheme

### Defined contribution scheme
The Group operates a defined contribution scheme, the Group Flexible Retirement Plan (GFRP). A defined contribution scheme is one into which the Group and the employee pay fixed contributions, without any obligation to pay further contributions. Staff employed after 1 January 2001 and those staff who were formerly members of the defined benefit scheme are eligible to join this scheme. The cost to the Group and Society of employer's contributions (before salary sacrifice arrangements) to the scheme in 2014 was £1.7m (2013: £1.1m). There were no contributions outstanding or prepaid at the end of the year.

From 1 January 2014 employees not currently in the pension scheme were auto-enrolled into the defined contribution scheme.

### Defined benefit scheme
A defined benefit scheme is one that defines the benefit an employee will receive on retirement, depending on such factors as age, length of service and salary. Staff, including executive directors, who entered service before 1 January 2001 were eligible to join the Society's Defined Benefit Scheme which is designed to provide pension entitlements based on career average salary (final salary until 31 December 2005) with assets held outside the Society in a separate fund administered by the Trustees of the pension fund. Membership of the Scheme is, however, available at the discretion of the Society and a small number of new members have been admitted to the scheme on this basis subsequent to 1 January 2001.

The defined benefit scheme closed to future accruals on 31 July 2010 and was replaced with an enhanced defined contribution scheme, the GFRP, described in the above section.

The defined benefit scheme was subject to a triennial valuation by the scheme's independent actuary on 30 September 2013. As part of the triennial valuation process, on 3 April 2014 the Trustees agreed with a proposal from the Society to change the index against which pension liabilities are uplifted from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI). This is in line with industry practice, with the majority of defined benefit schemes having changed their reference index to CPI. Under IAS19, amendments to benefits payable for past service are treated as a past service cost, and recognised in the income statement in full at the point at which the change is made. The amount of the past service cost is measured as the change in the present value of the defined benefit obligation resulting from the change in benefits. The total past service cost relating to the index change was £10.1m, which is recognised in full in the income statement for the period.

During 2012, the Trustees of the defined benefit scheme agreed a buy-in of the pensioner element of the scheme with Legal and General Assurance Society Limited. The buy-in involved the purchase of a bulk annuity policy by the scheme under which Legal and General assumed full responsibility for the benefits payable to the scheme's current pensioners. The buy-in took effect from September 2012. The pensioner liability and the matching annuity policy remain within the scheme. The premium paid for the annuity policy was £30.8m which the scheme settled with a combination of cash and assets including an additional Group contribution of £5.4m. This additional contribution is recognised in the statement of other comprehensive income. The annuity policy is retaining a link to RPI whereas the liability is now linked to CPI.

A further £2.1m was paid in to the pension scheme from the Society during 2014. This total is comprised of the agreed schedule of contributions £1.9m, and an additional contribution of £0.2m as a result of the disposal of Peter Alan in order to extinguish the element of the Scheme's deficit attributable to that employer.

Scheme management consists of a Board of Trustees, comprising five individuals, two of whom were elected by the members to the Board of Trustees as Member Nominated Trustees. The power of appointment and removal of the Trustees is vested in the Society in accordance with the Trust Deed.

The Trustees have continued to act in accordance with the Statement of Investment Principles adopted on 1 November 2007 as required by Section 35 of the Pensions Act 1995. Assets supporting the Scheme are managed by Royal London Asset Management, Baring Asset Management and Standard Life Investments. In addition the Trustees may hold cash from time to time. The assets managed by Standard Life Investments and Baring Asset Management during the year were invested to target a long-term rate of return well in excess of inflation.

The Society also funds the cost of life assurance cover for staff members, and provides unfunded pensions directly to certain directors and employees who retired prior to 1997.

Updated calculations prepared by the scheme actuary on the IAS19 basis at 31 December 2014, including the unfunded liability referred to above, reflected a deficit amounting to £6.9m (2013: £17.1m).

The cumulative amount of actuarial losses recognised in other comprehensive income since the date of transition to IFRS is £21.3m (2013 Restated: £19.7m).

Pension obligation risk is discussed in the Risk management report on page 23.

The major assumptions used for the purpose of the actuarial valuation were as follows:

| | At 31 December | | | | |
|---|---|---|---|---|---|
| | 2014 | 2013 | 2012 | 2011 | 2010 |
| | % | % | % | % | % |
| Rate of increase in pensionable salaries | 2.05 | 3.50 | 3.00 | 3.05 | 3.55 |
| Rate of increase of pensions in payment and deferred pensions | 2.05 | 3.50 | 3.00 | 3.05 | 3.55 |
| Discount rate | 3.55 | 4.50 | 4.60 | 4.70 | 5.40 |
| Inflation assumption (RPI) | 3.05 | 3.50 | 3.00 | 3.05 | 3.55 |
| Inflation assumption (CPI) | 2.05 | 2.70 | 2.60 | 2.25 | 3.05 |

# Notes to the accounts
for the year ended 31 December 2014

## 12. Retirement benefit obligations (continued)

The assumptions on mortality are determined by the following tables:

| | 2014 | 2013 |
|---|---|---|
| Retired and non-retired members | SAPS CMI2013 LTR1.25% | SAPS CMI2013 LTR1.5% |
| **The assumptions are illustrated by the following year of life expectancy at age 65:** | | |
| **Retired members** | | |
| Males currently aged 65 | 22.4 | 22.4 |
| Females currently aged 65 | 24.8 | 24.9 |
| **Non-retired members** | | |
| Males currently aged 45 | 24.1 | 24.5 |
| Females currently aged 45 | 26.7 | 27.2 |

The retirement benefit obligation relating to the scheme recognised in the statement of financial position is made up as follows:

| | At 31 December | | | | |
|---|---|---|---|---|---|
| | 2014 | 2013 | 2012 | 2011 | 2010 |
| | £m | £m | £m | £m | £m |
| Target return funds | 26.5 | 25.0 | 24.2 | 22.6 | 22.4 |
| Debt securities | - | - | - | 22.6 | 20.4 |
| Annuities | 25.2 | 23.4 | 22.7 | - | - |
| Bonds and cash | 2.9 | 1.3 | 0.5 | 0.9 | 0.4 |
| Total fair value of plan assets | 54.6 | 49.7 | 47.4 | 46.1 | 43.2 |
| Present value of funded obligations | (61.0) | (66.3) | (60.1) | (57.1) | (52.0) |
| Present value of unfunded obligations | (0.5) | (0.5) | (0.5) | (0.5) | (0.5) |
| **Net deficit recognised in the statement of financial position** | **(6.9)** | **(17.1)** | **(13.2)** | **(11.5)** | **(9.3)** |

The actual return on plan assets was £2.9m (2013: £1.5m). The amounts recognised in the income statement are as follows:

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| **Analysis of the amounts recognised in the income statement** | | |
| Interest on pension scheme assets | (2.2) | (1.2) |
| Interest on pension scheme liabilities | 2.6 | 1.7 |
| Net interest expense | 0.4 | 0.5 |
| Past service credit | (10.1) | - |
| **Total amount recognised in the income statement** | (9.7) | 0.5 |
| **Analysis of amount recognised in statement of other comprehensive income** | | |
| Gain on scheme assets in excess of interest | 2.4 | 0.4 |
| Experience losses on liabilities | - | (0.6) |
| Gains from changes to demographic assumptions | 0.9 | 0.8 |
| Losses from changes to financial assumptions | (4.9) | (4.9) |
| **Total remeasurement** | **(1.6)** | **(4.3)** |
| **Analysis of the movement in the statement of financial position deficit** | | |
| Deficit in scheme at beginning of year | (17.1) | (13.2) |
| Movement in year: | | |
| Net interest expense | (0.4) | (0.5) |
| Remeasurements | (1.6) | (4.3) |
| Contributions paid and accrued | 2.1 | 0.9 |
| Past service credit | 10.1 | - |
| **Deficit in scheme at end of year** | **(6.9)** | **(17.1)** |

# Notes to the accounts
for the year ended 31 December 2014

## 12. Retirement benefit obligations (continued)

Analysis of the movement in the fair value of pension scheme assets

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| Fair value of assets at the beginning of the year | 49.7 | 47.4 |
| Interest on assets | 2.2 | 1.1 |
| Society contributions | 2.1 | 0.9 |
| Benefits paid | (1.8) | (0.5) |
| Return on plan assets less interest | 0.6 | 0.4 |
| Change in fair value of the annuity policy | 1.8 | 0.4 |
| **Fair value of assets at the end of the year** | **54.6** | **49.7** |

Significant actuarial assumptions in the determination of the defined benefit obligation are the discount rate, inflation rate and life expectancy. The sensitivity analysis below represents the net impact on the Scheme liabilities taking in to account the change in the value of both the Scheme's liabilities and the bulk annuity contract. No allowance has been made for any changes to the non-insured asset values.

| | Increase 0.5% | Decrease 0.5% |
|---|---|---|
| | £m | £m |
| Discount rate | (4.1) | 4.8 |
| Inflation | 4.4 | (3.7) |
| Life expectancy (+1 year/-1 year) | 1.8 | (1.8) |

The sensitivity analysis presented above may not be representative of the actual change in the scheme liabilities as it is unlikely that the change in assumptions would occur in isolation of one another as some of the assumptions may be correlated.

## 13. Taxation

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| **Current tax** | | | | |
| UK corporation tax charge for the year | 10.8 | 7.5 | 7.6 | 3.4 |
| Adjustments in respect of prior years | (1.0) | (1.0) | (0.5) | (0.6) |
| | 9.8 | 6.5 | 7.1 | 2.8 |
| **Deferred tax** | | | | |
| Deferred tax charge for year | 1.4 | (0.8) | 1.4 | (0.7) |
| Adjustments in respect of prior years | 0.5 | 0.5 | 0.5 | 0.5 |
| | 1.9 | (0.3) | 1.9 | (0.2) |
| **Taxation on profit on ordinary activities** | **11.7** | **6.2** | **9.0** | **2.6** |

The statutory rate of corporation tax was reduced to 21.0% from 1 April 2014. The Group was subject to corporation tax at a rate of 23.0% for the period 1 January to 31 March 2014, and 21.0% for the period 1 April to 31 December 2014, resulting in an effective rate of corporation tax of 21.5% for the full year in 2014.

# Notes to the accounts
for the year ended 31 December 2014

## 13. Taxation (continued)

The actual tax charge for the year differs from that calculated using the standard rate of corporation tax in the UK. The differences are explained below.

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Profit before taxation | 64.0 | 28.4 | 51.4 | 11.3 |
| Profit multiplied by the standard rate of corporation tax at 21.5% (2013: 23.3%) | 13.8 | 6.6 | 11.0 | 2.6 |
| **Effects of:** | | | | |
| Expenses not deductible for tax purposes | 1.1 | 0.1 | 0.8 | 0.3 |
| Adjustments to prior years | (0.4) | (0.5) | - | (0.1) |
| Other | (2.8) | - | (2.8) | (0.2) |
| **Total taxation for the year** | **11.7** | **6.2** | **9.0** | **2.6** |

In addition to the amount charged to the income statement, the following amounts relating to tax have been recognised in other comprehensive income:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| **Current tax** | | | | |
| Relating to retirement benefit obligations | (0.6) | (0.3) | (0.6) | (0.3) |
| Revaluations of available-for-sale financial assets | 1.5 | (1.8) | 1.5 | (1.8) |
| | 0.9 | (2.1) | 0.9 | (2.1) |
| **Deferred tax** | | | | |
| Relating to retirement benefit obligations | 0.2 | (0.1) | 0.2 | (0.1) |
| | 0.2 | (0.1) | 0.2 | (0.1) |
| **Total charged to other comprehensive income** | **1.1** | **(2.2)** | **1.1** | **(2.2)** |

# Notes to the accounts
for the year ended 31 December 2014

## 14. Discontinued operations

On 30 July 2014, the Group entered into a sale agreement to sell Peter Alan Limited, its subsidiary businesses and the Group's surveyors business (together 'Peter Alan'), which together carried out all of the Group's estate agency, lettings and surveying operations. The disposal was completed on 30 July 2014, on which date control of Peter Alan passed to the acquirer.

Upon completion, in exchange for the sale of its 100% shareholding, the Group received consideration of £16.4m. The consideration generated a gain of £10.5m, being the sale proceeds less costs, less the carrying amount of Peter Alan's net assets and attributable goodwill at the time of completion.

The sale of the investment in Peter Alan generated a profit within the income statement of the Society of £12.3m, with the difference to the Group profit attributable to the lower carrying value of the investment on the Society's statement of financial position. The surveying activities of the Group formed part of the Society's activities and hence have been reclassified as discontinued operations. The Society's surveying activities generated a loss for the period of £0.4m (2013: £0.5m).

The sale is in line with the Group strategy of focusing on the core business of the building society. The Board considered that significant investment would be required to maximise the potential of Peter Alan, and the focus on the core Society has reduced the strategic rationale for maintaining an estate agency and letting business within the Group.

The results of the discontinued operations, which have been included in the consolidated income statement, were as follows:

| | 2014 | 2013 |
|---|---|---|
| | £m | £m |
| Revenue | 6.9 | 10.7 |
| Expenses | (6.7) | (10.2) |
| Profit before tax | 0.2 | 0.5 |
| Attributable tax expense | (0.2) | (0.3) |
| **Profit attributable to discontinued operations** | **-** | **0.2** |

During the year, Peter Alan Limited contributed £1.4m (year to 31 December 2013: £2.4m) to the Group's net operating cash flows, received £0.3m (year to 31 December 2013: paid £3.0m) in respect of investing activities and received £Nil (year to 31 December 2013: £Nil) in respect of financing activities.

## 15. Loans and advances to credit institutions

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| On demand | 117.8 | 87.6 | 16.8 | 16.9 |
| Less than three months | - | 5.0 | - | 5.0 |
| Between three months and one year | - | 5.0 | - | 5.0 |
| Credit Support Annex (CSA) assets | 32.9 | 22.9 | 32.9 | 22.9 |
| | **150.7** | **120.5** | **49.7** | **49.8** |

The International Swaps and Derivatives Association (ISDA) Master Agreement is Principality's preferred agreement for documenting derivative activity. For certain counterparties a Credit Support Annex (CSA) has been executed in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between counterparties to mitigate the market contingent counterparty risk inherent in the outstanding positions. £32.9m has been pledged at the statement of financial position date (2013: £22.9m).

# Notes to the accounts
for the year ended 31 December 2014

## 16. Debt securities

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| Issued by UK government | 300.5 | 347.0 |
| Issued by Supranational entities | 79.1 | 116.0 |
| Issued by other borrowers and unlisted | 74.5 | 103.0 |
| | **454.1** | **566.0** |

Debt securities are held as available-for-sale assets and carried at their fair value.

Other than the Supranational entities, all liquid assets are obtained from sources within the UK.

The debt securities set out above are repayable from the date of the statement of financial position in the ordinary course of business as follows:

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| Accrued interest | 2.0 | 3.7 |
| Less than three months | 45.9 | 60.0 |
| Between three months and one year | 25.0 | 63.6 |
| Between one year and five years | 381.2 | 415.8 |
| Greater than five years | - | 22.9 |
| | **454.1** | **566.0** |

The movement in available-for-sale debt securities is summarised as follows:

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| At 1 January | 566.0 | 447.6 |
| Additions | 232.2 | 476.2 |
| Disposals and maturities | (349.5) | (350.5) |
| Gains/(losses)from changes in fair value | 7.1 | (8.2) |
| (Decrease)/increase in accrued interest | (1.7) | 0.9 |
| **At 31 December** | **454.1** | **566.0** |

# Notes to the accounts
for the year ended 31 December 2014

## 17. Derivative financial instruments

Currency and interest rate swaps are used by the Group for hedging purposes. These are commitments to exchange one set of cash flows for another. No exchange of principal takes place.

| | Group | | | |
|---|---|---|---|---|
| | Contract/notional amount | | Fair value | |
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| **Derivative assets held for hedging purposes and designated fair value hedges:** | | | | |
| Interest rate swaps | 1,936.7 | 1,736.3 | 26.2 | 30.8 |
| Cross currency interest rate swaps | 15.5 | 16.6 | 2.0 | 3.1 |
| Equity and RPI index linked interest rate swaps | 36.1 | 48.2 | 2.7 | 3.7 |
| **Total recognised derivative assets** | **1,988.3** | **1,801.1** | **30.9** | **37.6** |
| **Derivative liabilities held for hedging purposes and designated fair value hedges:** | | | | |
| Interest rate swaps | 2,690.1 | 1,205.9 | (42.8) | (25.5) |
| Equity and RPI index linked interest rate swaps | - | 14.2 | - | (0.7) |
| **Total recognised derivative liabilities** | **2,690.1** | **1,220.1** | **(42.8)** | **(26.2)** |

| | Society | | | |
|---|---|---|---|---|
| | Contract/notional amount | | Fair value | |
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| **Derivative assets held for hedging purposes and designated fair value hedges:** | | | | |
| Interest rate swaps | 1,936.7 | 1,736.3 | 26.2 | 30.8 |
| Cross currency interest rate swaps | 15.5 | 16.6 | 2.0 | 3.1 |
| Equity and RPI index linked interest rate swaps | 36.1 | 48.2 | 2.7 | 3.7 |
| **Total recognised derivative assets** | **1,988.3** | **1,801.1** | **30.9** | **37.6** |
| **Derivative liabilities held for hedging purposes and designated fair value hedges:** | | | | |
| Interest rate swaps | 2,374.5 | 1,205.9 | (40.8) | (25.5) |
| Equity and RPI index linked interest rate swaps | - | 14.2 | - | (0.7) |
| **Total recognised derivative liabilities** | **2,374.5** | **1,220.1** | **(40.8)** | **(26.2)** |

# Notes to the accounts
for the year ended 31 December 2014

## 18. Assets measured at fair value

| | Group and Society | | |
|---|---|---|---|
| | 2014 | Level 1 | Level 2 |
| | £m | £m | £m |
| **Financial assets at fair value through profit or loss:** | | | |
| Derivative financial instruments | 30.9 | - | 30.9 |
| **Available-for-sale financial assets:** | | | |
| Debt securities | 454.1 | 454.1 | - |
| **Total** | **485.0** | **454.1** | **30.9** |

| | Group and Society | | |
|---|---|---|---|
| | 2013 | Level 1 | Level 2 |
| | £m | £m | £m |
| **Financial assets at fair value through profit or loss:** | | | |
| Derivative financial instruments | 37.6 | - | 37.6 |
| **Available-for-sale financial assets:** | | | |
| Debt securities | 566.0 | 566.0 | - |
| **Total** | **603.6** | **566.0** | **37.6** |

The tables above provide an analysis of financial instruments that are measured subsequent to initial recognition at fair value, grouped into levels 1 to 3 based on the degree to which the fair value is observable.

| Level | Hierarchy for fair value disclosures |
|---|---|
| 1 | Quoted prices (unadjusted) in active markets for identical assets or liabilities. |
| 2 | Inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly (i.e. derived from prices). |
| 3 | Inputs for the asset or liability that are not based on observable market data. There are no instruments classified as level 3 in 2014 (2013: none). |

# Notes to the accounts
for the year ended 31 December 2014

## 19. Loans and advances to customers

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Maturity analysis of loans and advances to customers from the date of the statement of financial position: | | | | |
| Less than three months | 179.0 | 157.7 | 168.3 | 146.9 |
| Between three months and one year | 214.5 | 245.6 | 182.6 | 214.7 |
| Between one year and five years | 1,088.5 | 1,036.3 | 920.8 | 865.7 |
| More than five years | 4,668.4 | 4,496.6 | 4,335.4 | 4,132.8 |
| | **6,150.4** | **5,936.2** | **5,607.1** | **5,360.1** |
| Provision for impairment losses | (62.7) | (59.9) | (37.2) | (32.7) |
| Unamortised loan origination fees | 15.2 | 18.4 | 4.5 | 1.4 |
| Fair value adjustment for hedged risk | 37.0 | 9.9 | 37.0 | 9.9 |
| | **6,139.9** | **5,904.6** | **5,611.4** | **5,338.7** |

The Society issued its second Residential Mortgage Backed Security (RMBS) in June of this year. The RMBS issue involved the formation of a Special Purpose Entity (SPE) Friary No. 2 Plc, which provides security to a £520.5m amortising bond. As at 31 December 2014, £467.5m of loans issued by the Society had been transferred to the SPE which remain on the statement of financial position of the Society as it retains the risks and rewards of the assets. The amortised value of the bond was £494.7m, with £45.5m retained by the Group.

As at 31 December 2014, £394.5m of loans issued by the Society had been transferred to the SPE in relation to the Society's first RMBS, Friary No. 1 Plc. These assets remain on the statement of financial position of the Society as it retains the risks and rewards. The amortised value of the bond was £410.5m, with £298.6m retained by the Group.

As at 31 December 2014, the Society repaid £143.0m of Treasury bills within the year, to leave £207.0m outstanding (31 December 2013: £350.0m) under the Bank of England's Funding for Lending (FLS) scheme. The draw down has been used primarily to support mortgage growth and supplement maturing wholesale funding. No further draw-downs are planned under the scheme.

Asset encumbrance is 19.0% (2013: 16.8%) of total assets. The Board has set an encumbrance limit of 30.0%.

# Notes to the accounts
for the year ended 31 December 2014

## 20. Provision for impairment losses

| | Specific | Collective | Total |
|---|---|---|---|
| | £m | £m | £m |
| **2014** | | | |
| **Group** | | | |
| At 1 January 2014 | 44.1 | 15.8 | 59.9 |
| Amounts written off during the year | (10.7) | - | (10.7) |
| Charge for loan impairment | 3.2 | 10.3 | 13.5 |
| **At 31 December 2014** | **36.6** | **26.1** | **62.7** |
| **Society** | | | |
| At 1 January 2014 | 18.1 | 14.6 | 32.7 |
| Amounts written off during the year | (6.8) | - | (6.8) |
| Charge for loan impairment | 11.0 | 0.3 | 11.3 |
| **At 31 December 2014** | **22.3** | **14.9** | **37.2** |
| | | | |
| **2013** | | | |
| **Group** | | | |
| At 1 January 2013 | 46.2 | 20.9 | 67.1 |
| Amounts written off during the year | (29.6) | - | (29.6) |
| Charge/(release) for loan impairment | 27.5 | (5.1) | 22.4 |
| **At 31 December 2013** | **44.1** | **15.8** | **59.9** |
| **Society** | | | |
| At 1 January 2013 | 15.7 | 20.4 | 36.1 |
| Amounts written off during the year | (20.5) | - | (20.5) |
| (Release)/charge for loan impairment | 22.9 | (5.8) | 17.1 |
| **At 31 December 2013** | **18.1** | **14.6** | **32.7** |

## 21. Provisions for liabilities

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| At 1 January | 12.7 | 9.9 | 3.6 | 3.6 |
| Additions | 8.7 | 12.5 | 4.8 | 4.5 |
| Utilisation | (17.5) | (9.7) | (5.0) | (4.5) |
| **At 31 December** | **3.9** | **12.7** | **3.4** | **3.6** |

Included in provisions is the FSCS levy of £2.2m which is the expected interest charge for scheme year April 2014 to March 2015. The Group took early adoption of IFRIC 21 Levies for the 2013 annual accounts.

Other provisions of £1.7m are held in respect of various customer and regulatory complaints (2013: £10.4m).

The contingent aspect of such provisions is described in note 38.

# Notes to the accounts
for the year ended 31 December 2014

## 22. Investments in subsidiary undertakings

| | Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| **Shares in subsidiary undertakings:** | | |
| At cost | 0.1 | 1.1 |
| Loans to subsidiary undertakings | 475.3 | 522.1 |
| **Total** | **475.4** | **523.2** |

| | Subsidiary undertakings | |
|---|---|---|
| | Shares | Loans |
| | £m | £m |
| **Movement in investments in subsidiary undertakings:** | | |
| At 1 January 2014 | 1.1 | 522.1 |
| Loan repayment | - | (46.8) |
| Disposal of subsidiary undertaking | (1.0) | - |
| **At 31 December 2014** | **0.1** | **475.3** |

The directors have reviewed the recoverability of outstanding loans and holdings in subsidiary undertakings and no impairment provision is deemed necessary.
The Society has the following subsidiary undertakings which operated in the United Kingdom during the year and are included in the Group accounts:

| | Place of registration | Principal activity | Class of shares held | Interest of Society | Direct or indirect |
|---|---|---|---|---|---|
| Nemo Personal Finance Limited | England and Wales | Secured personal lending | Ordinary | 100% | Direct |
| Loan Link Limited | England and Wales | Loan broking | Ordinary | 100% | Indirect |
| Principality Mortgage and Insurance Services Limited | England and Wales | Provision of advisory and administration services | Ordinary | 100% | Direct |
| Principality Covered Bond LLP | England and Wales | Mortgage acquisition and guarantor of covered bonds | Ordinary | 100% | Direct |

During the year the Group sold 100% of the ordinary shares of Peter Alan Limited and its subsidiaries Mead Property Management Limited and Thomas George Cardiff Limited, all incorporated in England and Wales. The principal activity of Peter Alan Ltd is Estate Agency and Financial Services. The principal activity of Mead Property Management Limited and Thomas George Cardiff Limited is letting agents. The Society also sold 100% of the share capital of two dormant companies Peter Alan Black Limited and Peter Alan Surveyors Limited.

The Society continues to participate in the Ely Bridge development, a scheme which aims to deliver a 700 house development on a brownfield site in Cardiff being a mix of affordable, social and private dwellings ultimately funded by the capital markets. Ely Bridge Development Company Limited was incorporated on 28 March 2012. The company is not for profit and limited by guarantee. The Society holds no beneficial interest in the company but has agreed to contribute £1 to the assets of the company in the event of it being wound up.

The Society also holds 100% of the ordinary share capital of the following subsidiary undertakings which have not carried on business during the year. These were all incorporated in the United Kingdom.

Brokerpoint Limited
Energy Assess Wales Limited
Home Information Pack Wales Limited
Nemo Loans Limited
Nemo Financial Limited
Nemo Financial Services Limited
Nemo Home Loans Limited
Nemo Secured Loans Limited
Nemo Insurance Services Limited
Principality Limited
Principality Asset Management Limited
Principality Bank Limited
Principality Direct Limited
Principality Estate Agency Limited
Principality Financial Management Limited
Principality Homes Limited
Principality (IFA Services) Limited
Principality Independent Financial Advisers Limited
Principality Life Assurance Services Limited
Principality (Life and Pensions) Limited
Principality Mortgage Corporation Limited
Principality Personal Loans Limited
Principality Property Development Services Limited
Principality Property Sales Limited
Principality Property Services Limited
Principality Property Solutions Limited
Principality Surveyors Home Condition Report Limited
Roderick Price Limited
Principality Syndicated Loans Limited
The Principality Home Information Pack Limited

# Notes to the accounts
for the year ended 31 December 2014

## 23. Intangible assets

| | Goodwill | | Computer software | | Total | |
|---|---|---|---|---|---|---|
| | Group | Society | Group | Society | Group | Society |
| | £m | £m | £m | £m | £m | £m |
| **2014** | | | | | | |
| **Cost:** | | | | | | |
| At 1 January 2014 | 2.5 | - | 7.3 | 7.3 | 9.8 | 7.3 |
| Additions | - | - | 0.4 | 0.4 | 0.4 | 0.4 |
| Disposals | (2.5) | - | - | - | (2.5) | - |
| **At 31 December 2014** | **-** | **-** | **7.7** | **7.7** | **7.7** | **7.7** |
| **Impairment/amortisation:** | | | | | | |
| At 1 January 2014 | 0.1 | - | 5.3 | 5.3 | 5.4 | 5.3 |
| Charge for the year | - | - | 0.6 | 0.6 | 0.6 | 0.6 |
| Impairment in the year | 0.7 | - | - | - | 0.7 | - |
| Disposals | (0.8) | - | - | - | (0.8) | - |
| **At 31 December 2014** | **-** | **-** | **5.9** | **5.9** | **5.9** | **5.9** |
| **Net book value:** | | | | | | |
| **At 31 December 2014** | **-** | **-** | **1.8** | **1.8** | **1.8** | **1.8** |
| At 31 December 2013 | 2.4 | - | 2.0 | 2.0 | 4.4 | 2.0 |

| | Goodwill | | Computer software | | Total | |
|---|---|---|---|---|---|---|
| | Group | Society | Group | Society | Group | Society |
| | £m | £m | £m | £m | £m | £m |
| **2013** | | | | | | |
| **Cost:** | | | | | | |
| At 1 January 2013 | 0.7 | - | 6.7 | 6.7 | 7.4 | 6.7 |
| Additions | 1.8 | - | 0.7 | 0.7 | 2.5 | 0.7 |
| Disposals | - | - | (0.1) | (0.1) | (0.1) | (0.1) |
| **At 31 December 2013** | **2.5** | **-** | **7.3** | **7.3** | **9.8** | **7.3** |
| **Impairment/amortisation:** | | | | | | |
| At 1 January 2013 | - | - | 4.8 | 4.8 | 4.8 | 4.8 |
| Charge for the year | 0.1 | - | 0.6 | 0.6 | 0.7 | 0.6 |
| Disposals | - | - | (0.1) | (0.1) | (0.1) | (0.1) |
| **At 31 December 2013** | **0.1** | **-** | **5.3** | **5.3** | **5.4** | **5.3** |
| **Net book value:** | | | | | | |
| **At 31 December 2013** | **2.4** | **-** | **2.0** | **2.0** | **4.4** | **2.0** |
| At 31 December 2012 | 0.7 | - | 1.9 | 1.9 | 2.6 | 1.9 |

The goodwill at the beginning of the year relates to the acquisition of 100% of the ordinary share capital of Loan Link Limited on 1 December 2004 and the goodwill relating to the acquisition of 100% of the ordinary shares of Mead Property Management Limited and Thomas George Cardiff Limited during 2013.

During the year, the Society sold its subsidiary Peter Alan Limited including its subsidiaries Mead Property Management Limited and Thomas George Cardiff Limited.  On sale the goodwill relating to these companies was written off in full.

In accordance with the requirements of IAS 36, the Group completed an impairment review of the carrying value for goodwill as at 31 December 2014 to ensure that the carrying value is stated at no more than its recoverable amount.  During this review the goodwill in relation to Loan Link Limited was deemed to be impaired and therefore written off in full to the income statement.

# Notes to the accounts
for the year ended 31 December 2014

## 24. Property, plant and equipment

| | Land and buildings | | Equipment, fixtures, fittings & vehicles | | Total | |
|---|---|---|---|---|---|---|
| | Group | Society | Group | Society | Group | Society |
| | £m | £m | £m | £m | £m | £m |
| **Cost:** | | | | | | |
| At 1 January 2014 | 62.2 | 57.2 | 39.2 | 27.6 | 101.4 | 84.8 |
| Additions | 4.7 | 4.7 | 2.4 | 2.2 | 7.1 | 6.9 |
| Disposals | (3.8) | - | (4.9) | - | (8.7) | - |
| **At 31 December 2014** | **63.1** | **61.9** | **36.7** | **29.8** | **99.8** | **91.7** |
| **Depreciation:** | | | | | | |
| At 1 January 2014 | 24.6 | 22.5 | 29.0 | 19.2 | 53.6 | 41.7 |
| Charge for the year | 1.9 | 1.9 | 3.6 | 3.2 | 5.5 | 5.1 |
| Impairment in the year | 2.3 | 2.3 | - | - | 2.3 | 2.3 |
| Disposals | (1.6) | - | (3.9) | - | (5.5) | - |
| **At 31 December 2014** | **27.2** | **26.7** | **28.7** | **22.4** | **55.9** | **49.1** |
| **Net book value:** | | | | | | |
| **At 31 December 2014** | **35.9** | **35.2** | **8.0** | **7.4** | **43.9** | **42.6** |
| At 31 December 2013 | 37.6 | 34.7 | 10.2 | 8.4 | 47.8 | 43.1 |

Included within land and buildings additions is £1.7m (2013: £0.8m) on account of assets in the course of construction.

The value of assets subject to operating leases where the Group acts as lessor is £26.8m (2013: £26.0m).

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | Group | Society | Group | Society |
| | £m | £m | £m | £m |
| **Land and buildings:** | | | | |
| Freehold | 32.5 | 31.8 | 34.6 | 32.0 |
| Long leasehold | 0.6 | 0.6 | 0.5 | 0.4 |
| Short leasehold | 2.8 | 2.8 | 2.5 | 2.3 |
| | **35.9** | **35.2** | **37.6** | **34.7** |
| Occupied by the Society and subsidiary undertakings | 23.5 | 23.5 | 26.2 | 26.2 |

# Notes to the accounts
for the year ended 31 December 2014

## 24. Property, plant and equipment (continued)

| | Land and buildings | | Equipment, fixtures, fittings & vehicles | | Total | |
|---|---|---|---|---|---|---|
| | Group | Society | Group | Society | Group | Society |
| | £m | £m | £m | £m | £m | £m |
| **Cost:** | | | | | | |
| At 1 January 2013 | 58.2 | 54.1 | 35.7 | 24.7 | 93.9 | 78.8 |
| Additions | 4.0 | 3.1 | 3.7 | 3.1 | 7.7 | 6.2 |
| Disposals | - | - | (0.2) | (0.2) | (0.2) | (0.2) |
| **At 31 December 2013** | **62.2** | **57.2** | **39.2** | **27.6** | **101.4** | **84.8** |
| **Depreciation:** | | | | | | |
| At 1 January 2013 | 22.7 | 20.7 | 24.9 | 16.1 | 47.6 | 36.8 |
| Charge for the year* | 1.9 | 1.8 | 4.3 | 3.2 | 6.2 | 5.0 |
| Disposals | - | - | (0.2) | (0.1) | (0.2) | (0.1) |
| **At 31 December 2013** | **24.6** | **22.5** | **29.0** | **19.2** | **53.6** | **41.7** |
| **Net book value:** | | | | | | |
| **At 31 December 2013** | **37.6** | **34.7** | **10.2** | **8.4** | **47.8** | **43.1** |
| At 31 December 2012 | 35.5 | 33.4 | 10.8 | 8.6 | 46.3 | 42.0 |

*The charge for the year for 2013 includes a charge of £0.5m in relation to discontinued operations.

## 25. Other assets

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| **Due within one year:** | | | | |
| Other | 3.0 | 6.3 | 1.8 | 3.0 |

## 26. Prepayments and accrued income

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Accrued interest on derivative financial instruments | 2.1 | 6.9 | 2.1 | 6.9 |
| Other | 4.0 | 4.1 | 3.6 | 3.0 |
| | **6.1** | **11.0** | **5.7** | **9.9** |

# Notes to the accounts
for the year ended 31 December 2014

## 27. Shares

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| Held by individuals | 5,596.2 | 5,551.0 |
| Other shares | 4.3 | 4.3 |
| Fair value adjustment for hedged risk | 12.5 | 7.3 |
| | **5,613.0** | **5,562.6** |

The repayment of the above balances from the date of the statement of financial position in the ordinary course of business is as follows:

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| Fair value adjustment for hedged risk | 12.5 | 7.3 |
| Accrued interest | 64.3 | 79.4 |
| On demand | 1,042.4 | 1,106.1 |
| Less than three months | 2,445.2 | 2,097.0 |
| Between three months and one year | 820.2 | 1,061.8 |
| Between one year and five years | 1,228.4 | 1,211.0 |
| | **5,613.0** | **5,562.6** |

## 28. Amounts owed to credit institutions

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Accrued interest | - | 0.1 | - | 0.1 |
| Credit Support Annex (CSA) liabilities | 5.5 | 13.8 | 5.5 | 13.8 |
| On demand | 2.1 | 2.2 | - | - |
| Less than three months | 5.8 | 180.9 | 31.1 | 187.6 |
| Between three months and one year | 3.0 | 65.4 | 78.8 | 83.7 |
| Between one year and five years | 211.1 | 230.9 | 573.7 | 290.8 |
| Greater than five years | - | 6.4 | - | 6.4 |
| | **227.5** | **499.7** | **689.1** | **582.4** |

## 29. Amounts owed to other customers

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Accrued interest | 1.6 | 2.6 | 1.6 | 2.6 |
| On demand and less than three months | 59.7 | 94.2 | 59.7 | 94.2 |
| Between three months and one year | 99.8 | 119.0 | 99.8 | 119.0 |
| Between one year and five years | 12.8 | 9.3 | 12.8 | 9.3 |
| | **173.9** | **225.1** | **173.9** | **225.1** |

# Notes to the accounts
for the year ended 31 December 2014

## 30. Debt securities in issue

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Certificates of deposit | 20.1 | 6.5 | 20.1 | 6.5 |
| Fixed and floating rate notes | 15.5 | 16.6 | 15.5 | 16.6 |
| Other debt securities | 562.0 | 151.8 | - | - |
| Fair value adjustment for hedged risk | 2.7 | 3.1 | 2.7 | 3.1 |
| | **600.3** | **178.0** | **38.3** | **26.2** |

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Fair value adjustment for hedged risk | 2.7 | 3.1 | 2.7 | 3.1 |
| Accrued interest | 1.7 | - | 0.2 | - |
| Less than three months | 51.5 | 11.1 | 17.0 | 2.5 |
| Between three months and one year | 106.5 | 28.6 | 3.0 | 4.0 |
| Between one year and five years | 437.9 | 135.2 | 15.4 | 16.6 |
| | **600.3** | **178.0** | **38.3** | **26.2** |

The effective interest rates at the date of the statement of financial position were as follows:

| | 2014 | 2013 |
|---|---|---|
| Certificates of deposit | 0.88% | 0.88% |
| Fixed and floating rate notes | 0.75% | 0.70% |

## 31. Other liabilities

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Due within one year: | | | | |
| Income tax | 0.7 | 0.8 | 0.7 | 0.8 |
| Other taxation and social security | 0.8 | 1.4 | 0.8 | 0.9 |
| Other creditors | 2.9 | 6.2 | 2.8 | 3.5 |
| | **4.4** | **8.4** | **4.3** | **5.2** |

## 32. Accruals and deferred income

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Interest accrued on subordinated liabilities | 0.3 | 0.3 | 0.3 | 0.3 |
| Interest accrued on subscribed capital | 0.4 | 0.4 | 0.4 | 0.4 |
| Other | 8.8 | 8.0 | 7.3 | 6.9 |
| | **9.5** | **8.7** | **8.0** | **7.6** |

# Notes to the accounts
for the year ended 31 December 2014

## 33. Deferred tax

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| At 1 January | (3.8) | (3.5) | (3.6) | (3.3) |
| Credited to the income statement | 1.9 | (0.3) | 1.9 | (0.2) |
| Credited to statement of other comprehensive income on actuarial losses | 0.2 | - | 0.2 | (0.1) |
| **At 31 December** | **(1.7)** | **(3.8)** | **(1.5)** | **(3.6)** |

Deferred tax assets and liabilities are attributable to the following items:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| **Deferred tax liabilities** | | | | |
| Accelerated tax depreciation | 0.1 | - | 0.3 | 0.1 |
| Other | 0.2 | 0.5 | 0.2 | 0.4 |
| | **0.3** | **0.5** | **0.5** | **0.5** |
| **Deferred tax assets** | | | | |
| Accelerated tax depreciation | - | (0.2) | - | - |
| Retirement benefit obligation | (1.6) | (3.8) | (1.6) | (3.8) |
| Other | (0.4) | (0.3) | (0.4) | (0.3) |
| | **(2.0)** | **(4.3)** | **(2.0)** | **(4.1)** |

The reduction of the UK Corporation tax rate to 20% from 1 April 2015 has resulted in a deferred tax charge arising from the reduction in the statement of financial position carrying value of the net deferred tax asset to reflect the anticipated rate of tax at which the asset is expected to reverse. The statement of other comprehensive income includes a charge of £0.3m arising from the actuarial loss on retirement benefit obligations.

The deferred tax asset relating to retirement benefit obligations is expected to be recovered within five years. More information on the triennial valuation can be found in note 12.

## 34. Subordinated liabilities

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| 5 3/8% Subordinated Notes due 2016 | 92.3 | 92.3 |

The Society's subordinated liabilities are unsecured. The subordinated liabilities rank pari passu with each other and behind the claims against the Society of all depositors, creditors and investing Members of the Society.
The Society did not exercise its option to call the subordinated liabilities on 8 July 2011. The Society has the option of calling these notes on a quarterly basis until financial maturity on 8 July 2016. From 8 July 2011, the rate of interest became LIBOR plus 1.005% reset quarterly.

Repaying the subordinated liabilities requires the prior consent of the Prudential Regulation Authority.

# Notes to the accounts
for the year ended 31 December 2014

## 35. Subscribed capital

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| 7.00% Permanent Interest Bearing Shares | 60.0 | 60.0 |
| Unamortised issue costs | (0.5) | (0.5) |
| Fair value adjustment for hedged risk | 12.4 | 10.7 |
| | **71.9** | **70.2** |

The Permanent Interest Bearing Shares (PIBS) are unsecured and denominated in Sterling. They were issued on 1 June 2004. Net proceeds of the issue were £58.6m.

The PIBS are repayable, at the option of the Society, in whole on 1 June 2020 or any fifth anniversary thereafter. Repaying the PIBS requires the prior consent of the Prudential Regulation Authority. If the PIBS are not repaid on a call date then the interest rate is reset at 1 June 2020 at 3% above the relevant equivalent gilt yield at the time.

PIBS are deferred shares of the Society and rank behind the claims of all depositors, creditors and investing Members of the Society.

The interest rate risk arising from the issuance of fixed rate PIBS has been mitigated through the use of interest rate swaps.

## 36. Analysis of general reserve

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Balance at 1 January | 357.7 | 339.4 | 316.4 | 311.6 |
| | | | | |
| Profit for the financial year | 52.3 | 22.2 | 42.4 | 8.7 |
| Actuarial loss on retirement benefit obligations | (1.6) | (4.3) | (1.6) | (4.3) |
| Movement in deferred tax relating to retirement benefit obligations | 0.4 | 0.4 | 0.4 | 0.4 |
| Total recognised income for the year | 51.0 | 18.3 | 41.2 | 4.8 |
| **Balance at 31 December** | **408.7** | **357.7** | **357.6** | **316.4** |
| | | | | |
| Reserves excluding pension liability | 415.6 | 374.8 | 364.5 | 333.5 |
| Pension liability | (6.9) | (17.1) | (6.9) | (17.1) |
| | **408.7** | **357.7** | **357.6** | **316.4** |

## 37. Other reserves

| | Group and Society | |
|---|---|---|
| | 2014 | 2013 |
| | £m | £m |
| Other reserves comprise | | |
| Revaluation reserve – available-for-sale investments | 2.6 | (3.0) |
| | | |
| Movement in other reserves: | | |
| Balance at 1 January | (3.0) | 3.4 |
| Gains/(losses) transferred to equity | 7.3 | (7.6) |
| Gains recycled to profit and loss on sales | (0.2) | (0.6) |
| Taxation | (1.5) | 1.8 |
| **Balance at 31 December** | **2.6** | **(3.0)** |

# Notes to the accounts
for the year ended 31 December 2014

## 38. Financial commitments and contingent liabilities

a) Financial Services Compensation Scheme levy

Based on its share of protected deposits, the Society pays levies to the Financial Services Compensation Scheme (FSCS) to enable the FSCS to meet claims against it. Since 2008 a number of institutions have been declared in default by the PRA (formerly the FSA). The FSCS has met the claims by way of loans received from HM Treasury. The terms of these loans are interest-only and the FSCS will seek to recover the interest cost, together with ongoing management expenses, by way of annual levies on member firms over this period.

In 2013, the Group took early adoption of IFRIC 21 Levies. During the year, the Group has recognised an FSCS interest charge of £2.2m in respect of scheme year April 2014 to March 2015 which is held as a provision at the year end and payable during 2015. During the year a payment was made in respect of interest in relation to scheme year April 2013 to March 2014 of £2.3m. It is expected that further interest payments be made in future years with interest relating to scheme year April 2015 to March 2016 being recognised in 2015. Based on the latest information available, the Group's share is expected to be £2.2m.

The Group has also recognised in 2014 an FSCS charge of £1.5m in respect of the second instalment of the capital repayment. This amount was paid during the year. It is expected that one further instalment will be made in 2015 in relation to the capital shortfall. Based on latest information which is subject to change, the Group's share is expected to be £1.5m. A provision will be made in 2015 for this liability.

The Group also has a potential exposure to future levies resulting from the failure of the Dunfermline Building Society along with potential capital shortfalls arising from the sale of assets in relation to Bradford and Bingley. During the year, an interim levy of £0.5m was paid as a contribution to costs of resolution for Dunfermline Building Society. The Group's share of any further costs cannot be quantified, although the Group's share could be material; no provision has been recognised.

b) Customer and Regulatory Complaints

During the year the Group completed the detailed and comprehensive review of its compliance with consumer credit legislation which had commenced in 2013. The total net remediation cost for the issues identified was £8.5m, of which £0.5m was charged in the current year (2013: £8.0m). As at 31 December 2014 the Group holds no provision in relation to this issue (2013: £8.0m). The remediation process is substantially complete and no further costs are foreseen.

Provisions have been made in respect of claims in relation to previous sales of Payment Protection Insurance (PPI) which, in the Group's case, relate to secured personal lending PPI products. The PPI remediation process is nearing completion. At 31 December 2014, the Group holds a provision of £0.4m (2013: £1.1m), which it expects to be sufficient to meet obligations in relation to previous sales of PPI.

Provisions are only made where the Group has responsibility for the original sale of the product. No provision has been made for sales by third parties as external legal advice has concluded that it is unlikely that the Group would be liable for redress in respect of such sales.

c) Defined benefit pension scheme

The defined benefit scheme is subject to a triennial valuation by the scheme's independent actuary on 30 September 2016. The Group has a potential exposure to future payments into the scheme arising from any deficit at that date. The quantification of any deficit is yet to be determined and hence, although the contributions into the scheme could be significant, no provision has been recognised.

# Notes to the accounts
for the year ended 31 December 2014

## 38. Financial commitments and contingent liabilities (continued)

### d) Commitments under non-cancellable operating leases

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | Property | Vehicles, plant and equipment | Property | Vehicles, plant and equipment |
| | £m | £m | £m | £m |
| **Group commitments in respect of operating lease rentals:** | | | | |
| Due within one year | 1.4 | 0.3 | 1.8 | 0.2 |
| Due between two and five years | 4.9 | 0.7 | 6.4 | 0.1 |
| Due after five years | 1.9 | - | 4.7 | - |
| | **8.2** | **1.0** | **12.9** | **0.3** |
| **Society commitments in respect of operating lease rentals:** | | | | |
| Due within one year | 0.8 | 0.2 | 1.0 | 0.1 |
| Due between two and five years | 2.7 | 0.5 | 3.6 | 0.1 |
| Due after five years | 1.6 | - | 3.0 | - |
| | **5.1** | **0.7** | **7.6** | **0.2** |

### e) Income receivable under non-cancellable operating leases

Property rental income earned during the year was £0.9m (2013: £0.8m).

At the statement of financial position date, the Society had contracted with tenants for the following future minimum lease payments:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Receivable within one year | 1.1 | 0.8 | 1.1 | 1.0 |
| Receivable between two and five years | 3.6 | 2.7 | 3.6 | 3.4 |
| Receivable after five years | 8.4 | 8.1 | 8.4 | 9.6 |
| | **13.1** | **11.6** | **13.1** | **14.0** |

On 28 January 2011, a 25 year lease of floors one to four of Principality Buildings was granted to Travelodge Hotels Limited.

### f) Capital commitments

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Capital expenditure contracted for but not provided for | 0.7 | 0.9 | 0.7 | 0.9 |

### g) Loan commitments

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| Loan commitments contracted but not paid | 70.6 | 48.5 | 70.6 | 48.5 |

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments

a) Categories of financial instruments
Financial assets and liabilities are measured on an on-going basis either at fair value or at amortised cost.

The accounting policies note describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following tables analyse the financial assets and liabilities in the statement of financial position by the class of financial instrument to which they are assigned and by the measurement basis.

| Group<br>As at 31 December 2014 | At amortised cost | Loans and receivables | Available-for-sale | Fair value through profits and loss | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Group assets** | | | | | |
| Cash in hand and balances with Bank of England | 432.6 | - | - | - | 432.6 |
| Loans and advances to credit institutions | - | 150.7 | - | - | 150.7 |
| Debt securities | - | - | 454.1 | - | 454.1 |
| Derivative financial instruments | - | - | - | 30.9 | 30.9 |
| Loans and advances to customers | - | 6,139.9 | - | - | 6,139.9 |
| **Total financial assets** | **432.6** | **6,290.6** | **454.1** | **30.9** | **7,208.2** |
| Total non-financial assets | | | | | 56.8 |
| **Total Group assets** | | | | | **7,265.0** |
| **Group liabilities** | | | | | |
| Shares | 5,613.0 | - | - | - | 5,613.0 |
| Amounts owed to credit institutions | 191.4 | - | - | 36.1 | 227.5 |
| Amounts owed to other customers | 173.9 | - | - | - | 173.9 |
| Debt securities in issue | 600.3 | - | - | - | 600.3 |
| Derivative financial instruments | - | - | - | 42.8 | 42.8 |
| Subordinated liabilities | 92.3 | - | - | - | 92.3 |
| Subscribed capital | 71.9 | - | - | - | 71.9 |
| **Total financial liabilities** | **6,742.8** | **-** | **-** | **78.9** | **6,821.7** |
| Total non-financial liabilities | | | | | 32.0 |
| General reserve and other reserves | | | | | 411.3 |
| **Total Group reserves and liabilities** | | | | | **7,265.0** |

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

a) Categories of financial instruments (continued)

| Society<br>As at 31 December 2014 | At amortised cost | Loans and receivables | Available-for-sale | Fair value through profits and loss | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Society assets** | | | | | |
| Cash in hand and balances with Bank of England | 432.6 | - | - | - | 432.6 |
| Loans and advances to credit institutions | - | 49.7 | - | - | 49.7 |
| Debt securities | - | - | 454.1 | - | 454.1 |
| Derivative financial instruments | - | - | - | 30.9 | 30.9 |
| Loans and advances to customers | - | 5,611.4 | - | - | 5,611.4 |
| Loans to and investments in subsidiaries | 0.1 | 475.3 | - | - | 475.4 |
| **Total financial assets** | **432.7** | **6,136.4** | **454.1** | **30.9** | **7,054.1** |
| Total non-financial assets | | | | | 53.9 |
| **Total Society assets** | | | | | **7,108.0** |
| **Society liabilities** | | | | | |
| Shares | 5,613.0 | - | - | - | 5,613.0 |
| Amounts owed to credit institutions | 653.0 | - | - | 36.1 | 689.1 |
| Amounts owed to other customers | 173.9 | - | - | - | 173.9 |
| Debt securities in issue | 38.3 | - | - | - | 38.3 |
| Derivative financial instruments | - | - | - | 40.8 | 40.8 |
| Subordinated liabilities | 92.3 | - | - | - | 92.3 |
| Subscribed capital | 71.9 | - | - | - | 71.9 |
| **Total financial liabilities** | **6,642.4** | **-** | **-** | **76.9** | **6,719.3** |
| Total non-financial liabilities | | | | | 28.5 |
| General reserve and other reserves | | | | | 360.2 |
| **Total Society reserves and liabilities** | | | | | **7,108.0** |

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

a) Categories of financial instruments (continued)

| Group<br>As at 31 December 2013 | At amortised cost | Loans and receivables | Available-for-sale | Fair value through profits and loss | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Group assets** | | | | | |
| Cash in hand and balances with Bank of England | 355.6 | - | - | - | 355.6 |
| Loans and advances to credit institutions | - | 120.5 | - | - | 120.5 |
| Debt securities | - | - | 566.0 | - | 566.0 |
| Derivative financial instruments | - | - | - | 37.6 | 37.6 |
| Loans and advances to customers | - | 5,904.6 | - | - | 5,904.6 |
| **Total financial assets** | **355.6** | **6,025.1** | **566.0** | **37.6** | **6,984.3** |
| Total non-financial assets | | | | | 73.8 |
| **Total Group assets** | | | | | **7,058.1** |
| **Group liabilities** | | | | | |
| Shares | 5,562.6 | - | - | - | 5,562.6 |
| Amounts owed to credit institutions | 434.3 | - | - | 65.4 | 499.7 |
| Amounts owed to other customers | 225.1 | - | - | - | 225.1 |
| Debt securities in issue | 178.0 | - | - | - | 178.0 |
| Derivative financial instruments | - | - | - | 26.2 | 26.2 |
| Subordinated liabilities | 92.3 | - | - | - | 92.3 |
| Subscribed capital | 70.2 | - | - | - | 70.2 |
| **Total financial liabilities** | **6,562.5** | **-** | **-** | **91.6** | **6,654.1** |
| Total non-financial liabilities | | | | | 49.3 |
| General reserve and other reserves | | | | | 354.7 |
| **Total Group reserves and liabilities** | | | | | **7,058.1** |

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

a) Categories of financial instruments (continued)

| Society<br>As at 31 December 2013 | At amortised cost | Loans and receivables | Available-for-sale | Fair value through profits and loss | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Society assets** | | | | | |
| Cash in hand and balances with Bank of England | 355.6 | - | - | - | 355.6 |
| Loans and advances to credit institutions | - | 49.8 | - | - | 49.8 |
| Debt securities | - | - | 566.0 | - | 566.0 |
| Derivative financial instruments | - | - | - | 37.6 | 37.6 |
| Loans and advances to customers | - | 5,338.7 | - | - | 5,338.7 |
| Loans to and investments in subsidiaries | 1.1 | 522.1 | - | - | 523.2 |
| **Total financial assets** | **356.7** | **5,910.6** | **566.0** | **37.6** | **6,870.9** |
| Total non-financial assets | | | | | 62.1 |
| **Total Society assets** | | | | | **6,933.0** |
| **Society liabilities** | | | | | |
| Shares | 5,562.6 | - | - | - | 5,562.6 |
| Amounts owed to credit institutions | 517.0 | - | - | 65.4 | 582.4 |
| Amounts owed to other customers | 225.1 | - | - | - | 225.1 |
| Debt securities in issue | 26.2 | - | - | - | 26.2 |
| Derivative financial instruments | - | - | - | 26.2 | 26.2 |
| Subordinated liabilities | 92.3 | - | - | - | 92.3 |
| Subscribed capital | 70.2 | - | - | - | 70.2 |
| **Total financial liabilities** | **6,493.4** | **-** | **-** | **91.6** | **6,585.0** |
| Total non-financial liabilities | | | | | 34.6 |
| General reserve and other reserves | | | | | 313.4 |
| **Total Society reserves and liabilities** | | | | | **6,933.0** |

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

### b) Carrying values and fair values
The table below compares carrying values and fair values of the Group's and the Society's financial instruments by category. It is accompanied by an explanation of the methods used to determine fair value.

| | Note | 2014 | | 2013 | |
|---|---|---|---|---|---|
| | | Carrying value | Fair value | Carrying value | Fair value |
| | | £m | £m | £m | £m |
| **Group assets** | | | | | |
| Cash in hand and balances with Bank of England | | 432.6 | 432.6 | 355.6 | 355.6 |
| Loans and advances to credit institutions | i. | 150.7 | 150.7 | 120.5 | 120.5 |
| Debt securities | ii. | 454.1 | 454.1 | 566.0 | 566.0 |
| Derivative financial instruments | iii. | 30.9 | 30.9 | 37.6 | 37.6 |
| Loans and advances to customers | iv. | 6,139.9 | 6,174.7 | 5,904.6 | 5,886.1 |
| | | **7,208.2** | **7,243.0** | **6,984.3** | **6,965.8** |
| **Group liabilities** | | | | | |
| Shares | | 5,613.0 | 5,613.9 | 5,562.6 | 5,562.6 |
| Amounts owed to credit institutions | vii. | 227.5 | 227.5 | 499.7 | 499.7 |
| Amounts owed to other customers | vii. | 173.9 | 173.9 | 225.1 | 225.1 |
| Debt securities in issue | vii. | 600.3 | 602.0 | 178.0 | 181.7 |
| Derivative financial instruments | iii. | 42.8 | 42.8 | 26.2 | 26.2 |
| Subordinated liabilities | viii. | 92.3 | 87.9 | 92.3 | 81.1 |
| Subscribed capital | viii. | 71.9 | 60.0 | 70.2 | 48.5 |
| | | **6,821.7** | **6,808.0** | **6,654.1** | **6,624.9** |

| | Note | 2014 | | 2013 | |
|---|---|---|---|---|---|
| | | Carrying value | Fair value | Carrying value | Fair value |
| | | £m | £m | £m | £m |
| **Society assets** | | | | | |
| Cash in hand and balances with Bank of England | | 432.6 | 432.6 | 355.6 | 355.6 |
| Loans and advances to credit institutions | i. | 49.7 | 49.7 | 49.8 | 49.8 |
| Debt securities | ii. | 454.1 | 454.1 | 566.0 | 566.0 |
| Derivative financial instruments | iii. | 30.9 | 30.9 | 37.6 | 37.6 |
| Loans and advances to customers | iv. | 5,611.4 | 5,646.2 | 5,338.7 | 5,337.3 |
| Loans and advances to subsidiaries | v. | 475.4 | 475.4 | 523.2 | 523.2 |
| | | **7,054.1** | **7,088.9** | **6,870.9** | **6,869.5** |
| **Society liabilities** | | | | | |
| Shares | | 5,613.0 | 5,613.9 | 5,562.6 | 5,562.6 |
| Amounts owed to credit institutions | vii. | 689.1 | 689.1 | 582.4 | 582.4 |
| Amounts owed to other customers | vii. | 173.9 | 173.9 | 225.1 | 225.1 |
| Debt securities in issue | vii. | 38.3 | 38.3 | 26.2 | 26.1 |
| Derivative financial instruments | iii. | 40.8 | 40.8 | 26.2 | 26.2 |
| Subordinated liabilities | viii. | 92.3 | 87.9 | 92.3 | 81.1 |
| Subscribed capital | viii. | 71.9 | 60.0 | 70.2 | 48.5 |
| | | **6,719.3** | **6,703.9** | **6,585.0** | **6,552.0** |

The gross amount of foreign currency swaps held was €20.0m (2013: €20.0m).

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

b) Carrying values and fair values (continued)

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The following methods and assumptions have been applied in determining fair value:

i) The carrying amount of loans and advances to credit institutions with a maturity of under 12 months is assumed to equate to their fair value.
ii) Debt securities classified as available-for-sale are measured at fair value by reference to market prices.
iii) All derivatives are held for economic hedging purposes. The fair value of interest rate swaps is calculated by utilising discounted cash flow valuation models. The fair value of cross currency interest rate swaps is obtained from external counterparties.
iv) The fair value of loans and advances to customers at a variable rate is assumed to approximate to their carrying amounts. The fair value of loans and advances to customers at a fixed rate of interest represents the discounted amount of estimated future cash flows expected to be received after taking account of expected loss provisions, expected levels of early repayment and discounting at current market rates.
v) The fair value of loans and advances to subsidiaries at a variable rate is assumed to approximate to their carrying amounts.
vi) The fair value of customer accounts represents the discounted amount of estimated future cash flows expected to be paid.
vii) The fair values of amounts owed to credit institutions, amounts owed to other customers and debt securities in issue are established by using discounted cash flow valuation models or are assumed to approximate to the amount payable at the date of the statement of financial position.
viii) The fair values of subordinated liabilities and subscribed capital are obtained from market prices.

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

The credit risk which the Group is exposed to is described in the Risk Management Report on pages 18 to 19. Credit risk in relation to loans and advances to customers including first and second charge retail credit risk and commercial lending credit risk is described in section c) below. Credit risk in relation to treasury financial instruments is described in section d).

c) Credit risk: loans and advances to customers
The Group's exposure to credit risk relating to loans and advances to customers can be broken down by security as follows:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | | 2014 | |
| | £m | % | £m | % |
| **In respect of loans and advances to customers:** | | | | |
| Fully secured by a first charge on residential property | 5,213.7 | 84.8 | 5,213.7 | 93.0 |
| Fully secured by a first charge on land | 393.4 | 6.4 | 393.4 | 7.0 |
| Secured by a second charge on residential property | 543.3 | 8.8 | - | - |
| | **6,150.4** | **100.0** | **5,607.1** | **100.0** |
| Provision for impairment losses | (62.7) | | (37.2) | |
| Unamortised loan origination fees | 15.2 | | 4.5 | |
| Fair value adjustments | 37.0 | | 37.0 | |
| | **6,139.9** | | **5,611.4** | |

| | Group | | Society | |
|---|---|---|---|---|
| | 2013 | | 2013 | |
| | £m | % | £m | % |
| **In respect of loans and advances to customers:** | | | | |
| Fully secured by a first charge on residential property | 4,913.6 | 82.8 | 4,913.6 | 91.7 |
| Fully secured by a first charge on land | 446.5 | 7.5 | 446.5 | 8.3 |
| Secured by a second charge on residential property | 576.1 | 9.7 | - | - |
| | **5,936.2** | **100.0** | **5,360.1** | **100.0** |
| Provision for impairment losses | (59.9) | | (32.7) | |
| Unamortised loan origination fees | 18.4 | | 1.4 | |
| Fair value adjustments | 9.9 | | 9.9 | |
| | **5,904.6** | | **5,338.7** | |

The Group's exposure to credit risk relating to loans and advances to customers can be broken down by business segment as follows:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | | 2014 | |
| | £m | % | £m | % |
| Retail financial services | 4,783.9 | 77.9 | 4,783.9 | 85.2 |
| Commercial lending | 790.6 | 12.9 | 790.6 | 14.1 |
| Secured personal lending | 528.4 | 8.6 | - | - |
| Fair value adjustments | 37.0 | 0.6 | 37.0 | 0.7 |
| | **6,139.9** | **100.0** | **5,611.5** | **100.0** |

| | Group | | Society | |
|---|---|---|---|---|
| | 2013 | | 2013 | |
| | £m | % | £m | % |
| Retail financial services | 4,505.9 | 76.3 | 4,505.9 | 84.4 |
| Commercial lending | 822.9 | 13.9 | 822.9 | 15.4 |
| Secured personal lending | 565.9 | 9.6 | - | - |
| Fair value adjustments | 9.9 | 0.2 | 9.9 | 0.2 |
| | **5,904.6** | **100.0** | **5,338.7** | **100.0** |

# Notes to the accounts

for the year ended 31 December 2014

## 39. Financial instruments (continued)

### ci) First and second charge retail credit risk

Retail credit risk can be categorised as first or second charge, where first charge consists of first time buyers, remortgage, buy-to-let and other, and second charge consisting of activities from Nemo.

Further detail of the Group's risk management strategy in relation to first and second charge retail credit risk is described in the Risk Management Report on page 18.

### First and second charge retail: Risk Concentrations

The Group provides loans secured on residential property across England, Scotland and Wales and the Society, as a regional building society, has a geographical concentration in Wales.

As at 31 December 2014, approximately 30.7% (2013: 31.9%) of first and second charge retail loans by account and 28.5% (2013: 29.6%) by value were concentrated in Wales.

Loan to value (LTV) is one of the main factors used to determine the credit quality of loans secured on residential property. The average index linked LTV in respect of the Group's loans secured on residential property including mortgages under offer is estimated to be 59.4% (2013: 63.2%). Index-linked LTV banding is shown below:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | % | % | % | % |
| Less than 70% | 68.7 | 59.8 | 70.6 | 62.0 |
| More than 70% but less than 80% | 15.2 | 19.0 | 14.7 | 19.0 |
| More than 80% but less than 90% | 9.6 | 10.9 | 9.1 | 10.5 |
| More than 90% but less than 100% | 3.9 | 5.8 | 3.5 | 5.0 |
| More than 100% | 2.6 | 4.5 | 2.1 | 3.5 |
| | **100.0** | **100.0** | **100.0** | **100.0** |

### First and second charge retail: Performance

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than 2.5% of the total outstanding balance is 0.74% (2013: 0.78%) which compares favourably with the industry average of 1.12% (CML arrears and possession data at 30 September 2014). Total arrears balances on residential lending fully secured by a first charge were £0.7m (2013: £0.7m) and there are 155 (2013: 146) residential cases six months or more in arrears.

The percentage of secured personal loans currently in arrears by number is 8.44% (2013: 8.74%), which by value is 10.14% (2013: 11.68%).

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

ci) First and second charge retail credit risk (continued)

First and second charge retail: Performance (continued)
The table below provides further information on the first and second charge retail loans secured on residential property by payment due status:

| | Group | | Group | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| | £m | % | £m | % |
| Current | 5,143.4 | 96.8 | 4,895.7 | 96.5 |
| Past due up to 3 months | 108.7 | 2.0 | 114.0 | 2.2 |
| Past due 3 months up to 6 months | 24.8 | 0.5 | 23.0 | 0.5 |
| Past due 6 months up to 12 months | 17.9 | 0.4 | 17.5 | 0.3 |
| Past due over 12 months | 15.7 | 0.3 | 17.8 | 0.4 |
| Possessions | 1.8 | 0.0 | 3.8 | 0.1 |
| | **5,312.3** | **100.0** | **5,071.8** | **100.0** |

| | Society | | Society | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| | £m | % | £m | % |
| Current | 4,674.3 | 97.7 | 4,385.5 | 97.3 |
| Past due up to 3 months | 81.5 | 1.7 | 88.2 | 2.0 |
| Past due 3 months up to 6 months | 14.7 | 0.3 | 15.3 | 0.3 |
| Past due 6 months up to 12 months | 8.9 | 0.2 | 10.5 | 0.2 |
| Past due over 12 months | 2.7 | 0.1 | 2.6 | 0.1 |
| Possessions | 1.8 | 0.0 | 3.8 | 0.1 |
| | **4,783.9** | **100.0** | **4,505.9** | **100.0** |

Collateral values are updated at the date of each statement of financial position based on the best information publicly available. Land Registry data is used in the Retail Financial Services sector with Hometrack being used in the Secured Personal Lending business. Both indices take account of the geographical location of the collateral.

Based on indexed valuations the total collateral held against lending secured against residential property is estimated to be £12,894.0m (2013: £11,349.0m). Any collateral surplus on the sale of repossessed properties, after a deduction for costs incurred in relation to the sale, would be returned to the borrower. The percentage of the book with a collateral shortfall is reflected in the table on page 102.

The Group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £3.2m (2013: £4.7m) of collateral is held against possession cases. Repossessed properties are made available for sale in accordance with statutory guidelines with proceeds used to reduce or repay the outstanding loan. The Group has a statutory duty to obtain the best reasonable price and to sell as soon as it reasonably can.

Provisions are held against loans and advances to customers in line with the accounting policy which is outlined in Note 1. Provisions on retail loans and mortgages by business segment are broken down as follows:

| | 2014 | 2013 |
|---|---|---|
| | £m | £m |
| Retail financial services | 6.0 | 5.8 |
| Secured personal loans | 25.5 | 27.2 |
| | **31.5** | **33.0** |

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

### ci) First and second charge retail credit risk (continued)

#### First and second charge retail: Forbearance

Whilst the economic environment has improved during 2014, conditions remain challenging for some borrowers. We continue to uphold our mutual values, exploring all reasonable and appropriate account management and forbearance options for borrowers experiencing financial difficulty.

The Group offers a range of account management and forbearance options for borrowers. In the event of short-term difficulty the Group operates temporary reductions in payments and 'rehabilitation' tools for borrowers in arrears or pre-delinquency. Actions may include granting a revised payment schedule, a temporary transfer to interest-only, arrangements for the borrower to underpay and changing the payment date or payment method.

Longer-term forbearance options include capitalisation of arrears, interest-only concessions, arrangements to underpay and term extensions. During the year 9 accounts (2013: 18) have been capitalised with balances of £0.3m (2013: £0.5m). Capitalisation of arrears requires a qualifying period, typically six months, or a number of qualifying payments being met prior to the restructure. Any restructure will result in cases being classified and reported as up to date. The term of 38 mortgages (2013: 186) were extended during the year with balances of £2.7m (2013: £9.6m).

Where suitable, the secured personal lending business will agree to release the legal charge on properties which fall into negative equity, thereby facilitating a vendor controlled sale and the achievement of their most advantageous selling price. The business may subsequently seek to reach agreement for payment of the unsecured shortfall with the borrowers. There have been 23 (2013: 20) successful cases during the year with balances of £0.9m (2013: £1.2m). Reduced settlement figures have been accepted on four (2013: eight) secured accounts with balances of £0.1m (2013: £0.3m).

All account management and forbearance options are considered based on the borrower's financial circumstances, agreed subject to set criteria and reviewed on a case-by-case basis. The Group will seek to agree a course of action following a comprehensive financial fact find. This may include establishing that a borrower is seeking or has received independent advice or guidance from one of a number of advice agencies.

Repossession of a property is the last resort and will only take place once all alternatives have been reviewed and there are no other solutions available. 109 properties were taken into possession during 2014 (2013: 70) with balances of £8.0m (2013: £7.2m).

20 (2013: 22) borrowers with balances of £0.6m (2013: £1.1m) were able to remain in their homes under the Mortgage Rescue Scheme and we continue to work with the Welsh Assembly Government, Local Authorities and debt advice agencies in Wales and England to ensure all options are available.

The underlying performance of previous capitalisations, interest-only concessions and arrangements to underpay are reflected in the provisioning methodology and are not individually or collectively material. Provisions of £1.5m (2013: £1.2m) are held in relation to accounts subject to previous forbearance.

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

### cii) Commercial lending credit risk
Commercial lending activity is split between lending to private sector landlords and property investors, registered social landlords, and funding for commercial property development projects.

Further detail of the Group's risk management strategy in relation to commercial lending is described in the Risk Management Report on page 19.

### Commercial Lending: Risk Concentrations
The Group's commercial loan portfolio on a gross basis comprises of the following:

| | Group and Society | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| | £m | % | £m | % |
| Loans to Registered Social Landlords secured on residential property | 157.5 | 19.1 | 158.9 | 18.7 |
| Other loans secured on residential property | 279.1 | 33.9 | 256.9 | 30.2 |
| Loans secured on commercial property | 386.8 | 47.0 | 435.7 | 51.1 |
| | **823.4** | **100.0** | **851.5** | **100.0** |

Loans secured on commercial property are well diversified by industry type and counterparty. An analysis of commercial property loans by industry is provided below:

| | Group and Society | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| | £m | % | £m | % |
| Office | 127.5 | 33.0 | 155.9 | 35.8 |
| Retail | 125.6 | 32.5 | 141.1 | 32.4 |
| Industrial | 70.6 | 18.2 | 72.9 | 16.7 |
| Leisure | 32.7 | 8.5 | 34.4 | 2.5 |
| Land | 4.8 | 1.2 | 6.0 | 1.4 |
| Other | 25.6 | 6.6 | 25.4 | 11.2 |
| | **386.8** | **100.0** | **435.7** | **100.0** |

The Group provides loans secured on commercial property across England and Wales and the Society, as a regional building society, has a geographical concentration in Wales. An analysis of commercial property loans by geographical location is provided below:

| | Group and Society | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| Region | £m | % | £m | % |
| Wales | 411.0 | 49.9 | 424.8 | 49.9 |
| Greater London | 168.2 | 20.4 | 166.3 | 19.5 |
| South East/East of England | 66.5 | 8.1 | 71.7 | 8.4 |
| Midlands | 46.6 | 5.7 | 52.0 | 6.1 |
| South West/South of England | 43.3 | 5.3 | 55.3 | 6.5 |
| North West/North of England | 40.2 | 4.9 | 38.9 | 4.6 |
| Mixed/other | 47.6 | 5.8 | 42.5 | 5.0 |
| | **823.4** | **100.0** | **851.5** | **100.0** |

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

### cii) Commercial Lending credit risk (continued)

#### Commercial Lending: Risk Concentrations (continued)
The average index-linked loan to value (LTV) in respect of the Group's commercial loans is estimated to be 70.8% (2013: 78.5%). LTV analysis has been undertaken by using a combination of external valuations and internal and external desktop reviews which consider the type and quality of security, lease term/tenant as well as geographical location.

£113.8m of exposures have an LTV of greater than 100%. Of these, £73.9m are already classified as Impaired and a further £28.5m are on the Watchlist, leaving £11.4m of exposures considered to be satisfactory notwithstanding that they include an unsecured element. In these instances, management are satisfied that the cash flows generated by the underlying assets will be sufficient to fully repay the debt over time.

The largest exposure to one counterparty is £30.0m (2013: £29.9m) or 3.6% (2013: 3.5%) of gross balances.

#### Commercial Lending: Performance
The commercial lending risk procedure for loans and advances to customers is described in the risk management report on page 19.

Using the commercial credit risk grading system the commercial loan portfolio is distributed as follows (the figures are gross balances not including provision for loan impairment or unamortised loan origination fees):

| | Group and Society | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| | £m | % | £m | % |
| Satisfactory | 698.4 | 84.8 | 711.2 | 83.5 |
| Watchlist | 46.1 | 5.6 | 78.1 | 9.2 |
| Impaired (including past due up to 3 months) | 78.9 | 9.6 | 62.2 | 7.3 |
| | 823.4 | 100.0 | 851.5 | 100.0 |

Watchlist exposures are categorised in line with the perceived severity of the risk to identify cases having the greatest potential cause for concern and to facilitate timely risk mitigation activity. Accounts in the watchlist are typically those which have had a material covenant breach, have persistent arrears (but are not presently past due) or where there are other concerns about the likelihood of eventual repayment. Defaulted accounts are described as impaired.

The table below provides further information on commercial loans and advances by defaulted and delinquency status:

| | Group and Society | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| | £m | % | £m | % |
| **Unimpaired** | | | | |
| Current | 742.4 | 90.2 | 789.3 | 92.7 |
| Past due up to 3 months | 2.8 | 0.2 | 3.7 | 0.4 |
| **Impaired** | | | | |
| Past due 3 to 6 months | - | - | 3.1 | 0.4 |
| Past due 6 to 12 months | 0.7 | 0.1 | - | - |
| Past due over 12 months | - | - | - | - |
| Defaulted but not past due | 72.9 | 8.9 | 52.3 | 6.1 |
| Law of Property Act (LPA) Receivers appointed | 4.6 | 0.6 | 3.1 | 0.4 |
| | 823.4 | 100.0 | 851.5 | 100.0 |

There are two commercial cases (2013: seven) three months or more in arrears, of which one has LPA Receivers appointed. Total arrears balances are £31k (2013: £86k).

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

### Commercial Lending: Performance (continued)
The total collateral held against commercial loans is estimated to be £1,383m (2013: £1,325.8m). Lending is classified by sector according to the property type held as collateral, as analysed in table on page 105. The current value of collateral is estimated based on the latest professional valuation adjusted for subsequent commercial property price movements. Where considered necessary, new professional valuations will be sought. In the case of Watchlist exposures this will typically be at least annually.

Provisions are held against impaired loans as follows:

| | 2014 | 2013 |
|---|---|---|
| | £m | £m |
| Collective provisions | 11.6 | 10.7 |
| Specific provisions | 19.5 | 16.2 |
| **Total Provisions** | **31.1** | **26.9** |

### Forbearance
In some cases of default, or in order to avoid a default, action plans are implemented which may require the granting of a concession involving amendments to the contractual terms of a loan, such as an extension of a maturity, reduction in interest rate or non-enforcement of covenants, recognising that providing such forbearance can often be the best way to avoid default and minimise losses, giving the customer time to take action to improve their situation. Such forbearance activity is always carefully considered with the aim of maximising the benefit and optimising the outcome for both the Group and the borrower. In 2014, 11 (2013: 20) accounts with balances totalling £11.7m (2013: £46.5m) in value were granted forbearance concessions. Total exposure in forbearance at December 2014 stands at balances of £147.6m and 58 accounts (2013: £164.2m, 56 accounts). The potential for losses on these accounts is assessed and considered in the level of overall provisions held against the Commercial Lending portfolio. Additionally their status in terms of whether deemed impaired, or placed on the Watchlist is also considered on a regular basis.

# Notes to the accounts

for the year ended 31 December 2014

## 39. Financial instruments (continued)

### d) Credit risk: Treasury financial instruments

The treasury credit risk strategy is described in the risk report on page 19.

The classes of financial instruments to which the Group is most exposed to Treasury credit risk are loans and advances to credit institutions, debt securities and financial derivatives. For financial assets recognised in the statement of financial position, the exposure to credit risk equals their carrying amount. For loan commitments and guarantees, the exposure to credit risk is the full amount committed. The following table shows the Group's estimated maximum exposure to credit risk without taking into account any collateral held or other credit enhancements.

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| UK government securities and amounts held with central banks | 300.5 | 347.0 | 300.5 | 347.0 |
| Supranational securities | 79.1 | 116.0 | 79.1 | 116.0 |
| UK financial institutions | 256.1 | 261.1 | 155.1 | 190.4 |
| | **635.7** | **724.1** | **534.7** | **653.4** |

None of these exposures was either past due or impaired and there are no assets that would otherwise be past due or impaired whose terms have been renegotiated.

Collateral is not held over loans and advances to credit institutions and debt securities. Collateral of £5.5m (2013: £13.8m) is held over derivative financial instruments.

The following table shows the exposures broken down by Fitch ratings:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| AAA to AA- | 506.8 | 528.9 | 460.2 | 528.9 |
| A+ to A- | 128.9 | 180.2 | 74.5 | 109.5 |
| BBB+ to BBB- | - | - | - | - |
| Unrated | - | 15.0 | - | 15.0 |
| | **635.7** | **724.1** | **534.7** | **653.4** |

The geographical distribution of these exposures is as follows:

| | Group | | Society | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | £m | £m | £m | £m |
| UK | 556.6 | 608.1 | 455.6 | 537.4 |
| Multinational Development Banks | 79.1 | 116.0 | 79.1 | 116.0 |
| | **635.7** | **724.1** | **534.7** | **653.4** |

The treasury risk function monitors exposure concentrations against a variety of criteria including counterparty and country limits and all exposures are well spread across this risk assessment framework. An assessment has been made of the Society's key counterparties regarding the potential levels of direct or indirect exposure to distressed Eurozone economies. This assessment concludes that no impairment provisions are required.

# Notes to the accounts

for the year ended 31 December 2014

## 39. Financial instruments (continued)

e) Liquidity risk

The following tables analyse the gross contractual principal cash flows payable under financial liabilities, excluding accrued interest and fair value adjustments. These balances will not agree directly to the balances in the consolidated statement of financial position as the table incorporates only principal amounts and does not reflect accrued interest or fair value adjustments.

| | 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Total | Undefined maturity | Less than 3 months | Between 3 months and 1 year | Between 1 year and 5 years | More than 5 years |
| | £m | £m | £m | £m | £m | £m |
| **Group** | | | | | | |
| **Non-derivative liabilities** | | | | | | |
| Shares | 5,536.2 | - | 3,487.5 | 820.2 | 1,228.5 | - |
| Amounts owed to credit institutions | 227.5 | 5.5 | 8.0 | 3.0 | 211.0 | - |
| Other customers | 172.3 | - | 59.7 | 99.8 | 12.8 | - |
| Debt securities in issue | 595.9 | - | 51.5 | 106.5 | 438.0 | - |
| Subordinated liabilities | 92.3 | - | - | - | 92.3 | - |
| Subscribed capital | 71.9 | - | - | - | - | 71.9 |
| | **6,696.1** | **5.5** | **3,606.7** | **1,029.5** | **1,982.6** | **71.9** |
| **Society** | | | | | | |
| **Non-derivative liabilities** | | | | | | |
| Shares | 5,536.2 | - | 3,487.5 | 820.2 | 1,228.5 | - |
| Amounts owed to credit institutions | 689.1 | 5.5 | 31.1 | 78.8 | 573.7 | - |
| Other customers | 172.3 | - | 59.7 | 99.8 | 12.8 | - |
| Debt securities in issue | 35.5 | - | 17.0 | 3.0 | 15.5 | - |
| Subordinated liabilities | 92.3 | - | - | - | 92.3 | - |
| Subscribed capital | 71.9 | - | - | - | - | 71.9 |
| | **6,597.3** | **5.5** | **3,595.3** | **1,001.8** | **1,922.8** | **71.9** |
| **Group** | | | | | | |
| **Derivative liabilities** | | | | | | |
| Interest rate swaps | 41.7 | - | - | 0.6 | 22.5 | 19.6 |
| Equity and RPI index linked interest rate swaps | - | - | - | - | - | - |
| | **41.7** | **-** | **-** | **0.6** | **22.5** | **19.6** |
| **Society** | | | | | | |
| **Derivative liabilities** | | | | | | |
| Interest rate swaps | 39.7 | - | - | 0.6 | 22.5 | 17.6 |
| Equity and RPI index linked interest rate swaps | - | - | - | - | - | - |
| | **39.7** | **-** | **-** | **0.6** | **22.5** | **17.6** |

# Notes to the accounts
for the year ended 31 December 2014

## 39. Financial instruments (continued)

### e) Liquidity risk (continued)

| | 2013 | | | | | |
|---|---|---|---|---|---|---|
| | Total | Undefined maturity | Less than 3 months | Between 3 months and 1 year | Between 1 year and 5 years | More than 5 years |
| | £m | £m | £m | £m | £m | £m |
| **Group** | | | | | | |
| **Non-derivative liabilities** | | | | | | |
| Shares | 5,475.9 | - | 3,203.1 | 1,061.8 | 1,211.0 | - |
| Amounts owed to credit institutions | 499.6 | 13.8 | 183.1 | 65.4 | 230.9 | 6.4 |
| Other customers | 222.5 | - | 94.2 | 119.0 | 9.3 | - |
| Debt securities in issue | 174.9 | - | 11.1 | 28.6 | 135.2 | - |
| Subordinated liabilities | 92.3 | - | - | - | 92.3 | - |
| Subscribed capital | 60.0 | - | - | - | - | 60.0 |
| | **6,525.2** | **13.8** | **3,491.5** | **1,274.8** | **1,678.7** | **66.4** |
| **Society** | | | | | | |
| **Non-derivative liabilities** | | | | | | |
| Shares | 5,475.9 | - | 3,203.1 | 1,061.8 | 1,211.0 | - |
| Amounts owed to credit institutions | 582.3 | 13.8 | 187.6 | 83.7 | 290.8 | 6.4 |
| Other customers | 222.5 | - | 94.2 | 119.0 | 9.3 | - |
| Debt securities in issue | 23.1 | - | 2.5 | 4.0 | 16.6 | - |
| Subordinated liabilities | 92.3 | - | - | - | 92.3 | - |
| Subscribed capital | 60.0 | - | - | - | - | 60.0 |
| | **6,456.1** | **13.8** | **3,487.4** | **1,268.5** | **1,620.0** | **66.4** |
| **Group and Society** | | | | | | |
| **Derivative liabilities** | | | | | | |
| Interest rate swaps | 25.5 | - | 0.5 | 1.0 | 11.5 | 12.5 |
| Equity and RPI index linked interest rate swaps | 0.7 | - | - | - | - | 0.7 |
| | **26.2** | **-** | **0.5** | **1.0** | **11.5** | **13.2** |

Annual commitments under non-cancellable operating leases are outlined in note 38.

### f) Market risk

Market risk can be sub-divided into interest rate risk and currency risk.

#### Interest rate risk

Interest rate risk refers to the sensitivity of net interest income to the periodic re-pricing of assets and liabilities and the imperfect correlation caused by basis risk. Interest rate risks generated by these activities are offset against each other, and the remaining net exposure to interest rate risk is managed on a continuous basis, within parameters set by ALCO, using a combination of derivatives and cash instruments (such as savings and deposits).

The Group's exposure to interest rate risk in terms of the net risk after taking account of management's action to hedge inherent exposures is measured using interest rate gap analysis. In this method each of the Group's financial instruments including on and off the statement of financial position assets and liabilities is assigned to future time periods on the basis of their contractual maturity or contractual re-pricing arrangements. In calculating the net exposure for each future period, account is also taken of those assets and liabilities with embedded optionality, such as pipeline and prepayment risk on fixed rate mortgages. If there was a 2% parallel upward shift in interest rates the favourable impact on reserves would be £9.8m (2013: £1.2m favourable impact on reserves).

#### Currency risk

After taking into account the effect of cross currency swaps the Group has no material exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates.

# Notes to the accounts

for the year ended 31 December 2014

## 40. Related party transactions

The remuneration of the directors (including non-executive directors), who are the key management personnel of the Group, is set out in the Report of the Remuneration Committee on page 49.

### Loans to and shares held by directors

There was an aggregate of £0.5m (2013: £0.4m) outstanding at the end of the financial year in respect of secured advances made prior to or during the year to directors.

In so far as it is required under Section 68(1) and Section 68(3) of the Building Societies Act 1986, details of such loans are maintained in a register kept at Principality Buildings, Queen Street, Cardiff, and a statement containing requisite particulars will be available for inspection by Members at the same address for the period of 15 days prior to the Annual General Meeting to be held on 24 April 2015.

As required by the Society's Rules, each director has a share account. The Society's duty of confidentiality to its Members precludes individual disclosure of these details; the aggregate total of deposits held by directors was £0.1m (2013: £0.2m).

### Directors' transactions

There were no other transactions with directors during the year.

### Transactions with Group companies

The Society undertook the following transactions with Group companies during the year:

| | Interest received from Society | Interest paid to Society | Fees received from Society | Fees paid to Society | Rent received from Society | Rent paid to Society |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **Year ended 31 December 2014** | | | | | | |
| Nemo Personal Finance Limited | - | 13.0 | - | 1.8 | - | - |
| Peter Alan Limited (to 30 July 2014) | - | - | - | - | - | 0.2 |
| | **-** | **13.0** | **-** | **1.8** | **-** | **0.2** |
| **Year ended 31 December 2013** | | | | | | |
| Nemo Personal Finance Limited | - | 13.6 | - | 2.0 | - | - |
| Peter Alan Limited | - | - | - | - | - | 0.2 |
| | **-** | **13.6** | **-** | **2.0** | **-** | **0.2** |

At the year-end the following balances were outstanding:

| | Loans owed to Society | Loans owed by Society | Loans owed to Society | Loans owed by Society |
|---|---|---|---|---|
| | 2014 | 2014 | 2013 | 2013 |
| | £m | £m | £m | £m |
| Nemo Personal Finance Limited | 475.3 | - | 517.9 | - |
| Peter Alan Limited | - | - | 4.1 | - |
| | **475.3** | **-** | **522.0** | **-** |

# Annual business statement
for the year ended 31 December 2014

## 1. Statutory percentages

| | At 31 December 2014 | At 31 December 2013 | Statutory limit |
|---|---|---|---|
| | % | % | % |
| The lending limit | 7.1 | 8.5 | 25.0 |
| The funding limit | 15.2 | 14.0 | 50.0 |

The percentages are calculated in accordance with, and the statutory limits are those prescribed by, Sections 6 and 7 of the Building Societies Act 1986 (as substituted by the Building Societies Act 1997) and are based on the consolidated statement of financial position.

The lending limit is the proportion of business assets not in the form of loans fully secured on residential property.

The funding limit is the proportion of shares and borrowings not in the form of customer accounts held by individuals.

Business assets are the total assets of the Society and its subsidiary undertakings as shown in the statement of financial position plus provision for loan impairment, less fixed assets and liquid assets.

Loans fully secured on residential property are the amount of principal owed by borrowers and interest accrued not yet payable. This is the amount shown in the statement of financial position plus provision for loan impairment and minus unamortised loan origination fees.

## 2. Other percentages

| | 2014 | 2013 |
|---|---|---|
| | % | % |
| **As a percentage of shares and borrowings:** | | |
| Gross capital | 8.7 | 8.0 |
| Free capital | 9.0 | 8.1 |
| Liquid assets | 15.7 | 16.1 |
| | | |
| Profit for the year as a percentage of total assets | 0.72 | 0.31 |
| Management expenses as a percentage of mean total assets | 0.90 | 0.95 |

Gross capital represents retained earnings, subscribed capital and subordinated liabilities as shown in the consolidated statement of financial position.

Free capital is gross capital plus provision for impairment losses less intangible assets and property, plant and equipment.

Liquid assets represent the total of cash in hand and balances with the Bank of England, loans and advances to credit institutions and debt securities.

Mean total assets represent the average of the total assets in the consolidated statement of financial position at the beginning and end of the year.

Management expenses represent the aggregate of administrative expenses, depreciation and amortisation.

# Annual business statement
for the year ended 31 December 2014

## 3. Directors

Details of directors are contained on pages 31 and 32.

Details of directors' service contracts are included in the Report of the Remuneration Committee on page 46.

Documents may be served on any of the directors c/o Eversheds LLP, Reference PDV, 1 Callaghan Square, Cardiff CF10 5BT.

### Managers
David Cunningham-Jones
Peter Hughes
Susan Lane
Elaine Morris
Julie-Ann Haines
Alan Jarman

No director or other officer, including connected persons, has any right to subscribe for shares in, or debentures of, any connected undertaking of the Society.

### Subsidiary companies
Nemo Personal Finance Limited
Chief Executive:
Alan Jarman

# Glossary

**ALCO**
Asset and Liability Committee.

**Arrears**
A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan payment is overdue. Such a customer can also be said to be in a state of delinquency.

**Basel II**
The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive and was implemented in the UK via the FSA Handbook.

**Basel III**
In December 2010, the Basel Committee on Banking Supervision issued the Basel III rules text, which presents the details of strengthened global regulatory standards on bank capital adequacy and liquidity. The standards will be phased in gradually from 2013.

**BIPRU**
The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive and was implemented in the UK via the FSA Handbook.

**Buffer eligible liquid assets**
Includes high quality debt securities issued by a government or central bank, securities issued by a designated multilateral development bank or reserves in the form of sight deposits with a central bank in an EEA State or Canada, the Commonwealth of Australia, Japan, Switzerland or the United States of America.

**Commercial lending**
Loans secured on commercial property and loans to Registered Social Landlords.

**Commercial Paper (CP)**
An unsecured promissory note issued to finance short-term credit needs. It specifies the face amount paid to investors on the maturity date.

**Commercial property**
Includes office buildings, industrial property, medical centres, hotels, retail stores, shopping centres, multifamily housing buildings, warehouses, garages and industrial properties.

**Contractual maturity**
The final payment date of a loan or other financial instrument, at which point the entire remaining outstanding principal and interest is due to be repaid.

**Core liquidity ratio**
Buffer eligible liquid assets as a proportion of savings, deposits and loans.

**Common Equity Tier 1 capital**
Tier 1 capital (see definition below) less Permanent Interest-Bearing Shares (PIBS).

**Common Equity Tier 1 capital ratio**
Common Equity Tier 1 capital as a proportion of risk-weighted assets.

**Cost income ratio**
A ratio that represents the proportion of management expenses (i.e. administrative expenses, depreciation and amortisation) to total income.

**Coverage ratio**
Impairment allowances (provisions) as a percentage of the loans and advances to which they relate.

**Covered bonds**
Debt securities backed by a portfolio of mortgages that is segregated from the issuer's other assets solely for the benefit of the holders of the covered bonds.

**Credit default swap**
An arrangement where the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of the protection. A credit default swap is a contract where the protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency.

**Credit risk**
The risk that a borrower or counterparty fails to pay the interest or to repay the capital on a loan. Credit risk is the largest risk category to which the Group is exposed and sub-divided as follows: retail lending, commercial lending, and Treasury credit risks.

**Credit risk mitigation**
Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.

**Credit Valuation Adjustment (CVA)**
An adjustment that represents an estimate of the change to fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures.

**Debt restructuring**
The changing of the terms and provisions of outstanding debt agreements. Restructuring may be done in order to improve cash flow and the ability of the borrower to repay the debt. It can involve altering the repayment schedule as well as debt or interest charge alteration.

**Debt securities**
Assets representing certificates of indebtedness of credit institutions, public bodies or other undertakings excluding those issued by central banks.

**Debt securities in issue**
Transferable certificates of indebtedness of the Group to the bearer of the certificates. These are liabilities of the Group and include certificates of deposit.

**Defined benefit pension scheme**
A scheme that defines the benefit an employee will receive on retirement, depending on such factors as age, length of service and salary.

**Defined contribution pension scheme**
A scheme into which the Group and the employee pay fixed contributions without any further obligation to pay further contributions.

**Delinquency**
See Arrears.

**ECAI**
External Credit Assessment Institution. An ECAI (e.g. Moody's, Standard and Poor's and Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.

# Glossary (continued)

**Economic capital**
An internal assessment of the amount of capital required to protect against potential unexpected future losses arising from business activities, across a defined time horizon and confidence interval.

**Effective Interest Rate method (EIR)**
The method used to measure the carrying value of a financial asset or a liability. EIR allocates associated interest income or expense to produce a level yield, either to maturity or to the next re-pricing date.

**Euro Medium Term Notes (EMTN)**
Euro notes issued by corporates across a range of maturities. EMTNs are frequently issued by corporates under EMTN programmes whereby notes are offered on a regular and continuous basis to investors.

**Expected Loss (EL)**
A Basel II calculation to estimate the potential losses on current exposures due to potential defaults over a one-year time horizon. It is the product of PD, LGD and EAD.

**Exposure**
The maximum loss that a financial institution might suffer if a borrower, counterparty or group fails to meet their obligations or if assets and off-statement of financial positions have to be realised.

**Exposure At Default (EAD)**
A Basel II parameter used to estimate the amount outstanding at the time of default.

**Final salary pension arrangements**
A defined benefit pension arrangement where the pension payable to the employee is based on final pensionable salary prior to retirement.

**Financial Conduct Authority (FCA)**
The statutory body responsible for conduct of business regulation and supervision of UK authorised firms from 1 April 2013. The FCA also has responsibility for protecting consumers and promoting healthy competition.

**Financial Services Authority (FSA)**
The former financial services industry regulator in the UK, which was superseded by the Financial Conduct Authority and the Prudential Regulation Authority from 1 April 2013.

**Financial Services Compensation Scheme (FSCS)**
The UK's compensation fund of last resort for customers of authorised financial services firms. The FSCS may pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it, usually because it has stopped trading or has been declared in default. The FSCS is funded by the financial services industry. Every firm authorised by the UK regulators is obliged to pay an annual levy, which goes towards its running costs and compensation payments.

**Forbearance strategies**
Strategies to assist borrowers in financial difficulty, such as extending loan terms, temporarily converting loans to an interest-only basis and agreeing a temporary reduction in payments. Forbearance strategies aim, if possible, to avoid foreclosure or repossession.

**Free capital**
The aggregate of gross capital and provisions for collective impairment losses on loans and advances to customers less property, plant and equipment and intangible assets.

**Funding limit**
The proportion of shares and borrowings not in the form of customer accounts held by individuals.

**GORC**
Group Operational Risk Committee.

**GRC**
Group Risk Committee.

**Gross capital**
The aggregate of general reserve, revaluation reserve, available-for-sale reserve, subscribed capital and subordinated liabilities.

**Guarantee**
An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.

**Individual Liquidity Adequacy Assessment (ILAA)**
The Group's own assessment of the levels of liquidity that it needs to meet its current and expected financial obligations. These are assessed under normal and stressed conditions.

**Impaired loans**
A loan is impaired if there is objective evidence that an impairment event has occurred, and that the event has an impact on the estimated future cash flows of the loan which can be reliably estimated. Impairment may be caused by a single event, or a combination of events. Impairment events include redundancy or marital breakdown.

**Impairment allowances**
Provisions held against assets on the statement of financial position. The provisions represent management's best estimate of losses incurred in the loan portfolio at the statement of financial position date.

**Indexed LTV (Loan to Value)**
A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).

**Individually/collectively assessed impairment allowances**
Impairment is measured individually for assets that are individually significant to the Group, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available. Collective assessment also covers losses that have occurred but are not yet individually identified on loans subject to individual assessment.

**Individual Liquidity Guidance (ILG)**
Guidance from the PRA on the quantity of a firm's liquidity resources and the firm's funding profile.

**Internal Capital Adequacy Assessment Process (ICAAP)**
The Group's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events.

**International Swaps and Derivatives Association (ISDA) master agreement**
A standardised contract developed by ISDA and used to enter into bilateral derivative transactions. The contracts grant legal rights of set-off for derivative transactions with the same counterparty. This reduces the credit risk of the derivatives to the extent that negative values offset positive values.

**IPD index**
Measures the returns on property investments in the UK.

**Internal Ratings Based (IRB)**
This is a risk assessment approach for capital calculations which allows a financial services business to use its own internal information to estimate risk weightings, rather than standard risk weightings prescribed by the Prudential Regulation Authority (PRA).

# Glossary (continued)

### Lending limit
The proportion of business assets not in the form of loans fully secured on residential property.

### Level 1 fair values
Fair value derived from unadjusted quoted prices in active markets for identical assets or liabilities, e.g. G10 government securities.

### Level 2 fair values
Fair value derived from inputs other than quoted prices that are observable for the asset or liability, either directly (i.e. a price) or indirectly (i.e. derived from prices), e.g. most investment grade and liquid bonds, asset backed securities, certain collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and OTC derivatives.

### Level 3 fair values
Fair value derived from inputs for the asset or liability that are not based on observable market data (unobservable inputs), e.g. private equity investments, derivatives including an equity element, deposits including an equity element, some CDOs and certain asset-backed securities and bonds.

### Leverage ratio
As currently proposed under Basel III rules, it is a supplementary measure of risk-adjusted capital requirements, defined as the ratio of Tier 1 capital to total exposures. Total exposures include on and off statement of financial position items (after netting derivatives).

### LIBOR
London Inter Bank Offered Rate.

### Liquid assets
Cash or other assets that can be readily converted to cash without loss of value.

### Liquidity Coverage Ratio (LCR)
As currently proposed under Basel III rules, this is a liquidity metric which aims to ensure that a firm maintains an adequate level of liquidity to meet its needs for a 30-calendar day time horizon under a severe stress scenario.

### Liquidity and funding risk
The risk that the Group is not able to meet its financial obligations as they fall due or can secure them only at excessive cost.

### Loan to deposit ratio
Represents loans and advances to customers divided by the aggregate of shares, other deposits and amounts due to customers.

### Loan To Value ratio (LTV)
A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).

### Loans past due/past due loans
Loans are past due when a counterparty has failed to make a payment when contractually due.

### Loss Given Default (LGD)
A Basel II parameter used to estimate the difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.

### Management expenses
The aggregate of administrative expenses, depreciation and amortisation.

### Management expense ratio
Management expenses as a proportion of total average assets.

### Market risk
The potential losses or decrease in value of the Group statement of financial position as a result of adverse market movements. Specific types of market risk include interest rate risk (banking book), swap spread risk and currency risk.

### Maturity
The remaining time in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, interest and fees) under the terms of a loan agreement.

### Member
A person aged 18 or over who has a share investment or a mortgage loan with the Society over £100 during the year.

### Negative equity mortgages
Negative equity occurs when the value of the property purchased using the mortgage is less than the balance outstanding on the loan. Negative equity is the difference between the current value of the property and the outstanding balance on the loan.

### Net interest income
The sum of the amount earned on assets (a combination of retail lending, commercial lending and liquid assets) less liabilities (savings products and borrowings).

### Net interest margin
Net interest income as a proportion of total average assets.

### Net Stable Funding Ratio (NSFR)
A liquidity ratio, currently proposed under Basel III, to calculate the proportion of long-term assets that are funded by stable, long-term funding sources (customer deposits and long-term wholesale funding).

### Non-standard lending
Consists of Buy-to-Let and other non-standard mortgages.

### Operational risk
The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.

### Overnight Indexed Swap rate (OIS)
A rate reflecting the overnight interest typically earned or paid in respect of collateral exchanged. OIS rates are also used to discount collateralised derivative future cash flows to calculate the fair value of collateralised swaps.

### Over-The-Counter (OTC)
A bilateral transaction (e.g. derivatives) that is not exchange traded and valued using valuation models.

### Own credit adjustment
Adjustment for the effect of the Group's credit standing on the fair value of its financial liabilities. This is sometimes referred to as a debit valuation adjustment.

### Permanent Interest-Bearing Shares (PIBS)
Unsecured, deferred shares of the Society that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, creditors and investing Members of the Group. Also known as subscribed capital.

### Prime residential mortgages
Prime mortgages are mainstream residential loans, which typically have a higher credit quality and fit standard underwriting processes. As such, they are likely to have a good credit history, and pass a standard affordability assessment at the point of origination.

### Probability of Default (PD)
A Basel II parameter used to estimate the probability that a borrower will default on their credit obligations in the next 12 months.

# Glossary (continued)

**Prudential Regulation Authority (PRA)**
The statutory body responsible for the prudential supervision of banks, building societies, insurers and a small number of significant investment firms in the UK from 1 April 2013. The PRA is a subsidiary of the Bank of England. The PRA's role emphasises the statutory objective of promoting the safety and soundness of firms.

**Regulatory capital**
The capital held by the Group, determined in accordance with rules established by the PRA. The regulatory capital base comprises Tier 1 and Tier 2 capital (see below).

**Renegotiated loans**
Loans and advances may be renegotiated either as part of an ongoing customer relationship with a creditworthy customer or in response to a borrower's financial difficulties. In the latter case, the renegotiated loan may no longer be treated as past due or impaired if there is no change to the estimated future flows. Individually significant loans whose terms have been renegotiated are subject to ongoing review to determine if they remain past due or impaired.

**Repurchase agreement (repo)/Reverse repurchase agreement (reverse repo)**
A repurchase agreement that allows a borrower to use a financial security as collateral for a cash loan. In a repo, the borrower agrees to sell a security to the lender subject to a commitment to repurchase the asset at a specified price on a given date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the counterparty to the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or reverse repo.

**Residential Mortgage Backed Securities (RMBS)**
A category of asset backed security that represents interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and/or principal).

**Retail loans**
Loans to individuals rather than institutions, including residential mortgage lending and consumer banking.

**Risk appetite**
The articulation of the level of risk that the Group is willing to take (or not take) in order to safeguard the interests of the Society's Members whilst achieving business objectives.

**Risk-Weighted Assets (RWA)**
The value of assets, after adjustment, under the Basel II capital rules to reflect the degree of risk they represent.

**Return on Capital (ROC)**
Profit after tax as a percentage of average gross capital (general reserve, revaluation reserve, available-for-sale reserve, PIBS and subordinated liabilities). Profit after tax excludes the interest cost of PIBS and subordinated liabilities.

**Securitisation**
A process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose entity (SPE) which then issues securities backed by the assets. The Group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.

**Shares**
Funds deposited by a person in a retail savings or current account with the Society. Such funds are recorded as liabilities for the Society.

**Shares and borrowings**
The total of shares, deposits from banks, other deposits, amounts due to customers and debt securities in issue.

**Solvency ratio**
A component of regulatory capital measuring of the Group's total capital as a proportion of the Group's risk-weighted assets.

**Special Purpose Entities (SPEs)**
Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses SPEs set up under a securitisation programme. Where the Group has control of these entities or retains the risks and rewards relating to them, they are consolidated within the Group's results. This term is used interchangeably with SPV (Special Purpose Vehicle).

**Standardised approach**
The basic method used to calculate credit risk capital requirements under Basel II. In this approach the risk weights used in the capital calculation are determined by PRA supervisory parameters. The standardised approach is less risk-sensitive than IRB.

**Stress testing**
Various techniques that are used by the Group to gauge the potential vulnerability to exceptional but plausible events.

**Subscribed capital**
See Permanent Interest-Bearing Shares (PIBS).

**Subordinated debt/liabilities**
A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors and investing Members but before the claims of holders of Permanent Interest-Bearing Shares (PIBS).

**Sub prime**
Loans to borrowers that typically have weakened credit histories that include payment delinquencies and potentially more severe problems such as court judgements and discharged bankruptcies. They may also display higher risk characteristics as measured by credit scores, or other criteria indicating heightened risk of default.

**Standard Variable Rate (SVR)**
The rate of interest on which mortgage pricing is based.

**Tier 1 capital**
A component of regulatory capital comprising general reserves from retained profits, Permanent Interest-Bearing Shares (PIBS), less goodwill, intangible assets and other regulatory adjustments.

**Tier 1 capital ratio**
Tier 1 capital as a proportion of risk-weighted assets.

**Tier 2 capital**
A further component of regulatory capital comprising subordinated debt and the collective impairment allowance (for exposures treated on a Basel II standardised basis), less certain regulatory deductions.

**Value at Risk (VAR)**
A technique that estimates the potential loss that could occur on risk positions as a result of future movements in market rates and prices over a specified time horizon and to a given level of statistical confidence.

# Branch addresses

**Principality Building Society**
Customer Support Centre, PO Box 89, Principality Buildings, Queen Street, Cardiff CF10 1UA
Telephone 0330 333 4000 www.principality.co.uk

| | | |
|---|---|---|
| ABERDARE | 10 Victoria Square CF44 7LA | 01685 872400 |
| ABERGAVENNY | 68 Frogmore Street NP7 5AU | 01873 856256 |
| ABERYSTWYTH | 15 Terrace Road SY23 1NY | 01970 612728 |
| BANGOR | 220 High Street LL57 1NY | 01248 364127 |
| BARRY | 1a Tynewydd Road CF62 8HB | 01446 733506 |
| BLACKWOOD | 129 High Street NP12 1AB | 01495 224687 |
| BRIDGEND | 28 Caroline Street CF31 1DQ | 01656 655120 |
| CAERPHILLY | The Twyn CF83 1JL | 029 2086 9364 |
| CARDIFF (Albany Road) | 105/107 Albany Road CF24 3LP | 029 2048 7030 |
| CARDIFF (Birchgrove) | 95 Caerphilly Road, Birchgrove CF14 4AE | 029 2061 5928 |
| CARDIFF (Canton) | 174 Cowbridge Road East, Canton CF11 9NE | 029 2037 3153 |
| CARDIFF (Llandaff) | 36/38 High Street, Llandaff CF5 2DZ | 029 2056 3094 |
| CARDIFF (Llanishen) | 18 Station Road, Llanishen CF14 5LT | 029 2076 4151 |
| CARDIFF (Queen Street) | Principality Buildings, Queen Street CF10 1UA | 0330 333 4032 |
| CARDIFF (Rumney) | 796 Newport Road, Rumney CF3 4FH | 029 2079 4721 |
| CARDIFF (St David's) | 39 Town Wall, St David's Centre CF10 2EW | 029 2022 7788 |
| CARDIFF (Whitchurch) | 21 Merthyr Road, Whitchurch CF14 1DA | 029 2062 4537 |
| CARMARTHEN | 13 Guildhall Square SA31 1PR | 01267 235403 |
| CHESTER | 14 Bridge Street CH1 1NQ | 01244 323039 |
| COWBRIDGE | 28 High Street CF71 7AG | 01446 773954 |
| CWMBRAN | Cwmbran Shopping Centre, Cwmbran NP41 1AH | 01633 835000 |
| DENBIGH | 11 Vale Street LL16 3AD | 01745 814549 |
| EBBW VALE | 2a The Walk NP23 6AY | 01495 305569 |
| FISHGUARD | 29 West Street SA65 9AL | 01348 873473 |
| GORSEINON | 86 High Street SA4 4BL | 01792 896389 |
| HAVERFORDWEST | 5 Victoria Place SA61 2JX | 01437 762147 |
| HEREFORD | 2 St Peter's Square HR1 2PG | 01432 273039 |
| LAMPETER | 45 High Street SA48 7BB | 01570 422844 |
| LLANDEILO | 40 Rhosmaen Street SA19 6HD | 01558 822638 |
| LLANDRINDOD WELLS | Carlton House, Middleton Street LD1 5ET | 01597 823511 |
| LLANDUDNO | 85 Mostyn Street, Llandudno LL30 2PD | 01492 876326 |
| LLANELLI | Unit 13, St Elli Square SA15 1SH | 01554 746950 |
| LLANTWIT MAJOR | 1 The Precinct CF61 1XA | 01446 794238 |
| MAESTEG | 139 Commercial Street CF34 9DW | 01656 737111 |
| MERTHYR TYDFIL | Beacons Place CF47 8ED | 01685 385421 |
| MOLD | 39 High Street CH7 1BQ | 01352 756345 |
| MONMOUTH | 1 Monnow Street NP25 3EF | 01600 717038 |
| NEATH | 1-3 Green Street SA11 1DR | 01639 635316 |
| NEWPORT | 33 High Street NP20 1RU | 01633 258206 |
| PENARTH | 1 Stanwell Road CF64 2AB | 029 2070 2094 |
| PONTYPOOL | 3 Commercial Street NP4 6JJ | 01495 758577 |
| PONTYPRIDD | 93-94 Taff Street CF37 4SL | 01443 404027 |
| PORTHCAWL | 23 John Street CF36 3AP | 01656 788257 |
| PORT TALBOT | 7 Riverside Walk SA13 1NY | 01639 884055 |
| PRESTATYN | 99 High Street LL19 9AP | 01745 852531 |
| PWLLHELI | 55a High Street LL53 5RT | 01758 613331 |
| SHREWSBURY | 2 The Square SY1 1LA | 01743 353430 |
| SWANSEA (Kingsway) | 64-65 The Kingsway SA1 5HW | 01792 655791 |
| SWANSEA (Morriston) | 101 Woodfield Street, Morriston SA6 8AS | 01792 795589 |
| SWANSEA (Mumbles) | 53 Newton Road, Mumbles SA3 4BD | 01792 360223 |
| TONYPANDY | 30 Dunraven Street CF40 1AL | 01443 422893 |
| TREORCHY | 220 High Street CF42 6AS | 01443 772190 |
| WREXHAM | 20-22 Regent Street LL11 1SA | 01978 261788 |

# Agency office addresses

| | | |
|---|---|---|
| ABERTILLERY | 11 Market Street NP13 1AH | 01495 213958 |
| AMMANFORD | 6 High Street, Dyfed SA18 2LY | 01269 591884 |
| BALA | 87 High Street, Gwynedd LL23 7AG | 01678 520495 |
| BARGOED | 65 Hanbury Road CF81 8QX | 01443 831100 |
| CAERNARFON | 17 Y Maes LL55 2NE | 01286 674500 |
| CARDIGAN | 3 Heathfield, Pendre SA43 1JT | 01239 615050 |
| CHEPSTOW | 27 High Street, Monmouthshire NP16 5LJ | 01291 628215 |
| COLWYN BAY | 14 Penrhyn Road LL29 8LG | 01492 878299 |
| HOLYHEAD | 2 Market Buildings, Holyhead LL65 1HH | 01407 760500 |
| LLANGEFNI | 21 Church Street, Llangefni LL77 7DU | 01248 724040 |
| MACHYNLLETH | Maldwyn House, Penrallt Street SY20 8AG | 01654 703110 |
| NEWCASTLE EMLYN | College Street SA38 9AJ | 01239 710481 |
| OSWESTRY | 12a Leg Street, Oswestry SY11 2NL | 01691 680044 |
| PORTHMADOG | 103 High Street, Gwynedd LL49 9EY | 01766 512011 |
| ROSS-ON-WYE | 8 Broad Street HR9 7EA | 01989 763553 |
| TALBOT GREEN | 38 Talbot Road CF72 8AF | 01443 224000 |
| TREHARRIS | 12 Fox Street CF46 5HE | 01443 412097 |
| YSTRADGYNLAIS | 18 Station Road, Pant Glas SA9 1NT | 01639 842013 |

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